ARTNeT POLICY BRIEF

An initiative of UNITED NATIONS ESCAP Economic and Social Commission for Asia and the Pacific

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Trade and Investment Linkages and Policy Coordination: Lessons from Case Studies in Asian Developing Countries

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Brief No. 15, June 2008

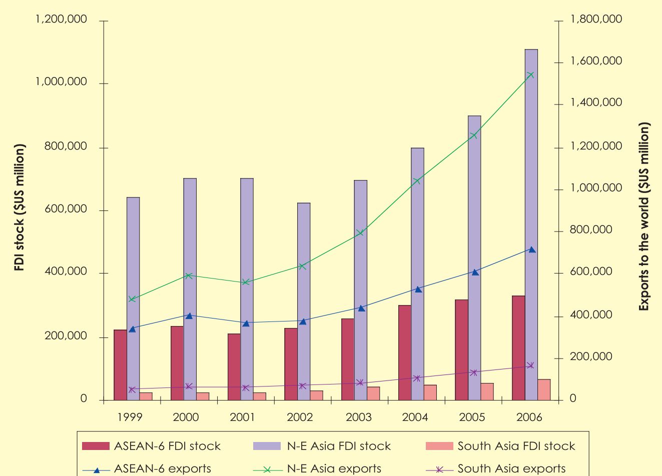
Asia has undoubtedly benefited greatly from globalization, with many countries of the region relying to a significant extent on international trade and investment as their main engine for economic growth and development. As the economies of the region continue to grow at the fastest pace of any other regions in the world, however, some have begun to question how well the gains are shared within the countries themselves. Indeed, there is some evidence that higher economic growth has led to increases in inequality in the countries of the region. This in turn has led to the realization that trade, investment and related domestic policies, which are de facto developed and implemented independently by various government bodies, need to be made more coherent if one is to achieve a more sustainable and inclusive growth, as well to maintain a country or a region's competitiveness in the global economy.

In that context, ARTNeT launched an exploratory study on trade and investment policy linkages and coordination in 2007,[1] which included small-scale exploratory surveys of private sector stakeholders in three South-Asian countries (Bangladesh, Nepal and Sri Lanka). The purpose of the pilot surveys was to identify the needs and priorities for improved trade and investment policy coordination and coherence in these countries. Following a short overview of trade and investment linkages from an Asian perspective, this brief summarizes the key findings from the surveys and draws preliminary policy implications.

Trade and investment linkages and coordination in Asia

The link between trade and investment, particularly foreign direct investment (FDI), has been extensively discussed in the literature. As trade barriers have fallen over the past two decades in most parts of the world and as intra-firm trade between countries have increased, a strong relationship has been observed between foreign trade and investment flows, including in Asia. For example, Chaisrisawatsuk et al. (2007), studying the linkages between trade and FDI flows of ASEAN and OECD countries,[2] finds strong positive and self-reinforcing relationships between bilateral trade and FDI flows, with trade inducing FDI as well as FDI inducing trade – the latter to a lesser extent, however.

Figure 1 - Exports and FDI stocks in Asia (1999-2006)



Source: Duval (2008); data compiled from WITS, ITC trade-map and investment-map.

Notes: (1) N-E Asia: North-East Asia flows include only China; Hong-Kong, China, Taiwan Province of China; Rep. of Korea and Mongolia exports and FDI stocks:
(2) South Asia includes Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka.

Figure 1 illustrates this positive link between trade and investment in Asia, where sub-regions that exports most are also the ones where FDI stocks are highest. Interestingly, although the South Asian grouping includes the fast growing economy of India, manufacturing

[1] Some of the papers undertaken as part of the regional study are available in ESCAP (2007).

[2] Dataset included OECD and ASEAN-6 countries bilateral trade flows and bilateral FDI inflows from 1980-2004.

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exports from that region remain small compared to those of other Asian subregions. The figure also suggests that exports of South-East Asian countries might not be keeping up with those of North-East Asia.

At the regional level, the realization that trade, investment and other economic policies were inextricably interlinked has led governments in the region to rethink the way economic cooperation agreements were negotiated. The tendency is now to negotiate broader economic cooperation agreements and the many bilateral preferential trade agreements that have flourished in recent years in Asia include investment provisions (see, e.g., Kumar, 2007).

At the national level, although some forms of overall economic policy coordination mechanisms are in place in all countries, the extent to which trade and investment policies are actually coordinated, and the extent to which they are developed through inclusive consultations, often remain unclear. Information obtained from Asian ESCAP member countries during an ARTNeT Consultative Meeting in July 2007 shows that the institutional mechanisms vary greatly from country to country.[3] Four of the eleven developing countries who provided inputs - for example, Malaysia - appear to have one ministry or department responsible for both trade and investment policy issues, while others - for example, Thailand - deal with trade and investment through two distinct institutions.

