Asia-Pacific Research and Training Network on Trade
Working Paper Series, No. 55, May 2008

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

By

Yann Duval*

*Yann Duval, Trade Policy Section, Trade and Investment Division, ESCAP. A previous version of this paper was presented at and included in the official documentation of the OECD Global Forum on International Investment, Paris, 27-28 March 2008. The paper is based on findings from country case studies and surveys coordinated by the author and conducted by Bhattacharya, Debapriya and Tazeen Tahsina, Center for Policy Dialogue (CPD, Bangladesh), Jayawardhana, Tilani, Institute for Policy Studies (IPS, Sri Lanka) and Khanal, Dilli Raj and Prakash Kumar Shreshta, Institute for Policy Research and Development (IPRAD, Nepal), in their respective countries. Comments and suggestions received from Tiziana Bonapace, Michael Gestrin and Rien Sikkel among others, are gratefully acknowledged. The author may be contacted at duvaly@un.org

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Introduction

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, the Asia-Pacific Research and Training Network on Trade (ARTNeT)[1] launched an exploratory study on trade and investment policy linkages and coordination in 2007[2], which included exploratory surveys of private sector stakeholders in three South-Asian countries (Bangladesh, Nepal and Sri Lanka) on the need for improved trade and investment policy coordination and coherence based on the Policy Framework for Investment (PFI) developed by OECD. Following a short overview of trade and investment linkages from an Asian perspective, this paper summarizes the key findings from the exploratory surveys and draw preliminary policy implications.

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[1] ARTNeT is a network of policy research institutions in developing countries of Asia and the Pacific, with the Secretariat provided by UN-ESCAP and financial support provided by IDRC, Canada, WTO, UNDP and other core partners. See www.artnetontrade.org for details.

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

I. Trade and investment Linkages and Coordination: Some evidence from Asia

The link between trade and investment, particularly foreign direct investment, has been extensively discussed in the literature. FDI can be a substitute for trade, e.g., when a firm decides to invest and produce in a foreign country to serve customers in that country. FDI can also be a complement to trade as efficiency-seeking firms look for the best location from which to produce and export their products.

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, an ARTNeT study by Chaisrisawatsuk et al. (2007), studying the linkages between trade and FDI flows of ASEAN and OECD countries[3], 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 (see table 1).

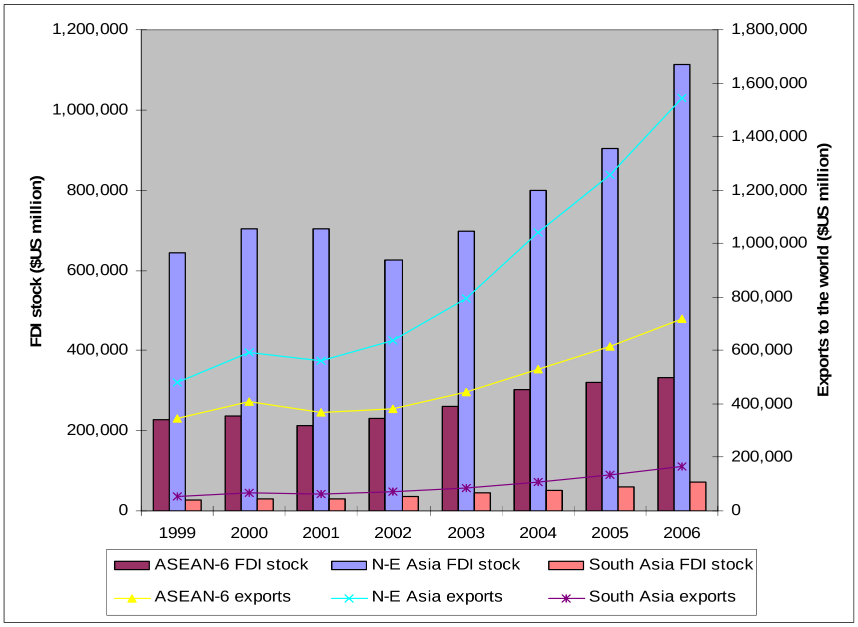
Table 1 - Summary of bilateral trade and investment relationships

