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*Foreign Direct Investment in Southeast Asia:
Experience and Future Policy Implications for
Developing Countries*

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Working Paper IWPS 001/05*

**The Evolving Nature of FDI Industrial Organisation
and
Challenges for Policy and Practice**

Frank L. Bartels**

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LIST OF ABBREVIATIONS

AFTA - ASEAN Free Trade Area
AIA - ASEAN Investment Area
APEC - Asia-Pacific Economic Cooperation
ASEAN – Association of Southeast Asian Nations
ASEAN-5 - Indonesia, Malaysia, Philippines, Singapore, Thailand
BITs - Bilateral Investment Agreements
CFMs - Capital and Financial Markets
DTTs - Double Taxation Treaties
EGM – Expert Group Meeting
FDI - Foreign Direct Investment
FPI - Foreign Portfolio Investment
FTAs - Free Trade Agreements
FTZs – Free Trade Zones
HQs – Headquarters
IP - investment promotion
IPAs - Investment Promotion Agencies
ISMEs - International Small and Medium-size Enterprises
LSAs - Location Specific Advantages
MNEs - Multinational Enterprises
MVA - Manufacturing Value-added
NIS - National Innovation System
RTAs - Regional Trade Agreements
SMEs - Small and Medium-size Enterprises
STI - Science Technology and Innovation
UN – United Nations
UNIDO - United Nations Industrial Development Organization
XBMA - Cross-border Mergers and Acquisitions

ABSTRACT

This working paper discusses the reinforcing role of investment in economic development and industrialisation. In this process, Foreign Direct Investment (FDI) is widely regarded as a key driver and enabler of industrial performance. The paper highlights the imbalances that exist within both FDI in-flow patterns and FDI stocks, at both global and regional levels. The paper also addresses major issues for developing countries in understanding the complex and continually evolving dynamics of FDI activity, and the need for clear, effective and cogent policies to attract and retain FDI. These key issues concern not only how developing countries articulate policies and strategies to compete effectively for FDI, especially from the integrated international operations of Multinational Enterprises (MNEs); but also ways in which developing countries can best harness motivations for FDI, and thereby maximise the positive effects from FDI and minimise any negative spillovers. In this context, developing countries can learn much from Southeast Asia's relative success in attracting FDI.

1. INTRODUCTION

The intentions of this working paper, to serve the UNIDO Expert Group Meeting (EGM) on *Foreign Direct Investment in Southeast Asia: Experience and Future Policy Implications for Developing Countries*, are twofold. Firstly, to provide a backdrop for deliberations on the evolving context and nature of inward Foreign Direct Investment (FDI), and their policy dimensions for host countries. Secondly, to provoke thought on the various aspects of investment promotion (IP) and facilitate a forward-looking view that goes beyond the increasingly redundant host country IP strategies of the past¹.

These intentions are based on the fundamental premise that FDI is crucial to industrial development and policy for attracting FDI should be closely aligned with a country's industrial policy. It is important to note from the outset that, given the complexity of FDI as actually practiced by Multinational Enterprises (MNEs) and their supply and marketing networks, the paper will not revisit in detail either the FDI data or the theoretics and empirics of FDI determinants and motivations. Suffice it to say that there is a rich body of literature dating from the late 1950s that is available to inform policy². Rather, this paper attempts to bring out salient features in the complexity of FDI for the benefit of policy craft in developing countries, bearing

¹ It is hoped that this forward-looking view will advance policy research and analysis on FDI. Also it is anticipated that the empirical conclusions put forward in the publication, *The Future of Foreign Investment in Southeast Asia*, Nick J. Freeman and Frank L. Bartels, Eds., London: RoutledgeCurzon, 2004 will be added to by the deliberations and lessons from FDI in actual practice.

² See *inter alia* Dunning J. H., 1958, *American Investment in British Manufacturing Industry*, London: George Allen and Unwin; Dunning J. H., 2000; *The Eclectic Paradigm as an Envelope for Economic and Business Theories of MNEs Activity*, *International Business Review*, Vol. 9, No. 1, pp. 163-190; UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries*, Vienna: UNIDO; and *The Future of Foreign Investment in Southeast Asia*, Nick J. Freeman and Frank L. Bartels, Eds., London: RoutledgeCurzon.

in mind that host policy for attracting inward FDI is manifest at different and interacting levels³. The emerging issues within the dynamics of international capital flows and the organisational behaviour of the principal actors in the world economy -- MNEs and the State [Stopford, Strange and Henley (1991)] -- are best illustrated by the international business of FDI. FDI is widely accepted as a key driver of economic growth in both developed and developing countries. Consequently, the industrial development plans of developing countries seek to articulate strategies for winning greater shares of global and regional FDI flows.

Notwithstanding the very real issues in FDI statistical concepts and definitions; methodological problems and challenges of measurement⁴, it is clear that global and regional flows and stocks have increased dramatically (see below). However, substantive empirical evidence from economic, managerial and organisational studies points to the positive correlation between FDI and; (i) trade capacity, (ii) productivity growth, (iii) industrial and export performance, as well as (iv) poverty reduction⁵. The significant role of FDI in socio-technological and economic development was recognised and confirmed by the UN Financing for Development Conference, Monterrey, Mexico, in 2002⁶. In spite of potential negative spillovers from FDI, policy choices are critical determinants in economic performance [Asiedu and Lien (2004); Comeau (2003); Zhang (2001)]. Maximising positive externalities while moderating negative spillovers is important. FDI, and its policy environment, are therefore of crucial concern for policy makers in developing and industrialised countries alike⁷.

³ These are the meta- or supra-national level of Multi-lateral Organisations and trade blocs, macro- or national level of government policies, meso- or regional and cluster level, micro- or level of industrial sectors, sub-sectors, and firm level of organisational strategy and competitiveness.

⁴ See Maitena Duce, Definitions of Foreign Direct Investment (FDI): A methodological note; material prepared by Banco de Espana for the BIS meeting of the CGFS Working Group on FDI, 2003, for methodological issues related to FDI from the perspective of balance of payments, and the international investment position, and data comparison. Note also that, while measurement is aggregated, FDI is ultimately an international business decision taken and executed at the level of the firm. This macro- micro- dichotomy presents challenges to policy.

⁵ See UNIDO, 2002, Industrial Development Report 2002/2003, Vienna: UNIDO. Wolfgang Keller and Stephen R. Yeaple, 2003, Multinational Enterprises, International Trade, and Productivity Growth: Firm-level Evidence from the United States, NBER Working Paper No. W9504, February 2003. World Bank, 1993, The East Asian Miracle: Economic Growth and Public Policy, Oxford, Oxford University Press. Luiz R. De Mello, 1997, Foreign Direct Investment in Developing Countries and Growth: A Selective Survey, The Journal of Development Studies, Vol. 34, No. 1, pp. 1-34, October.

⁶ United Nations, A/55/1000, 26 June 2001, General Assembly 55th Session Agenda item 101, High-level international intergovernmental consideration of financing for development – Technical report of the High-level Panel on Financing for Development (known as the Zedillo Report), pp. 45-48.

⁷ See Asian Development Outlook 2004, part 3, Foreign Direct Investment in Developing Asia, for the importance of FDI; and how in some instances the policy framework has been unable to keep pace with the changing complexity of FDI.

In recent years, we have seen increasing competition for diminishing levels of global FDI⁸. Simultaneously, there is increasingly dynamic cross-border configuration, reconfiguration and articulation of the manufacturing assets and servicing operations of international investors. The increasing complexity of FDI is demonstrated by the integrated international sourcing, technology, production, marketing and servicing networks of MNEs as inter-connected systems which are geo-economically and spatially distributed. Further, the distribution and performance of these networks is operationally and contemporaneously managed through strategic relations (co-operation with, co-ordination, command and control) between subsidiaries and suppliers using information and communications technology. The systemic nature of MNEs networks leads to the emergence of asymmetric properties of, and synergistic relations between, the constituent elements (HQs, Regional HQs, Subsidiaries and out-source partner firms, etc.).

In concert, the various network nodes responsible for manufacturing value-added (MVA) transformations; and the inter-relationships accountable for economic transactions, comprise what has been referred to as 'the global factory' [Buckley (2003)]. This is illustrated stylistically in Figure 1 below.

