Questions, questions, questions:

Facing the tough ones

By

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<u>The Current Picture</u>

The 13 countries in ASEAN plus Three ('APT') can take pride in being one of the leading, if not the leading, groupings in the world where attracting investments in concerned. According to the World Investment Report ('WIR') 2005, the FDI inflows for the selected regional groupings and the APT countries in 2002 to 2004 are as follows:

	FDI Inflows (USD mn)				
Country/ Region	**2002**	**2003**	**2004**	**2004 growth %**	**3 yr growth %**
World	**716,128**	**632,599**	**648,146**	**2.46**	**-9.49**
*Developed econs**	538,539	435,833	372,206	-14.6	-30.9
Africa	12,994	18,005	18,090	0.5	39.2
Latin America	50,492	46,908	67,526	43.9	33.7
S/E Europe & CIS	12,821	54,106	34,897	172.2	-35.5
West Asia	5,691	6,522	9,840	50.9	72.9
South Asia	4,528	5,331	7,005	31.4	54.7
Greater China	64,245	67,985	97,163	42.9	51.2
Japan	9,239	6,324	7,816	23.6	-15.4
Korea	2,975	3,785	7,687	103.1	158.4
Brunei	1,035	2,009	103	-94.9	-90.0
Cambodia	145	84	131	55.9	-9.6
Indonesia	145	597	1,023	71.3	605.5
Laos	25	19	17	-10.5	-32.0
Malaysia	3,203	2,473	4,624	86.9	44.4
Myanmar	191	291	556	91.1	191.1
Philippines	1,792	347	469	35.2	-73.8
Singapore	5,822	9,331	16,060	72.1	175.8
Thailand	947	1,952	1,064	-45.5	12.35
Vietnam	1,200	1,450	1,610	11.0	34.2
APT Total	**90,964**	**96,647**	**138,323**	**43.1**	**52.1**
As % of world	**12.7%**	**15.3%**	**21.3%**	**-**	**-**
*Vs. Dev. Econs.**	16.9%	22.2%	37.2%	-	-
Vs. Africa	7.0x	5.4x	7.6x	-	-
Vs. Latin Am.	1.8x	2.1x	2.0x	-	-
Vs. S/E Eur.+ CIS	7.1x	1.8x	3.9x	-	-
Vs. West Asia	15.9x	14.8x	14.1x	-	-
Vs. South Asia	20.1x	18.1x	19.7x	-	-

Source: *World Investment Report 2005, UNCTAD*

*Developed economies ex-Japan

APT countries have also increased their investing offshore as the following table shows:

	FDI Outflows (USD mn)				
Country/ Region	**2002**	**2003**	**2004**	**2004 growth %**	**3 yr growth %**
World	**652,181**	**616,923**	**730,257**	**18.4**	**11.9**
*Developed econs**	567,614	548,523	606,409	10.6	6.8
Africa	427	1,215	2,824	132.4	561.3
Latin America	11,351	10,562	10,943	3.6	-3.6
S/E Europe & CIS	4,511	10,584	9,707	-8.3	115.2
West Asia	910	n/a	n/a	n/a	n/a
South Asia	1,149	962	2,288	137.8	99.1
Greater China	24,938	11,017	48,008	335.8	92.5
Japan	32,281	28,800	30,951	7.5	-4.1
Korea	2,617	3,426	4,792	39.8	83.1
Brunei	27	n/a	n/a	n/a	n/a
Cambodia	6	10	10	0.0	66.7
Indonesia	182	15	107	613.3	-41.2
Laos	n/a	n/a	n/a	n/a	n/a
Malaysia	1,905	1,369	2,061	50.5	8.2
Myanmar	n/a	n/a	n/a	n/a	n/a
Philippines	59	197	412	109.1	598.3
Singapore	4,095	3,705	10,667	187.9	160.5
Thailand	106	486	362	-25.5	241.5
Vietnam	n/a	n/a	n/a	n/a	n/a
APT Total	**66,216**	**49,024**	**97,370**	**98.6**	**47.0**
As % of world	**10.1%**	**7.9%**	**13.3%**	**-**	**-**
*Vs. Dev. Econs.**	11.7%	8.9%	16.1%	-	-
Vs. Africa	155x	40.3x	34.5x	-	-
Vs. Latin Am.	5.8x	4.6x	8.9x	-	-
Vs. S/E Eur.+ CIS	14.7x	4.6x	10.0x	-	-
Vs. West Asia	72.8x	n/a	n/a	-	-
Vs. South Asia	57.6x	50.9x	42.6x	-	-