In addition, consultations with the private sector appear to take place through chambers of commerce and business associations, implicitly assuming that those organizations are truly representative of the needs of the private sector, which may not always be the case. Finally, involvement of non-governmental stakeholders other than from the business sector seems limited in most of the countries, although experts from academia are involved in some of the apex policy planning bodies.

Importance of trade policies among investment-related policies

The discussion below is based on small scale perception surveys on trade and investment policy coherence that were conducted among investors, importers and exporters in three South Asian countries – Bangladesh, Nepal and Sri Lanka.[4] One important objective of the surveys was to identify the importance of policies other than investment policies and related investment promotion activities on investment. The results suggest that both trade and tax policies play a crucial role in influencing investors' decision to continue to invest (see table 1). Infrastructure and financial sector development as well as public governance are also perceived as very important by investors, followed by human resource development policies. In contrast, competition policies, corporate governance policies and responsible business conduct policies are ranked as relatively less important investment-related policies by investors in the three countries. Those results are broadly consistent with expectation, as these policies, and the last two in particular, may be seen as likely to reduce the freedom of investors.[5] In addition, the non-existence or weakness of these policies in the countries studied, as in many other developing countries in the region, may lead investors to undervalue their importance and potential benefits.

Table 1- Importance of selected policies for investors in three South Asian countries

Policies	BANGLA-DESH	NEPAL	SRI LANKA	*Overall Rank*
Trade Policy	1	1	2	*1*
Tax Policy	2	2	1	*2*
Infrastructure and Financial Sector Development	2	3	4	*3*
Public Governance	4	4	2	*3*
Human Resource Development Policies	4	4	4	*5*
Competition Policy	7	8	4	*6*
Corporate Governance Policy	7	4	7	*6*
Responsible Business Conduct Policies	4	7	8	*6*

Source: ARTNeT pilot surveys conducted by IPS, CPD and IPRAD, 2007

The difference in importance between the first four policy areas that may affect investors is not large, suggesting that investors on average value an integrated and balanced approach to the development of a favorable investment environment. This result points to the need for regular assessment of the various policy areas from investors' point of view to monitor which may be becoming the "weakest link" for investment.

The results of the exploratory surveys also suggest that the priority and importance of various components of a holistic/comprehensive policy framework are likely to vary substantially across stakeholder groups, including among investors themselves. For example, results from Bangladesh indicate that foreign investors put the same emphasis on trade and tax policies, while domestic investors emphasized mainly trade policy. Non-exporting domestic producers also stressed the importance of tax policy relative to trade policy, in contrast to exporters. Interestingly, multinational corporations seemed to perceive all policy areas as equally important, while other private stakeholders' ranking of the importance of policies varied much more substantially – the absolute ranking in importance of the policies remained similar, however.

The regular assessment of the various policy areas within an agreed comprehensive trade and investment policy frameworks, as suggested above, would therefore need to involve a balanced representations of the various investors (e.g., based on size and export orientation), as well as from consumer and other stakeholder groups which are likely to emphasize competition policies and corporate governance and social responsibility[6].

[3] See country notes at: http://www.unescap.org/tid/artnet/mtg/tipc.asp.

[4] The design of the initial survey instrument was inspired from the OECD Policy Framework for Investment (PFI), as this framework was thought to provide an appropriate basis for the development of more comprehensive and integrated trade and investment policy frameworks in countries of the region. The pilot survey/interview instrument is provided in Annex of Duval (2008).

[5] This argument is less compelling for competition policies as investors may assess these policies differently depending on market structure and their relative market dominance. Competition policies can indeed be seen as increasing investor's freedom to compete and enter into new markets.

Complementarity between trade and investment policies

The perception of the business sector stakeholders interviewed support the idea of complementarity between trade and investment, with 92%, 88% and 80% of respondents in Sri Lanka, Bangladesh and Nepal, respectively, agreeing that "policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment".[7] The perception of the business sector is consistent with findings based on econometric analysis [e.g., Chaisrisawatsuk et al. (2007)].[8] The differences in perception across the three countries may provide an indication of the business sector's readiness for further liberalization.

Satisfaction with trade policy measures for investment

While business sector stakeholders overwhelmingly recognize the importance of the trade and investment link, they generally indicate that they are only "somewhat satisfied" with trade policies and measures taken by their governments and which may affect investment (Duval, 2008). *Uncertainty and unpredictability of trade policy and regulations* (TPM1)[9] may be more of an issue in Bangladesh, while *Mechanisms in place to consult investors on planned changes to trade policy* (TPM2) appear to be of most concern in Nepal and Sri Lanka. Among the trade policy/regulatory areas included in the survey, *Customs, regulatory and administrative procedures at the border* (TPM3) is the one with which the Nepalese business sector seems to be least satisfied.