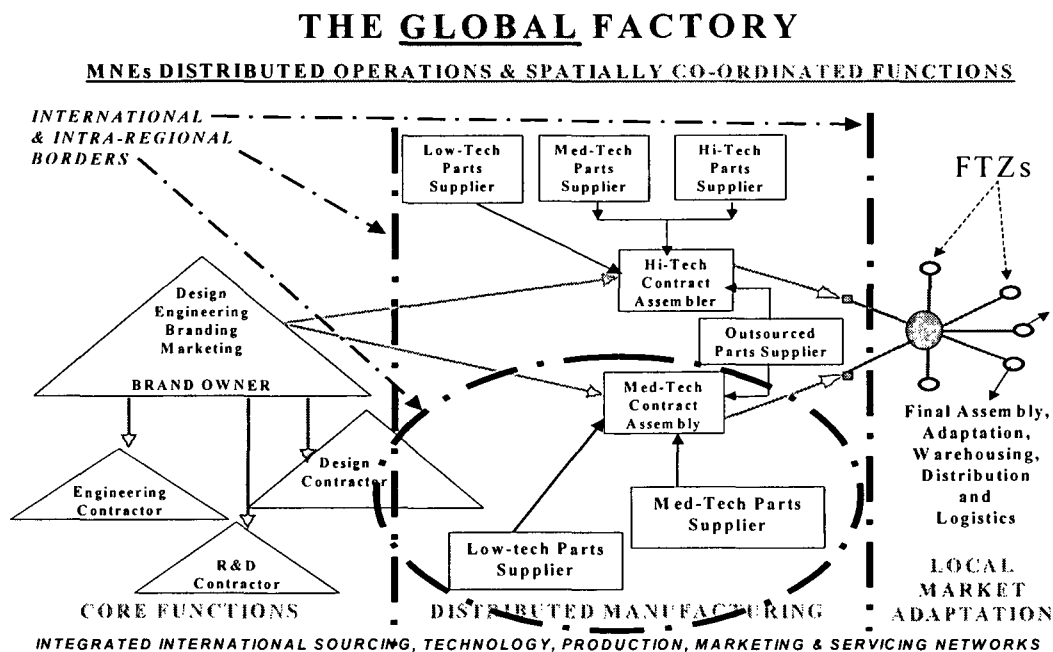


Figure 1 - The Global Factory

'The global factory' is co-evolving with the policy environment. It is characterised by inter-changeability and is in dynamic tension with its internal constituents as well as with external

⁸ Global levels of inward FDI have fallen since the peak of US\$1,400 billion in 2000, through US\$800 billion (2001) and US\$700 billion (2002) to US\$560 billion (2003); and preliminary estimates suggest a modest increase to US\$612 in 2004 according to UNCTAD [UNCTAD/PRESS/PR/2005/002, 11 January 2005].

forces of competition and co-operation. Thus the shape, boundaries and extent of 'the global factory' and the industrial landscape it inhabits (and forms) are continuously changing resulting in a complex system that approaches 'self-organisation'⁹ [Dagnino (2004); Fioretti and Visser (2004); Price (2004); Urry (2003); Walby (2003); Krugman (1996);].

The complexity of FDI and 'the global factory' is therefore increasingly difficult to view through isolated economic and management disciplines. It is even more testing to capture in terms of data and information as well as FDI policy research and analysis; IP policy design and implementation. This is especially so for developing countries and is due partly to the rapidly changing characteristics of industry competition and factor markets; and partly to the inadequate levels of capacity building in some developing countries. Competition is evolving into more internationally collaborative forms¹⁰. And while capital and financial markets are global, the markets for goods and services are overwhelmingly regional. In contrast, most labour markets are national. Developing countries in general, and particularly those marginalised from FDI flows, often lack high-resolution instruments to calibrate and recalibrate their policies fast enough to keep pace with the rapidly changing context and dynamics of FDI, international production and markets.

UNIDO's analysis of FDI shows South and East Asia capturing most of the FDI flows to developing countries. On average South and East Asia attracted 7.0% of annual global FDI flows in the 1980s and 14.7% in the 1990s. In comparison, Latin America, the other best performance region, attracted 7.9% and 9.4% respectively. In stark contrast, Sub-Saharan Africa captured only 1.2% and 0.8% during the same respective periods¹¹. In terms of transferable policy lessons from the success of Southeast Asia in attracting FDI, since the first development decade of the 1960s, this paper acknowledges that initial geo-strategic conditions were crucially important [Arrighi (2002); Arrighi, Hamashita and Selden (1997)].

As FDI and MNEs responses have co-evolved with increasing complexity in organisational form and processes, this paper puts forward a few notions for consideration. First, host country policy makers need to take a systems view of FDI and MNEs and understand the structural dynamics therein in relation to industrial development objectives and strategies. Secondly, as MNEs activities and systems co-evolve with the host environment, there is a pressing need for the host policy environment to reflect 'the global factory' of MNEs. Thirdly, the competition for FDI calls for host country attention to increase the efficiency of doing

⁹ Phenomena which appear to determine their own form and processes.

¹⁰ Dunning, J. H., 1997, *Alliance Capitalism and Global Business*, London and New York: Brunner-Routledge.

¹¹ See UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment flows to Developing Countries*, Vienna: UNIDO, Table 1 and 2, pp. 3-4 for regional comparisons.

business domestically (improving intermediation and lowering transaction costs). Fourthly, developing countries need to accelerate from *first*, *second* and *third* generation IP¹² to a new, *fourth generation* IP. A *fourth generation* IP should be seen as an adaptive response to the increasing complexity of MNEs, and is characterised by diminishing distinction between domestic and foreign investment activity in policy terms. Herein the thorny issue of ‘incentives’ should be addressed by focusing on information and communications technology infrastructure, human resource development and social capital formation; and positioning strategic domestic sectors and sub-sectors within the interstices of ‘the global factory’ and networks of MNEs.

The remainder of the paper is organised as follows. Section 2 – Background Issues, briefly presents the stylised facts of the political economy of FDI and the operations of MNEs. It then addresses the key trends as a complex systemic co-evolution of the integrating factors of the world economy and globalisation, and raises implications for FDI policy makers. The spatiality of ‘the global factory’ and its structural coupling with the policy environment, and the response of MNEs to greater competition and uncertainty, are examined for policy implications.

Section 3 - Thematic Challenges for FDI Policy Craft, addresses the five themes of the EGM by drawing out potentially transferable policy lessons and identifying problems posed by the changing nature of FDI industrial organisation. The implications of the ‘new economy’, and intra-regional FDI within trading arrangements are highlighted. The boundaries of ‘the global factory’ and its spatial distribution as well as implications for policy are addressed. Importantly, the China dimension to FDI competition and complementarity is examined with a view to identifying potential policy responses for Southeast Asia and other developing countries beyond the region. This section also addresses the intermediating role of capital and financial markets in FDI that is crucial to enabling deal flow especially in FDI activity that is dominated by cross-border mergers and acquisitions (XBMs).

Section 4 - Concluding Remarks, looks ahead at the broadening agenda for FDI policy makers with respect to, for example, social capital formation, the role of the national innovation system (NIS), and the spatial sequencing and temporal switching of policy measures in IP. Related areas of concern are: trade policy; competition policy; labour policy; regional development policy; and science technology and innovation (STI) policy. This section points to those location factors and enterprise variables that are likely, in the future, to increase their significance for FDI.

¹² See UNCTAD, 2002, World Investment Report: Transnational Corporations and Export Competitiveness, Geneva: UNCTAD, pp. 234-242 for comparative descriptions.

2. BACKGROUND ISSUES

An accurate perspective on trends in the world economy indicates that the co-evolution of FDI, MNEs and host country policy is unfolding in an environment characterised by the fission in politics and fusion of markets¹³. At the same time, advances (and convergences) in technology ‘drivers’ have enabled greater differentiation in the various stages of industrial production. Also, the governance of the world trading system has increasingly become ‘hard’ law and rules-based thus not only reducing trade barriers but also narrowing the range of discretion available to policy makers. And, while economic maps of the world show the dominance of ‘Triad’ economies¹⁴, apart from high performance Asian economies and newly industrialising countries of ASEAN¹⁵, there are new influential players emerging onto the global economic stage – notably the vanguard of “Group-21”; Brazil, China, India and South Africa. Together, these background developments affect the relative ease with which policy to attract and contain inward FDI can be crafted, implemented and promoted by developing countries.

As noted above, UNIDO’s analysis of FDI indicates consistently that South and East Asia have successfully and consistently captured the lion’s share of FDI flows to the developing countries. Furthermore, as the total levels of official development assistance have decreased from the 1992 peak of US\$ 67.5 billion through a low point of US\$ 51 billion (1997) to US\$ 65 billion in 2002, the value of FDI to industrial development and the formation of industrial assets, which developing countries can link to the global production networks of MNEs, has grown in importance.

The integrating factors of the world economy, and the central role of FDI, are revealed by four inter-connected facts. First, the rate of growth in world trade has outstripped world output growth since the 1960s. Secondly, the rate of growth in FDI from 1980-2000 outstripped that of world trade growth. Thirdly, an estimated three-quarter of world trade is held *internally* within the international operations of MNEs¹⁶. Fourthly, the growth of vertically integrated

¹³ There were 62 states in 1914, 74 in 1946, 149 in 1978 and 193 in 1999 according to the Economist, A Survey of Geopolitics, 31 July 1999. In many countries, decentralisation, or subsidiarity (in EU terms), is extensive. Contemporaneously there is the remarkable growth of trading blocs ranging from customs unions, free trade areas to full-blown economic and monetary union (EU), and by 2000, there were increasing numbers of Bilateral Investment Treaties (BITs) (Approx. 963) Double Taxation Treaties (DTTs) (approx. 1413), Bilateral Trade Agreements (BTAs) (approx. 250), including Regional Trade Agreements (RTAs) (approx. 181), according to Jagdish Bhagwati and Arvind Danagariya, “Bilateral trade treaties are a sham”, Financial Times, 13 July 2003.