Source: *World Investment Report 2005, UNCTAD*

*Developed economies ex-Japan

In terms of cross-border mergers & acquisitions (M& A) activity, APT countries have had a relatively stable amount of spending at an average around USD 22 billion per annum for the years 2002 and 2004 despite some large swings in the world spending figures for the same time period. The table below showcases the cross-border M&A figures for that period of time.

	Cross-border M&As by Purchaser (USD mn)				
Country/ Region	**2002**	**2003**	**2004**	**2004 growth %**	**3 yr growth %**
World	**369,789**	**296,988**	**380,598**	**28.2**	**2.9**
*Developed econs**	332,887	248,493	336,012	35.2	0.9
Africa	1,999	1,067	2,718	154.7	35.9
Latin America	11,701	11,460	16,487	43.8	40.9
S/E Europe & CIS	691	8,992	991	-88.9	43.4
West Asia	3,038	1,555	1,280	-17.7	-57.9
South Asia	336	1,362	877	-35.6	305.4
Greater China	6,183	6,068	4,798	-20.9	-22.4
Japan	8,661	8,442	3,787	-55.1	-56.3
Korea	98	662	409	-38.2	317.3
Brunei	n/a	n/a	n/a	n/a	n/a
Cambodia	n/a	n/a	n/a	n/a	n/a
Indonesia	197	2	491	24,450.0	149.2
Laos	n/a	n/a	n/a	n/a	n/a
Malaysia	930	3,685	816	-77.8	-12.2
Myanmar	n/a	n/a	n/a	n/a	n/a
Philippines	2	1	105	10,400.0	5,150.0
Singapore	2,946	5,018	11,638	131.9	295.0
Thailand	87	176	185	5.1	112.6
Vietnam	n/a	4	n/a	n/a	n/a
APT Total	**19,104**	**24,058**	**22,229**	**-7.6**	**16.4**
As % of world	**5.2%**	**8.1%**	**5.8%**	**-**	**-**
*Vs. Dev. Econs.**	5.7%	9.7%	6.6%	-	-
Vs. Africa	9.6x	22.5x	8.2x	-	-
Vs. Latin Am.	1.6x	2.1x	1.3x	-	-
Vs. S/E Eur.+ CIS	27.6	2.7x	22.4x	-	-
Vs. West Asia	6.3x	15.5x	17.4x	-	-
Vs. South Asia	56.8x	17.7x	25.3x	-	-

Source: *World Investment Report 2005, UNCTAD*
*Developed economies ex-Japan

The 2005 study called "*Connecting East Asia: A New Framework for Infrastructure*" by the ADB, JBIC and the World Bank states:

"*Investment levels* (in East Asia) *are generally high, averaging more than 30% of gross domestic product (GDP) since the 1990s. Much of this investment has been to provide infrastructure services. A number of countries invest more than 7 percent of GDP in infrastructure services."*

The APT countries that spend more than 7 percent of their GDP in infrastructure p.a. are China, Thailand, and Vietnam. Since 1990, the private sector itself has invested approximately USD190 billion in East Asian infrastructures; the amount, while large, has been considered minor.

However, despite some impressive growth rates in infrastructure attainment and building, the report goes on to say that there is great divergence in the outcomes of the infrastructure spending, access to infrastructure is uneven, and that East Asia has a long way to go.

