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Investment Provisions in Regional Trading Arrangements in Asia: Relevance, Emerging Trends, and Policy Implications

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Executive Summary

Investment liberalization occupies an important place in the schemes of regional economic integration complementing trade liberalization to facilitate the process of restructuring of industry on more efficient lines. This restructuring enables fuller exploitation of the locational advantages or synergies between the member countries of the regional trading bloc besides facilitating businesses reaping the economies of scale and specialization. The Single Market Plan of the European Union has unleashed such a pattern of industrial restructuring not only European corporations but also the operations of foreign multinationals operating in the EU. Such restructuring also facilitates creation of supply capabilities in relatively poorer countries thus facilitating a convergence of levels of development.

In recent times, Asian countries have also started to attach a far greater importance to regional economic integration in their trade policy after decades of faithful adherence to multilateralism. A large number of free trade arrangements are taking shape in Asia at the sub-regional levels in Southeast Asia (ASEAN) and South Asia (SAARC) or between the sub-regional groupings and their dialogue partners and between the dialogue partners. There is also a discussion on building on these attempts and evolve broader grouping. Although many of Asian RTAs are early stages of their development, the trend is quite clear. Another noticeable trend is an increasing number of Asia-Pacific RTAs extend their scope to investments. Hence, there is recognition of the importance of investment liberalization for exploiting the full benefits of RTAs.

The investment provisions included in Asian RTAs have tended to follow progressive liberalization approach given the varying levels of development existing in the region. They also have included provisions on investment protection, promotion and facilitation, MFN and dispute settlement. Asia-Pacific RTAs are consistent with the provisions of multilateral disciplines on investment as enshrined in the WTO's TRIMs Agreement and have some times attempted to adopt a more ambitious approach to elimination of performance requirements.

ASEAN's attempt to progressively deepen regional economic integration through expedited schedules of implementation of AFTA, adoption of ASEAN Investment Area, ASEAN Industrial Cooperation (AICO) Schemes and Framework Agreement on Trade in Services indicate recognition of the potential of industrial restructuring by the grouping. ASEAN has also facilitated economic integration with other Asian countries by bring them together as dialogue partners. This process has led to a number of bilateral FTAs that together form an emerging virtual community. However, due to varying scope and coverage of trade and investment rules in these initiatives, they hardly provide a seamless market to the region's enterprises for facilitating efficiency-seeking industrial restructuring.

The approach of India towards regional economic integration in Asia, and the place of investment provisions in it, is also discussed in the paper. India has accorded due place to regionalism in its trade policy. Besides participating in sub-regional economic integration in South Asia, India has engaged ASEAN and other East Asian countries as a part of the Look East Policy since 1991 that have resulted a number of RTAs/FTAs involving ASEAN as a group and several ASEAN countries, China, Japan and South Korea. The recent

RTAs/FTAs being pursued by India with Asian countries include investment provisions and have led to significant industrial restructuring already.

It is imperative that these attempts to deepen regional integration are viewed as building blocs of a broader Asian Community. The launch of East Asia Summit (EAS) bringing together leaders of ASEAN and its six dialogue partners viz. Japan, China, Korea, India, Australia and New Zealand, provides an important forum for initiatives towards creating an East Asian economic space. By providing a framework for removing trade and investment barriers, a Comprehensive Economic Partnership of East Asia (CEPEA) has the potential of unleashing a process of efficiency-seeking restructuring across countries in Asia and facilitating exploitation of their locational advantages or synergies for mutual benefit.

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I. Introduction

Regional economic integration has been a most striking trend of the 1990s led by Single European Market by European Union in 1992 and North American Free Trade Agreement (NAFTA) in 1994. These RTAs pursued a deeper type of integration covering preferential free trading arrangements complemented by investment liberalization across the region. The level of economic integration was progressively deepened and coverage of RTAs expanded over time. Thus EU progressively evolved into an economic union and then a monetary union with a single currency while expanding the membership to cover 27 countries and possibly more.

A major motivation for pursuing deeper regional economic integration has been to facilitate restructuring or rationalization of industry across the region on the most efficient basis so as to exploit the economies of scale and specialization and strengthen the competitiveness of their industries. These RTAs have over time become major factors in shaping global patterns of trade, foreign direct investments (FDI), production, and competitiveness. As they began to account for the bulk of global trade, other regions also started to evolve their own schemes of global economic integration.