¹⁴ North America, European Union, Japan spheres of economic influence that dominate the world economy and technology (see Digital Access Index; and the New Map of the World, The Economists, 22 June 2004).

¹⁵ Hong Kong SAR, Singapore, South Korea, Taiwan Province of China, Indonesia, Malaysia, Philippines, Thailand.

¹⁶ Approximately 61,000 MNEs with over 900,000 subsidiaries spatially distributed within geo-economic space operationally constitute 65% to 75% of international business and world trade according to UNCTAD, 2004, World Investment Report 2004: The Shift Towards Services, Geneva: UNCTAD; and UNCTAD, 1995, World

intra-industry trade, which accounts for about 30% of world trade, at about 40% since 1975, has outpaced that of FDI growth¹⁷. The consequences of this structural change in the pattern of global economic activity are that FDI -- and the associated vertically integrated intra-industry exports-imports of intermediate goods -- are precursors to productivity gains for domestic firms. This assists in overcoming supply capability constraints, expanding trade capacity and linking developing countries to the Triad economies of North America, Europe and Japan. MNEs, FDI and export-import trade in intermediate products and services have therefore become the preponderant integrating factors in the world economy. Also trade in intermediate products and services resulting from FDI has become significant in improving the efficiency of resource allocation, specialisation, value-chain disaggregation and productivity.

Access by developing countries to this '*internalised*' market of MNEs is not possible without creating, through appropriate FDI policy craft and trade instruments, conditions that will either induce MNEs to seek out domestic firms in supply collaboration or enable domestic firms to pro-actively insert themselves into the global production networks and value chains of MNEs. Moreover, this access is increasingly framed by the over 250 preferential trading arrangements that cover, *inter alia*, services, investment, competition policy and government procurement¹⁸. Under these circumstances FDI policy is of crucial importance to the economic health and industrialisation efforts of developing countries.

The relatively successful East Asian development experience, and the central part played by MNEs, FDI in-flows and their linkages to domestic investment, holds significant lessons for other developing regions. This is especially so with regard to path dependency, and the role of the State in integrating the local economy with regional and global economies. The Asian experience assists us in advancing the 'state-of-the-art' policies for other developing countries [Dobson and Chia (1997)].

Empirical evidence indicates that increasing FDI stock to GDP ratio correlates positively with a decreasing share of the population living below US\$ 1per day¹⁹; and increases in FDI are correlated with industrial development as manifest in the performance of South and East Asian

Investment Report 1995: Transnational Corporations and Competitiveness, Geneva: UNCTAD. This geospatiality is operationalised in part as cross-border collaborative inter-firm relations (mergers and acquisitions, joint ventures, strategic alliances, etc.)

¹⁷ Dicken P., 2003, *Global Shift: Reshaping The Global Economic Map in the 21st Century*, London: Sage, p. 53; David Hummels, Jun Ishi and Kei-Mu Yi, 1999, *The Nature and Growth of Vertical Specialization in World Trade*, FRBNY, Mimeo; and UNIDO, 2003, *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries*, Vienna: UNIDO for the growth of vertical specialisation as share of exports at between 26% and 82% from Australia, Canada, France, UK and USA from 1970 to 1990.

¹⁸ Karolina Ekholm, Rikard Forslid and James R. Markusen, 2003, *Export-platform Foreign Direct Investment*, NBER Working Paper, No. W9517, February.

¹⁹ OECD, 2002, *Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs*, Paris: OECD.

economies. In contrast, Sub-Saharan Africa's policy capacity to capture the benefits of FDI has not performed as well²⁰. FDI in-flows therefore are linked directly to poverty reduction and the Millennium Development Goals. However, FDI in-flows can contribute to poverty reduction in a particular country only when the enabling environment and actual FDI flows are enveloped by a policy coherence that is well-attuned to prevailing economic conditions and well-articulated, by that particular host country's policy-makers, to local, regional and global investment dynamics [Bartels and Pass (2000)].

As a consequence of successive GATT rounds resulting in the WTO, as well as policy liberalisation encouraged in part by the international financial institutions, the integrating factors of the world economy have increased their influence in policy making in line with decreasing barriers to factor mobility. However, FDI flows, and accumulations of FDI stock, are asymmetrically distributed between the industrialised and developing countries in overwhelming favour of the former. Also, FDI is highly skewed across the community of developing countries benefiting a few hosts at the expense of the majority²¹.

These twin asymmetries in FDI flows (and stocks) and questions over the magnitude of FDI effects, vector and path dependency, as well as the changing nature of linkages within the 'new' knowledge-based economy, present challenges for industrial policies in developing countries at all levels. First, is in terms of the predominance of the Triad of North America, Europe and Japan as hosts to, and sources of, FDI; and the persistent production relations they have with relatively few emerging regional zones of growth including Southeast Asia, China and India. Second, is in terms of the local embedding of FDI decisions in individual cities and localities that display an attractive dynamism with specially incentivised areas and facilities, for example Singapore-Johor Baharu-Bintan and Bangalore on the one hand, and the cluster of cities of costal China on the other hand. Regional asymmetries in the growth patterns of FDI therefore can be explained econometrically by differences not only in factor costs, market access, availability and quality of production inputs between countries and regions but also, and perhaps more importantly, because governments and their policies differ in credibility [Janeba (2001)]. The implications of these asymmetries need to be disclosed more vividly for the benefit of policy-makers in developing countries.

²⁰ UNIDO, 2004, *Industrial Development Report 2004: Industrialization, Environment and the Millennium Development Goals in Sub-Saharan Africa*, Vienna: UNIDO.

²¹ Latest data for 2003 shows developing region shares of the US\$172 billion total as 62.3 % to Asia Pacific, 28.9% to Latin America Caribbean, 12.2% to Central Eastern Europe and 8.7% to Sub-Saharan Africa [UNCTAD WIR 2004, Overview, Table 2, p. 3]; and estimates for 2004 show shares of US\$255 billion total as 65.1 % to Asia Pacific, 27.1% to Latin America Caribbean, 14.1% to Central Eastern Europe and 7.8% to Sub-Saharan Africa [UNCTAD Press Release UNCTAD/PRESS/PR/2005/002].

The agglomeration of markets and diminishing constraints to factor mobility is associated with increasing environmental risk, uncertainty and volatility that has evoked a highly specialised response from MNEs. This response is encapsulated by ‘the global factory’ illustrated above. The tentacles of this system, HQs, regional HQs, subsidiaries, supply-chain network nodes, and relations, are cohered and orchestrated in a dynamic of value-chain integration, disintegration and reintegration that is distributed across economic space, countries and border regions [Giroud (2003a); McKinsey & Co. (2003)]. ‘The global factory’ permits MNEs to spatially distribute FDI and associated stages of production according to host location specific advantages (LSAs) related to cost efficiencies, market segmentations, input factors and/or strategic assets, thereby maximising the long-run value added to the firm.

The analytical basis of the FDI business decision itself has also evolved dramatically moving from the macro- to the micro- and firm- level, on the one hand. And, on the other hand, from gravity models of trade [Anderson and van Wincoop (2001a, 2001b)] and transaction cost economics [Williamson (1975)], location economics [Dunning (2000, 1988)] to the organisational morphology of MNEs [Buckley and Casson (2002)] and, more recently, to the real options approach [Roemer (2004); Chen and Funke (2003); Xiuyun (2003); Nordal (2000); Trigeorgis (1996)]. The later developments in the analysis of MNEs FDI decision-making are crucial for host country policy makers. They provide a powerful means by which the ways MNEs organise their operations and view risk, capabilities and flexibility in an increasingly uncertain and complex environment, can be incorporated into policy craft. There are a number of policy implications for developing countries at different stages of development. These may be seen in terms of (a) developing countries that have yet to match their *FDI performance* to their *FDI potential*, as well as those with above average *FDI potential* but below average *FDI performance*²², (b) developing countries that have yet to match their *Industrial Capacity* to their *Industrial Complexity* and those with above average *Industrial Complexity* but below average *Industrial Capacity*, as well as (c) those with above average *Industrial Capacity* but below average *Industrial Complexity* in the UNIDO Competitive Industrial Performance Index²³.

First, the foreign investor is increasingly less of a ‘stand-alone’ operator and more of sophisticated agent in a complex co-ordinated chain, or network, of transactions and/or value-adding transformations. The foreign investor therefore is unlikely to consider the FDI decision in isolation. The location factor in FDI is likely to be increasingly influenced by the availability of domestic firms able to competitively intermediate within the investor’s networks to lower

²² See UNIDO, 2002, *Industrial Development Report 2002/2003*, Vienna: UNIDO; and UNCTAD, 2002, *World Investment Report: Transnational Corporations and Export Competitiveness*, Geneva: UNCTAD.