<u>Observations</u>

Some observations may be made of the three tables in the preceding section which sum up the picture of APT investments as follows:

1. APT countries' inward FDIs have been on the uptrend for the past 3 years, and have remained, for the most part, stable or steadily increasing for most individual countries of APT,
2. The share of APT countries' inward FDI has been growing as a proportion of the World's, at 21.3% in 2004 from almost half of that at 12.7% in 2002. It is also a third compared to that of Developing Economies (ex-Japan)'s own inward FDIs, and significant multiples of other geographic regions, including those of Latin America (2.0 times more), oil-rich West Asia (14.1 times more) and India-inclusive South Asia (19.7 times more) in 2004.
3. The volatility of outward FDI flows by APT countries on a year-by-year basis from 2002 to 2004 is high. This indicates that APT, with the exception of Japan and possibly Korea and Singapore, is new to the 'game' of outward investments. This is reasonable given that the three aforementioned countries are at different phases of economic growth and maturity compared to the rest. Hence, they would have turned into being creditor countries with their companies seeking growth outside their own countries or for strategic investments worldwide.
4. In terms of outflows, the APT countries' share of the world's FDI outflows is almost half of that of inflows in 2003 and 2004. Nonetheless, it shows growth, and is far larger than West Asia (73 times more in 2002) and South Asia (42.6 times more in 2004), while having a decided advantage versus other regions in the world.

5. Cross-border M&A activity accounted for 22.8% of APT outward FDI activity in 2004, against the Developed Economies (ex-Japan)'s own 55.4% and the World's 52.1%. This percentage can be expected to increase going forward as more and more APT countries and their companies engage the globalized marketplace.

It is further apparent that the APT countries are at different levels where the investments 'game' is. There are many who would like to attract FDIs, others who would like to boost their exports and foreign exchange earnings via FDIs, some who are trying to climb up the if not fully capture entire, value-chains, and others who are right at the cutting edge of direct investments, being more outward FDI prevalent than inward.

<u>Some Deliberations on Observable Minutiae of the Current State of Play</u>

FDIs are generally financed by companies through three main means, equity capital, intra-company loans, and/or reinvested earnings. On page xx, the WIR 2005 states:

"*In terms of the three main forms of FDI financing, equity investment dominates at the global level. During the past decade, it has accounted for about two-thirds of total FDI flows. The shares of the other two forms of FDI – intra-company loans and reinvested earnings – were on average 23% and 12% respectively.*"

These findings are well supported by research done by Atkins and Glen (1992), Singh, Hamid, Salimi, and Nakano (1992), and Fogarty (1998), all of whom examined the financing patterns of large companies in the developing world. A longer term study done by the Financial Management Association ("*Financing Capital Investments: Evidence from Emerging Markets in East Asia*") on the corporate investments financing patterns in Hong Kong, Taiwan province, Korea, Malaysia, Singapore and Thailand from 1975 to 1996 found that:

- Non-financial corporate sectors relies more heavily on external funds than on internal funds and they rely more on equity than debt financing,
- Firm size, profitability, asset tangibility, and the development of equity markets play an important role in financing decisions,
- Large firms tend to use more debt and less retained earnings to finance new projects,
- More profitable firms tend to use less debt & equity and more internal cash flows to fund their investments,
- Firms with high collateral assets values tend to issue more debt than raise capital, and
- Stock market developments show a strongly positive influence on firms making equity financing decisions.

It also appears that while good effort has been expanded by APT countries with regards to bonds (e.g. ABF and ABF2), little has been done with regard to equity investments collectively. Given the evidence from so many studies above, it then behooves us to explore ways and means to boost direct investments via equities as well.

The WIR 2002 remarked there are three core elements that are critical to international production systems:

1. Global value chains,
2. Geographic configuration, and
3. Governance.

In this last point, governance, the aforementioned ADB/ WB/ JBIC study in 2005 stated that of a survey of 48 companies in and outside the East Asia region, most stated that the constraints to investment were the lack of enforcement of contracts, inconsistencies in regulations & in the courts, and corruption. This then ties into the value systems of the APT countries and the need for us to develop the soft side of investments.

There also arises the questions of how one captures the greatest amount of benefits through FDIs, how to create the optimal environment domestically to capture FDIs, how to focus on capturing specific investments for a targeted industrial sector, how to handle the infusion of values and ethics which comes through the presence of non-national industries, the inter-mixing of our workers, and so on and so forth. For the development of industrial clusters involving inward FDI, WIR 2002 noted three kinds of effort being undertaken by successful investee countries:

1) Investment and promotion in a targeted manner,
2) Institutional building, and
3) Training and upgrading of human resources.