Asian countries which had continued to follow multilateralism all along very faithfully, began to respond to the trend of regionalism towards the late-1990s. The East Asian Crisis of 1997 provided a much needed stimulus for regional economic integration in the region. The ASEAN countries expedited the programme of implementation of ASEAN Free Trade Area (AFTA) from 2008 to 2002 and moved on to further deepen the economic integration. Japan revised its trade policy in 1999 giving a due place to regional economic integration and concluded its first FTA with Singapore. Other Asian countries also followed the trend. In particular, ASEAN facilitated the trend of regional economic integration by bringing all major Asian countries viz. Japan, China, India, Republic of Korea, and Australia and New Zealand together as dialogue partners. This has led to ASEAN+1 FTAs evolving between ASEAN countries and the dialogue partners besides a number of FTAs between the dialogue partners themselves such as those under negotiation between India and Republic of Korea and India and Japan. South Asian Association for Regional Cooperation (SAARC) has also adopted a SAFTA in 2004 which is being implemented from 2006 over a ten year period. India has been a part of this emerging trend of RTAs and FTAs in Asia. Besides being a part of SAFTA, it is evolving bilateral FTAs with a number of Asian countries. It considers these sub-regional and bilateral initiatives as building blocs of a broader Asian economic integration and has a vision of an Asian Economic Community.

The East Asian cooperation led to the launch of several regional initiatives such as the Chiang-Mai Initiative which brought together ASEAN plus three countries viz. Japan,Republic of Korea and China. Another initiative of interest is the launch in December 2005 of the East Asia Summit (EAS) as an annual forum of dialogue on regional affairs bringing together leaders of ASEAN10, Japan, China, Republic of Korea, India and Australia and New Zealand. Bringing together leaders of 16 largest and most dynamic economies of Asia, EAS is likely to provide a forum to launch a broader Asian community. Asia has therefore finally woken up to the importance of regional economic integration for its development and to respond to the challenge thrown by the worldwide trends. The emerging Asian regionalism has to be accompanied by investment liberalization to enable region's businesses to rationalize their operations to exploit the locational advantages or synergies for mutual benefit.

Against that backdrop, this paper begins by summarize the conceptual rationale for investment liberalization to fully exploit the potential of regional trading arrangements. It goes on to examine the treatment of investment in emerging FTAs/RTAs in the Asia-Pacific region and the specific investment provisions and their consistency with the existing multilateral provisions on investment viz. WTO's TRIMs Agreement. The provisions of ASEAN framework on investment area and industrial cooperation are summarized in Section 4. Section 5 briefly examines the trends in India's RTAs policy in Asia and the emerging patterns of efficiency-seeking industrial restructuring unleashed by it. Finally Section 6 concludes with a few remarks on the importance of a broader framework for regional economic integration.

1.1 Relevance of Investment Liberalization in Regional Trading Arrangements: Lesson from European Economic Integration

Foreign direct investment (FDI) has a close relationship with the process of regional economic integration. By extending the effective size of the market by linking the partner countries, RTAs strengthen the investment climate for investors from outside the region. The EU has increased its share in global FDI inflows following the formation of the Single market from nearly 30 per cent in 1980s to about 50 per cent in 1990s and has stayed there.[1] More recent studies show that Mexico has seen a sharp rise in FDI inflows since becoming a part of NAFTA from US$ 12 billion per year on average during 1991-93 to US$ 54 billion during 2000-02.[2] A number of quantitative studies conducted in inter-country contexts have also found strong association between membership in RTAs and FDI inflows.[3] However, market extending (or enlargement) effect is only one and a relatively minor effect of RTAs. It is argued here that a more important effect of RTAs is strengthening of overall competitiveness of the region forming it through extensive industrial restructuring or rationalization across the region. This process of efficiency-seeking industrial restructuring is accomplished by intra-regional FDI. It is not a coincidence that the new age RTAs or FTAs generally extend their scope beyond trade to include investment liberalization and facilitation.

The trend of 'new regionalism', as the phenomenon is described to distinguish it from the earlier wave of shallow regional economic cooperation, was clearly motivated by the desire to strengthen the competitiveness of their industries is evident from the case of the EU. The major motivation of formation of the Single Market was not promotion of intra-regional trade as is commonly understood. The intra-regional trade was already quite high in the EU before the Single Market Plan and MFN tariffs were quite low and were nearly zero for intra-EU trade. The deeper regional economic integration was undertaken to facilitate restructuring or rationalization of industry across the region on the most efficient basis so as to exploit the economies of scale and specialization. The Cecchini Report commissioned by the European Commission which provided the basis for the White Paper on the Single European Market had empirically established that the European economies were losing substantially in welfare terms by not cooperating between themselves. The projected gains from industrial restructuring to exploit economies of scale and increased competition within the EU were estimated to be of the order of 3.7 per cent of GDP.[4]

The efficiency-seeking industrial restructuring is facilitated by liberalization of trade and investment regimes as a part of regional trading arrangements that enables free movement of goods across borders facilitating internal restructuring by removing the need to maintain horizontal national operations for multinational enterprises (MNEs). Therefore, MNEs restructure their operations by assigning the responsibility for serving specific regional or even global markets in particular product lines to certain affiliates. This strategy is sometimes called product mandating and results from the efficiency seeking restructuring or specialization within the MNE. The EU integration as also facilitated industrial restructuring of European businesses by adopting a statute of a European Company (*Societas Europaea*, S.E.) and through another legal instrument called the

[1] See Kumar 1994; UNCTAD 2006
[2] see Kose et al. 2004
[3] see e.g. Kumar 2000; Medvedev 2006, among others.
[4] See Cecchini (1988).