²³ See UNIDO, 2002, *Industrial Development Report 2002/2003*, Vienna: UNIDO, Table A3.1, pp. 177-178.

costs, boost quality and accelerate the distribution of goods to domestic and regional export markets²⁴. In this vein, the capabilities of the domestic communications, logistics and distribution sector and its infrastructure capacities and orientation are of crucial importance. FDI policy would need to be well-attuned to this area. The key challenge for FDI policy makers is how, through anticipatory policy postures and adaptive incentive instruments, to insert their economies (and thereby their industrial sectors and firms) more robustly into the interstices of the global value-chains and co-ordinated networks of MNEs when the FDI decision is increasingly location specific relative to other locations? [Yeaple (2003)]

Secondly, the previous separated patterns of FDI by firms (in sequential time and place and, hitherto, more predictable modes of entry²⁵) have been superseded by parallel modes of entry in multifaceted international patterns of ‘alliance capitalism’²⁶. This is illustrated stylistically in Figure 2 below.

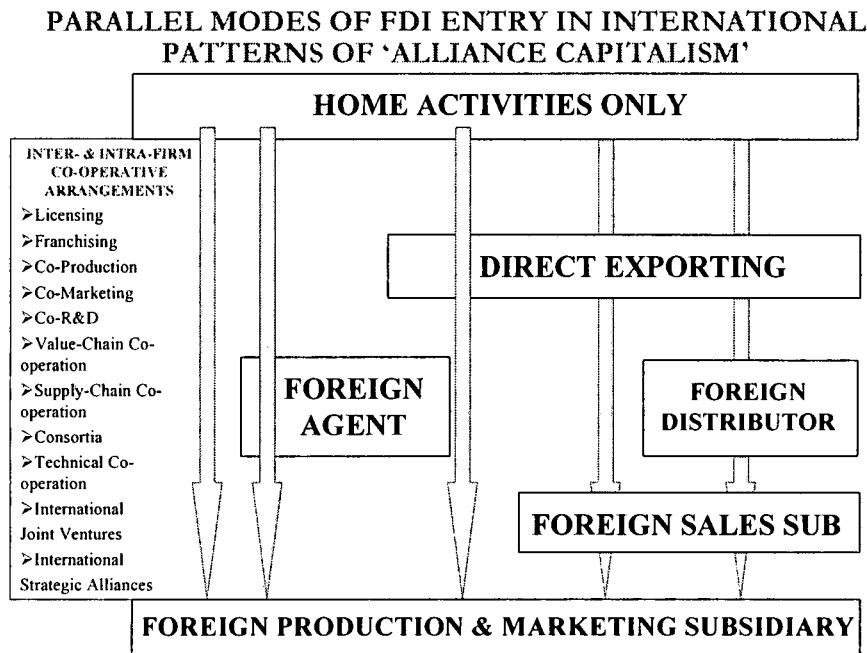


Figure 2 – Parallel Modes of FDI Entry in International Patterns of ‘Alliance Capitalism’

²⁴ Factor analysis of data from Africa Foreign Investor Survey 2003: Implications for Investment Promotion, Vienna: UNIDO

²⁵ See Jan Johanson and Jan-Erik Vahlne, 1977, The internationalization process of the firm – a model of knowledge development and increasing foreign market commitments, *Journal of International Business Studies*, Vol. 8, No. 1, pp. 23-32; and Bruce Kogut, Foreign Direct Investment as a sequential process, in C. P. Kindleberger and D. Audretsch, Eds., *Multinational Corporations in the 1980s*, Cambridge, Mass.: MIT Press (1983).

²⁶ Including Joint Ventures, Strategic Alliances, Co-production and Marketing, Co-R&D, Contract Design and Manufacturing with Equity and Non-equity formalities.

These patterns are characterised by FDI involving simultaneous collaboration with competitors and rivalry (in different economic spaces and industrial sectors) with strategic partners, as well as participation in dense networks of technology suppliers [Hill (2002, 2001)]. In this context, policy makers need to move beyond the idea of capturing FDI with the lure of cheap labour and tax incentives²⁷. The intricacies of these international networked systems of industrial sourcing, technology, production, marketing and servicing place a severe challenge on economic, industrial and development policy-making in developing countries. The essence of the challenge is the selection of appropriate economic and industrial policies on the one hand, and, on the other hand, how to sequence and switch policy instruments in a manner that captures the desired (but 'shape-changing') components of MNEs' networks.

The performance of Southeast Asian economies, since the 1960s and particularly over the last two decades, elucidated in part by, *inter alia*, the 1993 World Bank study -- *The East Asia Miracle: Economic Growth and Public Policy* -- highlights the essential role of government in overcoming market failures and assisting economic development. That performance also demonstrates what is possible for other developing countries. For developing countries, not sufficiently well-versed in the lessons from Southeast Asia, the practical issue is how to emulate, and compress into a shorter time, that kind of performance while coping simultaneously with the triple confrontation of: (i) a 'rules-based' world trading system; (ii) technological 'componentisation' (the slicing up of the stages of production and its spatial distribution); and (iii) the emergence of China 'as the workshop of the world'²⁸.

Thirdly, in keeping with the view that the world economy is regionalised more than globalised [Hirst and Thompson (1999)], the regional dimension to 'the global factory' of MNEs becomes an important issue for FDI policy craft. Through mechanisms that contemporaneously reduce cross-border transaction costs, enlarge market access and market size by increased economies of scale, regional integration is positively correlated with the location of FDI [Yeyati, Stein and Daude (2003); Blomstrom and Kokko (1997)]. The key question, therefore, revolves around how an individual host country participates effectively in regional arrangements with FDI policy instruments that ensure optimal inward FDI flows in the face of other member countries' competitive and/or complementary policy postures.

²⁷ See Diana Farrell, Antonio Puro and Jaana K. Remes, 2005, *Beyond Cheap Labor: Lessons for Developing Countries*, *The McKinsey Quarterly*, No. 1.

²⁸ See Dan Roberts and James Kyngé, "How cheap labour, foreign investment and rapid industrialisation are creating a new workshop of the world", *Financial Times*, 4 February 2003, p. 13.

Fourthly, in terms of a framework for IP, there is a pressing need for developing countries to improve the sophistication of IP strategy and organisation [UNIDO (2003a)] and move towards a *fourth generation* of investment promotion policies, measures and techniques.

3. THEMATIC CHALLENGES FOR FDI POLICY CRAFT

Serious challenges and questions are posed by the five themes of the EGM. It is instructive to note that MNEs production networks and regional dimensions of FDI are major issues for the macro-economy and are very much to the fore²⁹. The themes that encapsulate the major areas of concern for policies to attract and retain FDI can be categorised as follows:

- FDI and MNEs in Southeast Asia: Globalisation's Challenges.
- Intra-regional FDI and Regional Trade and Investment.
- Boundaries, Hierarchies, Markets and FDI.
- The China Dimension to FDI in Southeast Asia
- Capital Markets and FDI in Southeast Asia

These themes reflect the weight and importance of FDI to industrial development. They present host country policy makers with an unenviable task of 'aiming at' the fast moving target (with rapidly changing shape) of MNEs.

Without anticipating the content of thematic presentations and plenary discussions on the emergent issues identified, this paper -- acting as a lens -- should enable a sharper focus on key aspects of the co-evolving structure, behaviour and environment of MNEs and FDI in order to tease out key questions for host country policy makers.

3.1. FDI and MNEs in Southeast Asia: Globalisation's Challenges

The long view of the political-economy of cross-border transactions in FDI within the 'new economy' and its impact has resulted in crucial changes in strategic thinking within MNEs and MNEs decision-making. This carries serious consequences for FDI policy craft in developing countries [Buckley and Ghauri (2004); Buckley (2003); Caplen (2001)].

MNEs with predictably structured divisions locked into rigid linkages with other parts of the *same* firm have evolved into a new international structure in an environment that is very different from earlier times. This is very challenging from a policy perspective. With competitive pressures increasing relentlessly, the questions asked by MNEs are first, where to locate productive assets and manufacturing activity in a manner that efficiently differentiates

²⁹ See Tokyo Club Foundation for Global Studies, Major Issues for The World Economy to 2005, Macro Economy Research Conference, 8-9 November 2004, Tokyo, Japan for the range of issues which concentrated on regionalisation and MNEs strategies.

between locations and maximises the difference between manufacturing value-added (and, ultimately, sales) and locational cost structures? Secondly, how should the assets and activity be co-ordinated and controlled as a system? And thirdly, should the spatially differentiated manufacturing plants producing similar products use similar technology and production processes. In other words, how should capital/labour intensities be distributed across the system?