These common factors can actually be attempted at a regionally-collective level which would help the smaller and/ or less naturally well-endowed countries who may not have either the capacity or economies of scale to create the necessary investment climate.

Without a doubt, many countries transitioning from becoming a pure FDI-receiver to one having a 'mixed' export-driven economy with FDI and domestic based industries driving growth, the questions of thrust-mix and optimality comes to the fore. In a mixed or dual approach to exports and economic growth, the WIR 2002 remarked:

"*….some of the countries most successful in boosting export competitiveness and leveraging export-oriented FDI practiced a two-pronged approach based on developing domestic capacities while targeting foreign resources and assets. Important elements of such an approach can include:*

1. *ensuring what is targeted through investment promotion is in line with the country's broader development and industrial strategies;*
2. *providing a package of incentives in a focused way to encourage TNCs to invest in strategic activities (taking into account WTO rules on export subsidies);*

3. *involving foreign affiliates in the development and upgrading of human resources;*
4. *developing high quality infrastructure, such as EPZs and science parks; and*
5. *providing targeted support for domestic enterprises and supplier and cluster development."*

<u>A Common Regional Investment Agreement?</u>

APT countries are also increasingly engaged in international rule-making in investments as part of their growing inwards and outwards FDIs; these create complex and sometimes conflicting situations which countries have to face and resolve. The WIR 2003 listed the following eight key questions to be faced:

1. How does one define "investment"?
2. How does one treat the entry of FDI and the subsequent operations of foreign affiliates?
3. Where is the dividing line between legitimate policy action and regulatory takings?
4. What are the mechanisms for dispute settlements?
5. How does one use performance requirements and incentives?
6. How does one encourage the transfer of technology?
7. How does one ensure competition, including the control of restrictive business practices by foreign affiliates of TNCs?

What about regional investment agreements? The WIR 2003 noted that Bilateral Investment Treaties ("BIT") now encompass 176 countries. It is the most widely-used international agreement for protecting FDI. For the world, roughly 7% of the FDI stock of USD 9.7 trillion at the end of 2004 was in countries party to a BIT, and 88% in those party to a DTT (Double Taxation Treaty); for developing countries and CEE (Central and Eastern Europe) countries, the figures were 27% and 64% respectively.

The 10 ASEAN countries entered into the Framework Agreement on the ASEAN Investment Area ('AIA') on 7th October 1998 in Makati, Philippines. The AIA's key objective is to substantially increase the flows of direct investments from ASEAN and non-ASEAN sources by making ASEAN a competitive, open and liberal investment area. The following are AIA's main activities:

- Implementing coordinated ASEAN investment cooperation and facilitation programmes;
- Implementing a coordinated promotion program and investment awareness opportunities;
- Opening immediately all industries, with some exceptions as specified in the Temporary Exclusion List ('TEL') and Sensitive List ('SL'), for investment to ASEAN investors by 2010 and all investors by 2020;
- Involving the private sector actively in the AIA development process;
- Promoting freer flow of capital, skilled labor and professional, and technology amongst the Member Countries;

- Promoting transparency of investment policies, rules, procedures and administrative processes;
- Provides a more streamlined and simplified investment process.

When The Going Gets Tough, The Tough Get Going

Perhaps it is time that these questions and issues, some rather difficult and unpalatable, are faced. What is at stake is obvious.

The magnitude of the task at hand is best summed up by the finding of the 2005 study by the ADB, JBIC and the World Bank which stated that developing countries in **East Asia need to spend more than USD 1 trillion over the next five years in roads, water, communications, power and other infrastructure to cope with rapidly expanding cities, increasing populations, and the growing demands of the private sector**. It notes that an estimated 65% of the USD1 trillion would need to be spent on new investment, with the remaining 35% on maintenance of existing assets. According to that report also, China is likely to need 80% of the total investment.