European Economic Cooperation Agreement (EECA). The latter is a form of cooperation between two or more firms which become a single body corporate with the aim of furthering the business activities of the participating firms.[5]

The formation of Single European Market has led to a substantial restructuring of industry to seek efficiency or competitiveness. The restructuring takes the form of specific subsidiaries receiving their parent's mandate for specific goods or services for the given markets. The product mandates are given for the entire regional market in the specific product lines. For instance, Unilever decided to make all its dishwasher powder meant for European market at its Lyons (France) plant and all its toilet soap for Europe at Port Sunlight (UK) in preference to smaller plants catering to each individual market in the entire range of products.[6]

The Single Market Plan of the European Union has also prompted extensive industrial restructuring of American and Japanese MNEs operating in the EU to restructure their operations on a pan-European basis. For instance, IBM has reorganized its operations in pan-European basis with IBM UK looking after PCs, IBM Germany, mainframe computers and manufacturing industry; IBM France, telecommunications, and IBM Italy, mid-range machines. Thus this type of restructuring enables the enterprise to exploit the economies of scale and specialization. The location for specific product mandates is chosen on the basis of the advantages a particular country has for the particular activity. These could include factor availability and their prices, agglomeration economies and other locational advantages.[7] Quantitative studies conducted in the inter-country contexts have also found strong evidence of the role of RTAs in shaping the patterns of export-oriented investments made by US and Japanese MNEs across countries to exploit the potential of efficiency-seeking industrial restructuring.[8]

The studies on the existing RTAs have shown that in the deeper type of integration, the biggest beneficiaries are relatively poorer or lesser developed economies because of migration of industry to them helping their economy converge with those of more developed ones. It is evident that poorest economies of EU, viz. Spain, Portugal, Greece and Ireland have rapidly converged with more developed economies of the region such as Germany, France or the UK. Although resource transfers have also played a role, investment restructuring (such as relocation of production to low wage locations within the EU) has played an important role bringing about this convergence. It is also clear that investment liberalization becomes a key to facilitate the process of industrial restructuring[9]. The barriers to investment flows may not allow the full benefits to be reaped from the regional trade liberalization.

1.2 Regional Trading Arrangements in Asia-Pacific and Treatment of Investment

As observed earlier, Asian countries have been rather late entrants in exploiting the potential of FTAs/RTAs. According to data compiled by the Asian Development Bank, Asian countries were involved in only 35 FTAs –bilateral as well as plurilateral- and with regional as well as outside the regional partners in 2000. However, there is an indication that once started, Asian countries are fast catching up in the trend of signing FTAs/RTAs. By the end of 2006, Asian countries were involved in as many as 191 FTAs/ RTAs between themselves or with the outside world. The bulk of these FTAs/RTAs are at different stages of evolution and many of them may take years to implement their provisions. But the trend is clear that Asia has woken up to the

[5] See Kumar (1994) for more details.
[6] see Kumar, 1994, for illustrations.
[7] see Dunning, 1998 for a typology of restructuring; Kumar 1994, 2001; Cool and Walters 1992, for a detailed analysis and case studies.
[8] See Kumar 1998, 2002, for evidence.
[9] Also see UNCTAD (2006) for a discussion.

potential of bilateral and regional arrangements like other regions to supplement trade liberalization in the multilateral framework.

As the focus of this paper is on RTAs of Asia-Pacific countries, we leave out FTAs initiated by Asia-Pacific countries with countries outside the region e.g. Singapore-US, or Australia-US. The FTAs initiated by Asian countries within Asia whether bilateral or plurilateral- are summarized in Table 1. It is apparent that they have been involved in 84 FTAs with other regional partners. As many as 26 of these agreements have been notified to WTO and 58 were in different stages of their evolution. Patterns across sub-regions suggest that countries in Central and West Asia were integrating between themselves with 17 FTAs. The other sub-regions such as East Asia, Southeast Asia and South Asia were integrating across the sub-regions. It is clear from as many as 12 FTAs between East Asia and Southeast Asia and 10 between Southeast and South Asian countries. The East Asian and Southeast Asian countries are also having 12 FTAs with the Pacific nations. These three sub-regions of Asia viz. East, Southeast and South Asia and the Pacific seem to be integrating with each other which might eventually lead to formation of a broader community.