The location decision concerns the relative merits of the cost and market-related advantages between different locations. The control decision concerns whether or not to own, or to have *an option* on ownership [Trigeorgis (1996)] through collaboration (for example outsourcing, sub-contract, joint venture, strategic alliance with different firms). The similar manufacturing process decision concerns horizontal integration and the effective technology transfer between subsidiaries so as to enable rapid response to competitors and market changes. In the new economic environment, MNEs desire for flexibility militates against the rigid backward and forward vertical integration into input factors or into distribution of the earlier era of MNEs organisation. The more advantageous alternative is to sub-contract production and franchise sales (thereby distributing the associated risk profiles). The new economic perspective for MNEs, in managing the international operations of their FDI, concentrates managerial attention on: (i) the characteristics of volatility and uncertainty in markets; (ii) the value of options and flexibility in entry modes for FDI; (iii) alliances, collaborative and network forms of co-operation and competition; (iv) entrepreneurship within networks; (v) managerial competence; and (vi) a corporate and organisational culture that is progressively more adaptable to the demands of change. This set of valuable attributes translates into flexibility of operations. This is the ability to orchestrate the allocation, and re-allocation, of resources efficiently, smoothly and rapidly in anticipation of, and response to, change. The greater the amplitude and frequency of change in the business environment, the greater this need for organisational and operational flexibility.

The analysis indicated above highlights the issue of accelerated dynamic market entry and exit as the strategic preference for MNEs. In a volatile environment, FDI can be seen as a high-risk strategy - particularly in the absence of location specific compensating factors such as a transparent and coherent business climate with the provision of both the 'hard' and 'soft' infrastructure to do business. Reflecting the flexibility inherent in spatially distributed production networks, the 'hub' and 'spoke' strategies employed by MNEs enable responsiveness to market decline by divesting distribution assets to local partners (exercising one of the options

in joint venturing), while retaining production capacities with high appropriabilities³⁰ the output of which can be diverted to other markets. The implications for developing countries are that their Investment Promotion Agencies (IPAs) need to fully understand the dynamics of these decisions by MNEs and incorporate them fully into their development policy and FDI promotion strategy.

The concerted outcome of these decisions by MNEs is manifest as disintermediation and re-intermediation of spatially distributed production networks, the internalisation of external markets by MNEs, and knowledge combination [Buckley and Carter (2004)]. With managerial competence being ever-increasingly emphasised, subsidiary managers have incentives to secure greater freedom to deal with economic agents external to their own firm. The overall result of this powerful dynamic is a very complex strategic set that confronts decision-makers, managers and policy-makers in developing countries who aspire to capture parts of the MNEs' system of production and marketing. It is evident that, in the course of the four 'development decades', policy-makers in Southeast Asia have probably been the best at understanding how exploitation of these co-evolving dynamics can be built into economic development strategies.

A related set of issues concern the differences that the advent of electronic commerce (Business-to-Business formalities); the increasing significance of firms that are 'regional or global from inception' to the FDI policy regime of host economies; and how to structure FDI incentives in an 'asset light' economy³¹.

3.2 Intra-regional FDI and Regional Trade and Investment

The regional dimension is crucial and correlates positively to FDI – given domestic liberalisation and macro-economic stabilisation efficiencies [Urata and Kiyota (2003)]. However, the regional dimension of FDI activity and FDI policy are arguably under some stresses and strains. This is so as the institutional mechanisms of the ASEAN Free Trade Area (AFTA), ASEAN Investment Area (AIA), and other 'concentricities' attempt to cohere the reality of the ASEAN + 3 initiative within a single market framework³². In this regard, the concept of a 'Fortress Europe' transposed to the ASEAN context is useful. The argument being that *outsiders* (in this case exporters to AFTA) would benefit from investing within the AIA, in order to

³⁰ Due to monopolistic-oligopolistic advantages that are derived, *inter alia*, from technological functions.

³¹ Evidence suggests that the 'new' knowledge-based economy is disrupting the 'flying geese' paradigm of Asian development (and hence also the FDI policies that sustained the paradigm). See S. Masuyama and D. Vandenbrink, Eds., *Towards a Knowledge-based Economy: East Asia's Changing Industrial Geography*, Singapore: ISEAS for an analysis of the institutional and physical dimensions of connecting knowledge and production networks in the region and implications for policy.

³² At the ASEAN summit, October 2003 in Bali, ASEAN declared the establishment of an ASEAN community notwithstanding the process, since 1997, to form closer economic cooperation with China, South Korea and Japan; and the complex multilateralism of APEC.

become *insiders* and thus avoid being discriminated against [Almor and Hirsch, 1995]). Similarly, and despite ASEAN's open regionalism [Ariff (1994)], AFTA may be discriminatory towards *outsiders*. Earlier evidence pointed to the greater *de facto* integration of ASEAN with the rest of the world than within the region itself [Amelung (1992)]. This has improved, at least with respect to intra-regional FDI [Bartels (2004)]. However, intra-regional trade as a percentage of total trade decreased by 19% between 1994 and 2001 [Schwarz and Villinger (2004)]. Recent analysis points to these stresses and strains arising from factors such as the costs of fragmentation within AFTA, tariffs and technical barriers, costs of doing business and standards. A view of the fragmented nature of doing business in ASEAN is illustrated in Appendix I - Doing Business in ASEAN Indicators 2005; and Appendix II – ASEAN Investment Climate Indicators.

The challenge of AFTA and ASEAN + 3 from a FDI policy perspective is how to disentangle the potential regulatory inconsistencies within Asia-Pacific Economic Cooperation (APEC) and between most favoured nations; and avoid the 'spaghetti bowl' problem of rules of origin and harmonisation of investment and trade provisions across the free trade areas [Soesastro (2003)]. The AFTA will be successful in attracting FDI if it proves to be a catalyst for increased market size and greater market growth with lower costs of doing business [Scally (2000)]. Member countries would need to make a greater effort in co-ordinating their approaches towards economic, financial and political management, to ensure that factors identified above do not undermine AFTA aims.

The areas of increasingly significant policy concern for creating competitive location advantages at the regional level necessary for the (mobile) assets of MNEs networks, are: (i) regional markets; (ii) quality of cross-border communications ('hard' and 'soft' infrastructure); (iii) regional innovation systems; (iv) presence of agglomerative economies (cross-border clusters); and (v) regional institutions able to restrain 'free rider' or 'defection' strategies of national governments. Related issues concern the challenges of cohering regional and national IP policies and strategies, at the different levels of subsidiarity, and the avoidance of 'incentive wars' given the increasing gravitational pull of China for FDI.

3.3 Boundaries, Hierarchies, Markets and FDI

The challenges for FDI and IP policy craft in this theme lie deep within the complexity of the organisational form and networked operations of MNEs. The shape and operations of MNEs are increasingly based on collaborative relationships with supplier- and value-chains and less on wholly owned assets. This is especially prevalent in services which are currently

experiencing the kind of global relocation that manufacturing experienced during the 1980s and 1990s³³.

The manufacturing and servicing operations of MNEs have been fully incorporated into 'the global factory'. This internalisation allows the international firm to transact market exchange functions, *within* its organisational boundaries³⁴, throughout the spatially distributed network of affiliates and subsidiaries [UNIDO (2003b); Dicken (2003a, 2003b); Buckley and Casson (2002)]. The real option of joint ventures and strategic alliances between international firms, and domestic companies, ranging from simple co-operation in R&D for example to full mergers and acquisitions, enable organisations to answer operationally the 'make or buy?' question much more efficiently. The developing countries face the evident increasing pace of liberalisation in FDI, trade, and capital and financial markets as well as the agglomeration of markets. The underlying common factor to these concerns is that in operationalising FDI, the boundaries of the firm are no longer well-defined and are often far more 'virtual' than real. The notion of arm's length markets is less solid as firms merge with markets and markets merge with firms.

A comprehensive view of the implications of variables related to ownership, location, alliance relations, the internalisation of markets and the spatially distributed yet integrated networks linking global and regional production plants, is crucial to policy for attracting FDI [Fukao, Ishido and Ito (2003); Ito and Fukao (2003)].

Within the frame of reference provided by location specific advantages, ownership, internalisation and alliances, motivations that induce large MNEs and international small and medium-size enterprises (ISMEs) to invest overseas and spatially distribute their manufacturing and marketing comprise groups of variables impinge on FDI policy. These are:

- (i) Those that relate to efficiency-seeking motives for FDI. Chief among these are: the productivity-adjusted cost of labour and relatively high quality to low input factor cost ratios. These variables are commonly a function of industry-wide technological adaptability.
- (ii) Those that relate to market-seeking motives for FDI. The major market variables are; size, the demographic profile of various market segments, tariff jumping and the vectors of domestic market growth. The latter is a function of

³³ See "The new global job shift" Business Week, 3 February 2003, pp. 36-48.

³⁴ To this extent the MNE is a phenomenon that internalises external markets to avoid opportunism and transaction costs.

supply factor and demand conditions, and the nature of related and supporting industries³⁵.