The Devil's Advocate View

Let me then take the stance of the Devil's Advocate in wanting to bring forth several hard questions that must be faced by investee and investor countries at different levels of the investment 'game'. The questions are meant to evoke thought and debate, with the final aim of seeking resolution to these same issues.

1. Can we define what an "ideal investment climate" would be? If so, can we then put up measurement indices and set targets and benchmarks to help drive the achievement of the "ideal investment climate" across APT?
2. Can we standardize investment incentives and competition policies across all APT countries? Should we? What about competitive and comparative national advantage? Can a standard package take care of the needs of the three different types of investors; the market-seekers, the resource-seekers, and the efficiency seekers?
3. Do we want to pursue a Regional Investment Agreement? Can we come to a convergence on the critical issues of incentive packages, level playing fields, investments protection, ownership restrictions, exclusivity, national treatment, and domestic market access, among others?
4. Can we harmonize investment laws and regulations across all APT countries? What about cultural and social needs and peculiarities? How long will a 'new' or 'contradictory' law take to be enforced effectively in another country? What

about the needed sense of ownership and belonging when laws are identified as being national instead of regional?

5. Can we catalyze cross-border intra-APT direct investments? What about the lack of final products coming from ASEAN? What about the simple fact that the main final buyer for much of the goods & services lie outside APT?
6. Can we, through judicious investments and planning, close the development and wealth gaps prevalent today? Can the flying geese all fly abreast instead of the two-tiered formation today?
7. Can we, through intra-APT investments and the interaction of our workers, mold and convey the 'soft side' of community building which concerns standards, codes, ethics, values and mindsets?
8. Can we create APT-based TNCs (trans-national corporations) which are the torch-bearers of uniquely Asian corporate governance, social responsibility and best practices that set the standards for the world?
9. Should the richer APT countries commit to a minimum amount of ODA (Official Development Assistance) for the investment into and for the development of the poorer APT countries? What would that amount be?
10. Should FDIs be the only mode of export and/ or economic growth or can it co-exist with domestic-sourced export and growth initiatives as well? What would be the optimal mix? Which would be the priority thrusts at specific points in time?
11. Can we ensure that once FDIs have landed:
    a. Our peoples can benefit fully and contribute better towards growth of our countries individually and collectively?
    b. Local industries and clusters can grow around the FDIs?
    c. Local industries can subsequently move up the value-added ladder and bring forth local brands of global quality, widely accepted final products and services?
    d. Distribute wealth equitably across segments of our countries' population, and also geographically; this last if for no other reason than to ensure that cities are not choked with people and rural areas left unpopulated or poor, hence threatening a country's food supply?

Recommendations

1. That equity mode(s) of financing, the most prevalent in FDI financing, be studied for implementation on an APT level. Such would be a perfect complement to the ABMI, ABF and ABF2.
2. That APT countries consider the need, benefits, and dis-benefits of a Regional Investment Agreement; given that such a move would be a step forward, especially for the poorer countries, in improving the investment climate. Care must be taken to provide and protect national policy space, however.
3. That a series of studies be commissioned to gauge the impact regional integration and its requirements, such as the establishment of regional monetary units, would

have on intra-APT trade and investments, as well as the impact on the behavior of TNCs from within and outside APT.

4. That a peer-help-peer mechanism be created with the purpose of closing the development gap between the APT countries, using the experience of more successful APT countries in their own development paths.
5. The need for proposed centralized APT institutions to catalyze investments in APT countries is a good idea that merits proper study and examination. Such an institution, while symbolic of APT cooperation, needs to be established with a niche in mind, especially in light of the many already existing multilateral institutions. Experiences from successful private sector examples, such as the Macquarie Infrastructure Group and Kohlberg, Kravis and Roberts (KKR) business models need to be examined further for possible adoption.
6. Modes of private sector financial initiatives and their involvement to develop intra-APT investments and infrastructure needs should be studied, intensified and made more widespread.
7. That the richer countries of APT consider committing to a minimum amount of ODA (Official Development Assistance) meant for the investment into and the development of the poorer APT countries. This should be targeted to close the wealth and development gaps between the richer and poorer APT countries.

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