Government efforts to enter into market-expanding international trade agreements (TPM4) is the area in which the highest level of satisfaction is reached in Sri Lanka. Businesses also seem to be relatively more satisfied with *Government measures seeking to support overall trading activities* (TPM5), potentially suggesting that they find that these specific trade support measures (e.g., Government backed trade finance) may not significantly affect investment, as opposed to tackling broader systemic issues.

Stakeholders satisfaction with policies appear to also depend on the sector in which they operate. In particular, companies or representatives of traditional manufacturing sectors appear to be relatively more satisfied than the companies operating in fast-growing services sectors. For example, in Sri Lanka, 78% of the services companies in the sample agreed that the Government tended to be unpredictable and discouraged further investment, while government policy was only seen as a problem by 35% of the textile and clothing manufacturing companies.

Priority trade policy measures for investment

The priorities identified by the business sectors generally reflect quite directly their levels of satisfaction discussed earlier. The highest priority identified in both Nepal and Bangladesh is to reduce compliance costs of regulatory and administrative procedures. Reducing trade policy uncertainty and consulting investors and other interested parties also receive high priority.

Priority rankings in Sri Lanka are different, reflecting in part its higher level of economic development. Reducing regulatory compliance costs only comes fourth in terms of policy priority. Increasing trade policy predictability appears to be highest priority, with 90% of the business sector asking for this issue to be tackled as part of a national policy framework on investment. Implementation of trade policy measures that address sectoral weaknesses in the country is also seen as high priority, followed by the need to consult investors on planned trade policy changes.

Interestingly, results in all three countries indicate that "increasing investment opportunities through market-expanding international trade agreements" should receive a low priority relative to the other trade policy measures identified in the survey (i.e., TPM1, 2 ,3 and 5). This result is striking given the time and resources governments in the region have allocated in recent years to the negotiation of trade agreements, particularly and increasingly at the bilateral level, and puts into question the effectiveness and need for these agreements.

Conclusion and implications

Results presented above should be interpreted with caution as they are mainly based on small scale exploratory pilot surveys in three countries. More extensive and structured data collection efforts would be needed in the three countries studied, as well as in other countries in Asia, to confirm the results and draw strong policy conclusions for either individual country in the region. That being said, the three case studies suggest the following trade-related policy directions to improve trade and investment policy frameworks in developing countries of the region:

- Reduce uncertainty/increase predictability of trade policy as well as related policies. This can be achieved by increasing lead time and information provided to stakeholders before a policy change is made and making sure that the policy changes do not occur too frequently. Simplification of trade policies, for example by simplifying tariff schedules, may be helpful in this regard. More effective use of the WTO and its rules-based system could also be made as a means to lend predictability and irreversibility to trade policy-making and trade policy reforms.

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[6] It may be worth noting in that context, that it is unlikely that any government agencies could conduct this assessment in an unbiased manner, and that it may therefore be more appropriate to leave these assessments to independent research institutions to the extent possible.

[7] Chapter 3, OECD Policy Framework for Investment (PFI).

[8] While Lee and Lee (2007) also find exports and FDI to be generally complementary, they find the relationship between exports and FDI of Korean multinational firms to be more complementary when their affiliates are located in a less developed country – as opposed to in a developed country.

[9] TPM1-5: Trade Policy Measures suggested in the OECD PFI.

- Review existing institutional mechanisms in place for trade and investment policy making, and revise them as necessary to ensure more complementarity. The mechanisms should, to the extent possible, engage all relevant stakeholder groups in developing policies regularly and consistently. Relying on independent research institutions to identify private sector and consumer interests may be necessary given the difficulty associated with identifying representative organizations and samples. In the context of identifying consumers' interest, regional and comparative analysis of consumers' well-being (purchasing power in various sectors) may be highly relevant and could be facilitated by Governments.
- Allocate resources to strengthening policy implementation and enforcement, as opposed to developing new policies. For example, as suggested by the results in this study, reducing human and capital resources spent on negotiations of bilateral agreements and increasing resources that go into border trade management and facilitation may be considered in many developing countries in the region.
- Build capacity and develop institutional mechanisms to regulate emerging or fast-growing sectors, particularly in services. While many governments have significant experience in regulating the agricultural and manufacturing sectors that were gradually opening, many have much less experience dealing with fast growing and sometimes fast-opening national services sectors. Services sectors (e.g., health, transport, finance, and telecommunication) often involve ministries and agencies that have not been routinely or closely involved in international trade and investment policy issues, leading to a lack of coherence and policy predictability in these sectors.
- Take a holistic, as opposed to a narrow or negotiation's based approach to international trade and investment policy making. Business representatives surveyed perceived that many non-trade policy and non-investment policy issues affect their ability and willingness to trade and/or invest. Focusing more on developing business facilitation and competitiveness policies - regardless of whether the businesses are domestic or foreign owned – may actually be more effective in increasing trade and generating investment.

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