- (iii) Those that relate to vertical integration with respect to access to raw materials.
- (iv) Those that relate to the “pull” of economic agents in the host country such as government or large clients and customers. These often take the form of requests and invitations to ‘come and set up shop’ in the country.
- (v) Those that relate to the “push” factors in the source country of FDI such as under-employed resources and pressures for risk diversification. These can take the form of various inducements from source governments, which are configured by strategic trade policy considerations³⁶.
- (vi) Those that relate to the business and investment climate such as the stability of political economy and commercial ability to do business without ‘a hassle’. These are largely a function of governance and transparency for investment (See Appendix I and II for ASEAN comparisons).

These motivations of MNEs for FDI are increasingly articulated in terms of reducing risk by cross-border collaboration with either domestic firms, their own subsidiaries, or those of other MNEs, in which the control of manufacturing assets is replaced by the control of options within multi-faceted economic relationships of supply [Giroud (2003b)]. The ‘componentisation’ of production -- that is, the slicing up of industry stages of production and firm value chains, and their subsequent global distribution³⁷ within the organisational boundaries of MNEs -- requires considerable analytical capacity and institutional understanding. Host governments require appropriate policy instruments and incentive measures to permit their selected strategic domestic sectors to intermediate industriously in international production networks.

As mentioned earlier, policy makers have to wrestle with the internationalisation of firms and the ‘conflict’ of markets [Buckley (2003)]. Capital and financial markets are international and the managerial implications therein concern the potential conflict with national policies in developing domestic capital markets. In contrast, the market for goods and services is overwhelmingly regional. For policy-makers the implications for managing industrial development in *a regionalised world* concern the integration and harmonisation of inter-country policies that permit networked MNEs to view developing country hosts to FDI *as part of a region*

³⁵ See the determinants of national competitiveness in Porter M., 1990, *The Competitive Advantage of Nations*, London: Macmillan, p. 127.

³⁶ See for example J. A. Brander, 1995, *Strategic trade policy*, NBER, Working Paper, No. W5020, February; and W. M. Corden, 1995, *Strategic Trade and Industrial Policy*, Center for Economic Policy, Paper No. 339, Australia National University.

³⁷ See G. Abonyi, “Linking Asia Together”, *The Asian Wall Street Journal*, 5 December 2000, Editorial page, for an elucidation of the dynamics involved in the spatial distribution of manufacturing value-added.

rather than isolated markets or locations for low cost production³⁸. Labour markets, on the other hand, being predominantly national in character, present the challenges of crafting viable policies for national employment, training and human skills development that will entice MNEs.

These three markets -- capital, goods and services, and labour -- conflict in the sense that the design of FDI policy instruments must weigh conflicting factors yet must be sufficiently coherent in application to achieve optimal developmental outcomes. For developing countries with youthful capital markets, policies for improving regional and national markets for goods and services as well as labour market flexibility are more significant to industrial development. FDI promotion and targeting then becomes a more concerted and subtle exercise regarding the stages of production which are distributed within the region on the basis of country differentiated strategies that reflect different -- but evolving -- location specific advantages rather than a process by which FDI is competed for, head on, through 'beggar-thy-neighbour' incentive wars.

Governments select from national policy choices and instruments to attract FDI in relation to, and in support of, overall economic development goals. These goals encapsulate the aim of creating wealth through industrialisation efficiencies that are gained ultimately from increases in total factor productivity growth. Hence government and institutional policies, and their effective implementation by ministries, can be crucially important determinants of FDI. However, as the empirical evidence on the industrial organisation of the firm clearly shows, the spatial location and dynamic distribution of vertical and horizontal international production is not territorially bound. The territorial freedom of the cross-border networks and organisational functions of MNEs therefore presents major policy challenges to developing countries as they attempt to capture FDI. Developing countries face difficulties such as:

- (i) Limited capacity to exploit the determinants of growth, and the motivations for FDI by MNEs.
- (ii) Constrained capability to design policy solutions that maximise the capture (and local embedding) of positive externalities from FDI while moderating the impact of negative spillovers.

Related issues concern the relative merits of policy instruments for technology diffusion and transfer, and R&D out-sourcing. As the boundaries of international firms become 'fuzzy' with constantly changing shape, critical success factors in FDI policy move towards an IP strategy and organisation that delivers ever decreasing costs of doing business; facilitates greater internationalisation of the investors operations while incorporating more domestic firms [World

³⁸ In this respect, despite differences in comparative indices, the perceptions of investors regarding Southeast Asia and Africa are in contrast with the former being considered much more in regional terms relative to the latter.

Bank (2005)]. An important concomitant to this is the need for developing countries to improve their indicators³⁹ of industrial performance [UNIDO (2002)], as illustrated for selected ASEAN countries in Appendix III - Ranking of Economies by basic indicators of industrial performance and by Competitive Industrial Performance 1998 and 1985 (see earlier Section 2 – Background Issues).

3.4. The China Dimension to FDI in Southeast Asia

Recent analysis⁴⁰ and commentary on China yields generally two contrasting views on the China dimension to FDI (and economic performance)⁴¹, which have challenging policy implications for Southeast Asia (and other developing regions). The first perspective suggests the highly competitive dynamics faced by Southeast Asia due to China's emergence as the pre-eminent host of the FDI flows to developing countries⁴². The second view looks to the growing complementarities between Southeast Asia and China (see earlier Section 3.2). The gravitational flow of manufacturing FDI to coastal China, which could have diversionary effects on intra-regional FDI flows, is unlikely to be reversed. In fact, should the efficiencies of reforms in China continue to increase, the FDI flow to China may well continue to accelerate⁴³. The issue of diversion of ASEAN intra-regional flows is complicated by; (i) the reality of MNEs production networks, (ii) vertical intra-industry trade, (iii) intra-firm exports and imports and (iv) inter-sectoral exchange (within clusters of close industrial classification) between and within Southeast Asia and China. For example, the sourcing patterns of MNEs with respect to local input linkages in the electronics and textile sectors, in which the types of mandates given to MNEs' subsidiaries are crucial determinants [Mirza, Cheung and Leung (forthcoming 2005); Giroud and Mirza (2004)].

³⁹ Per capital functions of manufacturing value added (MVA) manufactured export; share of medium- and high technology activities in MVA; and share of medium- and high technology activities in manufactured export.

⁴⁰ See Tokyo Club Foundation for Global Studies, *The Emergence of China and The Evolution of Regional Economic Integration in East Asia*, AT 10 Researchers' Conference, 3-4 February, 2004, Tokyo, Japan.

⁴¹ See M. Schaaper, 2004, *An emerging knowledge-based economy in China?: Indicators from OECD databases*, STI Working Paper, No 2004/4, OECD DSTI/DOC(2004)4, Paris; and "The Chinese Boom...;" Comment and Analysis, *Financial Times*, 24 March 2004, p.11, for the upbeat assessment. See "Behind the mask: A survey of business in China"; *The Economist*, 20 March 2004, pp.3-18; "China: headed for a crisis?"; *Business Week*, 3 May 2004, pp 26-33; and "China's economy"; Special Report, *The Economist*, 15 May 2004, pp. 11-12, pp. 67-69, for the downbeat assessment.

⁴² This is notwithstanding key issues concerning the issues of measurement of flows to China. See Geng Xiao, 2004, *Round-tripping Foreign Direct Investment in the People's Republic of China: Scale, causes and implications*, ADB Institute Discussion Paper, No.7, June, ADB Institute; and Alex Erskine, 2004, *The Rise in China's FDI: Myths and Realities*, Conference Paper, Australia-China Free Trade Agreement Conference, 12-13 August, Sydney, Australia.

⁴³ Net in-flows of FDI to ASEAN and China have completely reversed in favour of China. While ASEAN hosted US\$10,1 billion in 1990 by 2001 this had collapsed to US\$2,5 billion. In contrast, China hosted US\$2,6 billion in 1990 and by 2001 was hosting US\$37.4 billion according to World Bank data.

Also, the trade surplus (or deficit) perspective⁴⁴ may not indicate underlying policy strengths (or weaknesses) due to the fact that whereas US and Asian MNEs, particularly Japanese MNEs, tend to be vertically integrated across Southeast Asia and China, European MNEs tend to be more horizontally integrated [Chia (2004); Sachwald (2004); Taube (2004, 2002)]. So, while ASEAN enjoys a trade surplus with China, what may be more important -- for policy from a FDI host country point of view -- is the structure of export oriented FDI competition, between Southeast Asia and China, for Triad markets (in terms of medium- and high-technology MVA).

Analysis indicates that, despite China's rapidly growing exports to US and Japan relative to Southeast Asia's, the region enjoys a competitive advantage over China in some trade categories including: primary products, resource based manufacturing and electronics/electrical to both US and Japan; and in automotive and process to Japan [Chia (2004, Table 6)]. Apart from primary resources, these are characterised by vertical intra-industry trade within MNEs production networks. This view also has to take into account Japan's outward FDI to Southeast Asia compared to China. This shows that cumulatively the ASEAN-5 received Yen 7,143 billion (1989-2002) compared to China which hosted Yen 2,479 billion in the same period [Sussangkarn (2004)].