	Effect of FDI inflow (FDI_{ij}) on Trade	**Effect of trade on FDI inflow (FDI_{ij})**
Total trade between home and host country	++	+++
Exports from home to host country (EX_{ij})	+	+++
Exports from host to home country (EX_{ji})	+	+
Imports of home from host (IM_{ij})	++	++
Imports of host from home country (IM_{ji})	++	+++
Exports from home country to ROW (EX_{io})	-	++
Exports of host country to ROW (EX_{jo})	--	+
Imports of home country from ROW (IM_{io})	+	+++
Imports of host country from ROW (IM_{jo})	+	++

Note: + and – signs represent the directions of the effect; the number of + or - signs for each relationship indicates the strength of the effect. ROW: rest of the world
Source: Chaisrisawatsuk et al. (2007)

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

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



Source: calculated by the author; 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 export and FDI flows; (2) South Asia includes Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka

Figure 1 illustrates this positive link between trade and investment flows in Asia, where sub-regions that exports most are also the ones where foreign direct investment flows are highest[4]. Interestingly, although the South Asian grouping includes the fast growing economy of India, manufacturing exports from that region remain small compared to those of other Asian sub-regions. The figure also suggests that exports of Southeast 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 re-think 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 now include investment provisions (see, e.g,, Kumar, 2007; Sauve, 2007).

At the national level, although some form 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 held in July 2007 show that the institutional mechanisms vary greatly from country to country (see Annex 1). Four of the eleven developing countries who provided inputs - for example, Malaysia - appear to have one reportedly 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.

[4] The figure also suggests that FDI lags exports by one to 2 years – e.g., the slowdown in export in 2001 seem to correspond to a slowdown in FDI inflows in 2003- , although this would need to be confirmed by a more rigorous analysis

All countries readily recognized the need for extensive consultations among ministries and agencies, as well as the private sector, in order to develop appropriate trade and investment policies. While little detail is available on the consultation processes in place in each country at this stage, it appears that consultations in some countries take place only at a relatively high level, thus possibly excluding relevant but less organized stakeholder groups in the discussion, such as small businesses, local governments, as well as unaware line ministries. In addition, consultations with the private sector appears 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-government stakeholders other than from the business sector seems limited in most of the countries, although experts from academia seem to be involved in some of the apex policy planning bodies.

II. Business perceptions on trade and investment policy coherence in Bangladesh, Nepal and Sri Lanka[5]

Small scale perception surveys were conducted among investors, importers and exporters in all three countries. 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 II.

A. On the importance of trade relative to other policies for investment

One important objective of the exploratory 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 investor’s decision to continue to invest (see table 2). 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[6]. 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.

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[6] 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 new markets.

Table 2- 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 the investor point of view to monitor which may be becoming the "weakest link" for investment.

The results of the exploratory survey 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, multi-national 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 from 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)[7].

B. On the 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% of Sri Lankan respondents, 88% of Bangladeshi respondents and 80% of Nepalese respondents agreeing that

[7] 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.

"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".[8] The perception of the business sector is consistent with findings based on econometric analysis, such as in Chaisrisawatsuk et al. (2007) and Lee and Lee (2007)[9]. The differences in perception across the three countries may provide an indication of the business sector's readiness for further liberalization.

C. On Businesses' 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.

Table 3 - Investors' satisfaction with trade related policies and measures

Private sector satisfaction with:	BANGLADESH	NEPAL	SRI LANKA	Average
The mechanisms in place to consult investors and other interested parties on planned changes to trade policy	2.2	**2.0**	**1.9**	***2.0***
The level of trade policy and regulatory certainty and predictability	1.9	2.4	2.0	*2.1*
The customs, regulatory and administrative procedures at the border and related compliance costs	**1.8**	2.1	2.4	*2.1*
The Government efforts to enter into market-expanding international trade agreements (including implementation of WTO commitments)	2.1	2.1	2.6	*2.3*
The measures seeking to address weaknesses in sectors of importance to traders (e.g., Gov. support to export finance and import insurance schemes)	2.2	2.3	2.5	*2.3*
Overall level of satisfaction	***2.0***	***2.2***	***2.4***	***2.2***

Note: 1=not satisfied; 2=some what satisfied; 3= satisfied; 4= very satisfied; 5= fully satisfied

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