Overall, inter-location (ASEAN-5, China, Japan) vertical intra-industry trade in medium- and high-technology MVA favours Southeast Asia in finished products, electronics components, petro-chemical basics, petro-chemical derivatives [Kinoshita, Kishida and Amemiya (2004)]. And this tends to suggest that, despite the vast flows of FDI to China, a deeper scrutiny of the layers in industrial dynamics, in relation to export structures of ASEAN economies, Southeast Asia's FDI policies and IP strategies remain competitive especially at the level of *third generation* IP⁴⁵.

However, as the competition for inward FDI is relentless, policy needs to shift to reflect the exposed underlying changes to industrial organisation. And key issues in relation to the above concern, for example, the need to account for third and fourth party logistics and distribution as well as supply-chain programmes in FDI policy and IP strategies [D'Avanzo, von Lewinski and van Wassenhove (2003); Quin (2002); Hertz and Macquet (2001)]. Additionally, FDI policy for Southeast Asia (and other regional groupings) as a 'single market' would need to

⁴⁴ Latest figures available indicate that ASEAN (mainly the ASEAN-5 i.e. Indonesia, Malaysia, Philippines, Singapore, Thailand) has a surplus trade balance with China of US\$10 billion (1997); US\$14 billion (2001); US\$18 billion (2002); and US\$ 30 billion (2003). See Stephen Green, 2003, *Reforming China's economy: A Rough Guide*, RIIA; and Eswar Prasad, Ed., 2004, *China's Growth and Integration into The World Economy: Prospects and Challenges*, Occasional Paper No. 232, IMF.

⁴⁵ Singapore's EDB and TDB have been exemplary since the 1960s in targeting export-oriented FDI. See UNCTAD WIR 2002: *Transnational Corporations and Export Competitiveness*, Geneva: UNCTAD p. 222.

evolve more rapidly to account for the increasing propensity for offshore decisions by MNEs especially with respect to the relocation of service industries⁴⁶. In this respect, economic integration between Southeast Asia and China, already relatively well advanced, requires continued complimentary policy reform with respect to barriers to; (i) financial liberalisation, (ii) improved risk management, and (iii) financial integration in terms of management practice of financial institutions [Laurenceson (2003)].

3.5. Capital Markets and FDI in Southeast Asia

Notwithstanding some technical differences between FDI and Foreign Portfolio Investment (FPI)⁴⁷, rising FPI flows, and recent activity⁴⁸ in XBMA as well as developments in global capital and financial markets (CFMs) have permitted FDI and FPI activity to converge. Furthermore, through venture capital and private equity mechanisms, equity funded growth prospects in SMEs have attracted FDI; and FDI -- especially in its backward and forward linkages to domestic industry -- can be a magnet for equity investments. Additionally, XBMA are increasingly enacted using equity instruments. The co-evolution of FDI and FPI thus enables regional capital and financial markets to develop and facilitate FDI, especially when product development in financial assets enables foreign investors to use local CFMs to make direct investments [UNIDO (2004); UNCTAD (1999)].

However, most of the region's CFMs are relatively under capitalised and financial intermediation is still largely dependent on bank financing with resource allocation efficiencies that are often biased in favour of the State, and at the expense of investors. Also price discovery functions have historically produced lending rates lower than required given the risk profile (given by bank spreads of 1.5-2%)⁴⁹. Furthermore, Southeast Asian CFMs, with low floats, are illiquid relative to their Triad counter parts thus deterring increased participation by global investment funds and institutions. And the regional CFMs arguably have been less than muscular in acting as checks on relatively poor corporate governance standards in a number of countries. The capacity of the region's CFMs to act as a conduit for FDI is therefore somewhat

⁴⁶ See A.T. Kearney's 2004 Offshore Location Attractiveness Index: Making Offshore Decisions, Chicago: A.T. Kearney; and Dan Roberts and Edward Luce, 2003, "Outsourcing", Financial Times, 20 August 2003, p.11 for the variables that determine the services outsourcing decision.

⁴⁷ See UNCTAD, 1999, Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI): Characteristics, similarities, complementarities and differences, policy implications and development impact, UNCTAD TD/B/com.2/EM.6/2, April.

⁴⁸ See Phillip Lee, "Bustling year for M&As", The Business Times, 19 May 2004, Singapore.

⁴⁹ According to Andrew Sheng, Chairman securities and futures commission Hong Kong, "The future of capital markets in developing countries: implications for China's equity markets", Stanford Centre for International development, China's Markets Reforms, 19 September 2003, Asia needs to deepen its CFMs with the full range of intermediating products and services in order to adequately take advantage of Asia's 'demographic endowment' of youth.

limited [Freeman and Bartels (2000)], due in large part to lower capitalisations and trading volumes⁵⁰.

Although FDI and FPI tend to have different velocities and characteristics, they both address financial needs that are converging, and therefore have congruent policy implications. Policy regimes have to be differentiated but must demonstrate a coherence that permits FDI liberalisation to be sufficiently well articulated with FPI regulatory reform, so as to avoid macro-economic shocks. Other issues concern the treatment of FPI in FDI and Bilateral Investment Agreements (BITs)⁵¹ and measures to manage volatility⁵².

Other areas that deserve policy attention include; (i) corporate governance practices and standards, (ii) transaction costs, (iii) protecting investors, and (iv) methods and standards necessary to deepen the symbiotic relationship between FDI and FPI. With respect to corporate governance, market contestability needs to increase in order to improve competition-based discipline. Transaction costs and efficiency related to financial transactions can act as a barrier to CFM development and therefore need improving. Policy should also be focused to clarify property rights⁵³, to assist in moderating the incidence of non-performing loans; and if regional CFMs are to play an improved FDI intermediating role, they need to integrate with the world's major CFMs by adopting international standards.

4. CONCLUDING REMARKS

The increasing international deployment of work⁵⁴ manifest as global production sharing [Yeats (1998)] and vertical intra-industry trade has networked MNEs with supply chains, domestic firms and ISMEs across geo-economic space. In a world of diminishing barriers to factor mobility, the reality of 'the global factory' has profound implications for FDI policy and IP strategies of countries wishing to attract and retain FDI. At a broad level, the long view of FDI indicates a change in the location decision from the sequential to the parallel in order to disintegrate and re-integrate differentiated stages of production and thereby maximise allocative and cost efficiencies as well as maintain flexible access to markets. This calls on developing country policy makers to create sensitive policy instruments and mechanisms to track the

⁵⁰ See Nick J. Freeman, 2001, A Regional Platform for Trading Southeast Asian Equities: Viable Option or 'Red Herring'? *Journal of The Asia Pacific Economy*, Vol. 6, No. 3, October, pp. 335-359, for a view on the dangerously close 'twilight zone' of marginal asset allocation that some of the region's CFMs face.

⁵¹ According to UNCTAD WIR 2003, the EU, Japan and US have signed a total of 963 BITs.

⁵² For example the pre-1998 30% reserve requirement applied by Chile.

⁵³ According to the World Bank Doing Business in 2005 indicators, the regional average for protecting investors is 2.5 compared to the OECD's 5.6 on a scale of 0 to 7 with 7 being the best.

⁵⁴ See *The Economist*, A world of work: A survey of outsourcing, 13 November 2004, pp. 3-16.

changing morphology of MNEs with a view to targeting specific parts of their production networks.

The spatial relevance of free trade agreements (FTAs) for market seeking investments is crucial with respect to lowering transaction costs. The challenge posed to policy craft is how to: (i) harmonise the ‘concentricities’ of ‘hard’ and ‘soft’ regulations that spill across the FTAs and BITs, DTTs, RTAs⁵⁵; (ii) cohere competitive policy instruments to attract FDI; and (iii) reduce the costs of doing business while increasing the robustness of the assets and intellectual property rights regime.

The boundaries of international firms are increasingly ‘fuzzy’ and permeable on the one hand while internalisation of external factor and intermediate markets, on the other hand, tends to militate against market-based measures to influence the location decision. The China dimension presents complex policy challenges to Southeast Asia as it attempts to compete with, and act as a viable complement to, China’s FDI trajectory. How Southeast Asia deals with this successfully holds lessons for other developing countries with a ‘giant’ neighbour.

The role of CFMs and FPI is no longer tangential to FDI. The massive domestic savings profile of the region requires policies to create diversified financial assets that in turn will help spur the kind of domestic investment attractive to FDI in its more collaborative forms.

IP strategies, given the increasing complexity of FDI and its real options decision making, require a special sensitivity to the spatially distributed nature of FDI. Attention to the ‘virtuous cycle’ of policy intervention [UNIDO (2003a, Figure 1, p. 18)] is essential to enable IPAs to graduate from *first* and *second generation* IP to *third* and *fourth generation* IP. Beyond targeting export-oriented FDI, *fourth generation* IP focuses holistically on the dynamics of ‘the global factory’ of MNEs and aligns modal neutrality, market contestability and policy coherence in the reform of regulations⁵⁶. It also takes a much broader and strategic view of the role of IPAs beyond the traditional focus on the ‘foreign’ in FDI attraction, advocacy, facilitation and regulation of entry. It is geared towards actively championing promising domestic firms in the supply-chain and networks of MNEs and ISMEs; and enabling cross-ministerial co-ordination in setting the regulatory regime. Furthermore, FDI policy needs to be increasingly coherent with a country’s industrial development trajectory. Therefore attention to the overall system of national (and regional) economic incentives with respect to the national innovation system; science,

⁵⁵ Bi-lateral Investment Treaties, Double Taxation Treaties, Regional Trade Agreements.

⁵⁶ Modal neutrality describes policies that allow foreign investors to decide for themselves how best to serve the markets they enter. Market contestability embodies the ability of both foreign and domestic investors to compete on a level of playing field for the factors of production. Policy coherence refers to the degree of internal consistency of objectives, FDI policies and interpretation of policies, in their regulatory form, across a range of issues and at different levels of Government.

technology and innovation policy; human resources and social capital formation in relation to FDI is also necessary.

The successful Southeast Asian development experience thus far, and the challenges it faces in the future, and the central part played by MNEs and FDI in-flows and their linkages to domestic investment, hold significant lessons for other developing regions⁵⁷. Especially with regard to path dependency, and the role of the State in integrating the local economy with the regional and global economies, this EGM aims to assist in advancing the ‘state-of-the-art’ policies for both Southeast Asian and other developing countries.

⁵⁷ In 1995, *Asian Industrialization and Africa: Studies in Policy Alternatives to Structural Adjustment*, Ed., Howard Stein, London: St. Martin’s Press, raised issues pertinent to FDI, structural adjustment, industrial policy and the role of the developmental state which have still to be resolved by applying lessons of international experience.

Appendix I - Doing Business in ASEAN Indicators 2005

Variable	Brunei	Cambodia	Indonesia	Lao PDR	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam	Timor Leste	Regional Average	OECD Average
Economy Characteristics 2004:													
Region: East Asia & Pacific													
GNI per capita (US\$)	NA	310	810	320	3,780	NA	1,080	21,230	2,190	480	NA	5,464	25,773
Informal economy (% GNI, 2003)	NA	NA	19.4	NA	31.1	NA	43.4	13.1	52.6	15.6	NA	24.3	16.8
Population (millions)	NA	13.4	214.5	5.7	24.8	NA	81.5	4.3	62.0	81.3	NA	139.5	41.5
Starting a Business (2004):													
Number of procedures	NA	11	12	9	9	NA	11	7	8	11	NA	8	6
Time (days)	NA	94	151	198	30	NA	50	8	33	56	NA	52	25
Cost (% of income per capita)	NA	480.1	130.7	18.5	25.1	NA	19.5	1.2	6.7	28.6	NA	47.1	8.0
Min. capital (% of income per capita)	NA	394.0	125.6	28.5	0.0	NA	2.2	0.0	0.0	0.0	NA	100.5	44.1
Hiring and Firing Workers (2004):													
Difficulty of Hiring Index	NA	33	61	11	0	NA	22	0	67	44	NA	20.6	26.2
Rigidity of Hours Index	NA	80	40	60	0	NA	60	0	40	40	NA	30	50
Difficulty of Firing Index	NA	30	70	80	10	NA	40	0	20	70	NA	22.7	26.8
Rigidity of Employment Index	NA	48	57	50	3	NA	41	0	42	51	NA	24.4	34.4
Firing costs (weeks of wages)	NA	39	157	185	74	NA	90	4	47	98	NA	53	40.4
Registering Property (2004):													
Number of procedures	NA	7	6	9	4	NA	8	3	2	2	5	NA	4
Time (days)	NA	56	33	135	143	NA	33	9	2	78	NA	51	34
Cost (% of property per capita)	NA	4.1	11.0	1.1	2.2	NA	5.7	2.7	6.3	5.5	NA	4.3	4.9

Getting Credit (2004):													
Cost to create collateral (% of income per capita)	NA	0.0	2.5	3.8	3.2	NA	8.3	0.3	1.1	2.0	NA	1.9	5.2
Legal Rights Index	NA	4	5	2	8	NA	5	10	5	4	NA	5.4	6.3
Credit Information Index	NA	0	3	0	6	NA	2	4	5	3	NA	2.0	5.0
Public credit registry coverage (borrowers per 1000 adults)	NA	0	4	NA	339	NA	0	0	0	8	NA	33.9	76.2
Private bureau coverage (borrowers per 1000 adults)	NA	0	0	0	NA	NA	34	335	150	0	NA	67.3	577.2
Protecting Investors (2004):													
Disclosure Index	NA	0	4	1	5	NA	6	5	6	1	NA	2.6	5.6
Enforcing Contracts (2004):													
Number of procedures	NA	31	34	53	31	NA	25	23	26	37	NA	27	19
Time (days)	NA	401	570	443	300	NA	380	69	390	404	NA	316	229
Cost (% of debt)	NA	121.3	126.5	30.3	20.2	NA	50.7	9.0	13.4	30.1	NA	57.0	10.8
Closing a Business (2004):													
Time (years)	NA	no practice	6.0	5.0	2.3	NA	5.6	0.8	2.6	5.5	NA	3.6	1.7
Cost (% of estate)	NA	no practice	18	76	18	NA	38	1	38	18	NA	29.8	6.8
Recovery rate (cents on the dollar)	NA	0.0	10.6	0	35.4	NA	3.9	91.3	42.0	16.4	NA	30.4	72.1

Source: World Bank, 2005, Doing Business in 2005: Removing Obstacles to Growth, Washington D. C.: World Bank.

NA – Not Available

Notes:

Hiring and Firing Workers (2004): Three indices measure how difficult it is to hire a new worker, how rigid the regulations are on working hours, and how difficult it is to dismiss a redundant worker. Each index assigns values between 0 and 100, with higher values representing more rigid regulations.

Getting Credit (2004): One set of indicators measures the coverage, scope, quality and accessibility of credit information available through public and private registries. A second set measures how well collateral and bankruptcy laws facilitate lending. It ranges from 0 - 10, with higher scores indicating that those laws are better designed to expand access to

credit. The Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. The index ranges from 0 - 6, with higher values indicating that more credit information is available from a public registry or private bureau.

Protecting Investors (2004): The Disclosure Index captures seven ways of enhancing disclosure: information on family; indirect ownership; beneficial ownership; voting agreements between shareholders; audit committees reporting to the board of directors; use of external auditors; and public availability of ownership and financial information to current and potential investors. The index varies between 0 and 7, with higher values indicating more disclosure.

Notes: Data are based on enterprise surveys conducted by the World Bank and its partners in the year indicated. While averages are reported, there are significant variations across firms. The data are not intended for the ranking of countries. The WDR Survey of Micro and Informal Firms was also conducted in 11 countries: Bangladesh, Brazil, Cambodia, Guatemala, India, Indonesia, Kenya, Pakistan, Senegal, Tanzania, and Uganda. The findings of these surveys are not reflected in this table. "NA" indicates data is not available.

- a. In 2002 the survey was expanded, so the earliest surveys include the firm performance measures, but not the full set of investment climate variables.
- b. India's first round survey of 895 firms was conducted in 2000.

Appendix III - Ranking of Economies by basic indicators of industrial performance and by Competitive Industrial Performance (CIP) 1998 and 1985

Index of Competitive Industrial Performance 1998				
	Manufacturing value added per capita index (a)	(a)+ Manufactured exports per capita index (b)	(b)+ Share of medium-and high-tech activities in manufacturing value added index (c)	(c)+ Share of medium-and high-tech products in manufactured exports-final index (d)
ASEAN 1998				
Singapore	0.743	0.871	0.872	0.883
Malaysia	0.112	0.101	0.103	0.278
Philippines	0.022	0.017	0.015	0.241
Thailand	0.069	0.046	0.045	0.172
Indonesia	0.013	0.008	0.009	0.054
Index of Competitive Industrial Performance 1985				
	Manufacturing value added per capita index (a)	(a)+ Manufactured exports per capita index (b)	(b)+ Share of medium-and high-tech activities in manufacturing value added index (c)	(c)+ Share of medium-and high-tech products in manufactured exports-final index (d)
ASEAN 1985				
Singapore	0.434	0.717	0.616	0.587
Malaysia	0.093	0.083	0.067	0.116
Thailand	0.041	0.025	0.020	0.058
Philippines	0.035	0.020	0.015	0.044
Indonesia	0.020	0.012	0.009	0.012

Source: UNIDO Scoreboard data set, UNIDO Industrial Development Report 2002/2003

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