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ASEAN and FTAA: External Threats and Internal Institutional Weaknesses

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Abstract

ASEAN countries perceive the possible formation of the FTAA as a potential threat on the grounds that it may divert export markets and foreign direct investment (FDI) capital to the FTAA region. This effect, together with the "China factor" and the hangover from the 1997 financial crisis, posts a concern to the ASEAN countries' economic growth. We show that, with Singapore as an exception, ASEAN countries are afflicted with state activism, poor property rights protection, and under-developed corporate governance. We argue that a poor institutional environment may exacerbate the effects of an external shock – such as that of FTAA – and thus we need to explicitly incorporate the role of institutional environments in our analysis. We further argue that while FDI flows to locations with market opportunities, a location's institutional environment affects the composition of FDI. Due to ASEAN countries' institutional weakness, its substantial inward FDI has mainly substituted, rather than complemented, local entrepreneurship. As FTAA may divert FDI flows into ASEAN countries, their appropriate response is to improve institutional quality so that the share of the more productive complementary FDI will increase in the total FDI inflows.

1. Introduction[1]

In this article, we evaluate ASEAN countries' concern that the potential FTAA may pose a competitive threat – in that the FTAA may divert trade and investment from the region. After discussing the validity of the concern based on trade patterns and FDI/GDP ratios, we point out that the FTAA is only one of a tripartite threat facing the ASEAN countries. A recent World Bank report, East Asia Integrates, points out that the most defining economic events of historic proportions have been the financial crisis of 1997-98 and China's WTO accession (World Bank, 2003, pp.1-2). Thus any effects arising from FTAA are likely to be compounded by these two additional events in the region, which underscores the severity of the future challenges to the region.

These problems lead us to a more fundamental concern – the low institutional quality of ASEAN countries. With an important exception of Singapore, ASEAN countries are afflicted with state activism, poor property rights protection, and underdeveloped corporate governance. There is solid empirical evidence for this claim. For example, Johnson et al (2000) suggest that poor property rights and corporate governance is an important contributing factor of the Asian financial crisis. Indeed, institutional quality has unfortunately not improved in some ASEAN countries since the 1997 financial crisis. We do not claim that good institutions are a panacea for all economic problems, far from it. As evidence, Singapore, with strong institutions, has experienced substantial economic difficulties in the recent years.[2] Our point is that good institutions may ameliorate the severity of the external shocks.

The conventional wisdom is that FDI flows to locations with immediate and future market opportunities and inexpensive inputs. We add the argument that the composition of FDI matters. FDI can substitute for, or complement, local entrepreneurship. The former type has little growth impact while the latter has a lot. While a location with poor institutions may still attract considerable inward FDI, it tends to attract the substitution type. To the extent that FTAA may have an investment diversion effect, the right policy response ought to aim at improving the growth impact of investment – whether foreign or domestic – in order to better

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[1] This paper was originally prepared for IDB/LAEBA Dec 2003 Conference "FTAA and Transpacific Business Linkages: Implications for Japan and East Asia." We are most grateful for the helpful comments by Drs. Antoni Estevadeordal and Simon Evenett, and two anonymous referees. All errors are ours.

[2] We thank a referee for reminding us of this fact.

withstand a possible FDI contraction. One such a policy response, we argue, is to improve institutional quality so as to increase the share of complementary FDI in the FDI composition.

The concern about institutional environment is shared by the recent social science literature, including papers in this special issue. For example, Vial (2004) points out the crucial role of institutions in economic growth. He suggests that FTAA can help to improve Latin American countries' internal institutions in part because provisions in FTAA can raise the incentives for Latin American countries to upgrade their internal institutions. Henisz (2004) emphasizes the importance of political institutions and its relationship with trans-pacific business linkages. He points out how political institutions affect multinational's choices of where to invest and how to organize their investment. His arguments and ours share a similar underlying thought – economic reform is a political economy issue. In the economics literature, Levine (2002) and Durnev et al (2004) both show that growth, especially productivity growth, is associated with a good institutional environment.

Our paper is organized as follows. In the next section we start with a quick survey of ASEAN economies. We show that ASEAN economies, except Singapore, are relatively poor and heavily reliant on trade and FDI. Hence, their concern about the trade/FDI diversion effect of FTAA is quite legitimate. The third section describes the actual and potential tripartite threats facing the ASEAN regions – FTAA, the China factor, and the 1997 financial crisis. It is difficult to precisely assess empirically the net effect of FTAA and the rise of China on ASEAN countries because FTAA and China may represent both a positive market opportunity effect and a negative FDI/trade diversion effect. We accept the general proposition that the diversion effect could be large enough to warrant policy concerns and for this reason we focus on the threat – rather than the opportunity – dimension of the question in this paper.[3]

In the fourth section, we provide empirical evidence that ASEAN countries – Singapore being a prominent exception – have poor institutional environments. We also provide well-documented findings that poor institutions reduce growth and increase the macroeconomic volatility. Some of these findings, it should be noted, are specifically drawn from data on ASEAN countries. ASEAN countries, despite their institutional problems, have attracted FDI and become more dependent on it for growth. We account for this high FDI

[3] One could argue, for example, that even if the market opportunity effect is large the export composition of ASEAN is likely to be different with the FTAA/China factor than without this factor. Thus there are re-structuring issues here even if the net effect of FTAA/China factor is positive.

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dependency by distinguishing between two kinds of FDI – FDI which substitutes for local entrepreneurship and FDI which complements local entrepreneurship. We argue that poor institutions affect the composition of FDI in favor of the FDI that substitutes for local entrepreneurship.

The fifth section offers a tentative conjecture that ASEAN countries may prefer trade expansion measures – as opposed to institution reforms – as a response to external threats such as FTAA and the rise of China. We argue that these policy measures, while a rational strategic response, will have a greater salutary effect if coupled with institutional reforms. But we are not sanguine that institutional reforms will happen, as indicated by the preliminary evidence on these issues. The sixth section concludes.

2. Some basic facts about ASEAN economies

We provide a brief profile of ASEAN economies here. ASEAN countries, while not homogeneous, share some economic commonalities. Many ASEAN economies have only a small domestic market with limited internal investment; they depend heavily on exports and inward FDI. Except for Singapore, they rely on natural resources, or basic unskilled or at best semi-skilled manufacturing. Given such an economic profile, their policy concerns about the formation of FTAA – the fear that FTAA shrinks their export opportunities and diverts FDI capital from them – are quite understandable.

We begin with the observation that ASEAN countries are poor non-industrialized countries whose GDP per capita falls below $3,000, with the exception of Singapore with a 2001 GDP per capita of $20,847, and oil-rich Brunei with a 2001 GDP per capita of $12,245. Malaysia only barely broke the $3,000 line in 2001. The poorest country is Cambodia with a per capita GDP of only $270 in 2001. Except for Singapore and Malaysia, these countries' major employment sector is agriculture, forestry, hunting, and fisheries. As of 2000, manufacturing accounted for more than 20% of employment in Singapore and Malaysia, but barely 20% of employment in Vietnam, 14.5% in Thailand, 13% in Indonesia and less than 10% for the rest of ASEAN countries. Other than Singapore, ASEAN countries are not known to have considerable endowment in managerial skills and technology.

As a group, the economies of ASEAN are highly trade-dependent. Table 1a and Table 1b show their exports and imports data, total GDP and exports and imports destinations. Before the Asian financial crisis, their exports/GDP was about 46% while their imports/GDP is about 49%. After the Asian financial crisis, their GDP declined while exports continued to grow. Hence, the exports to GDP

ratio climbed to 71% in 2000. The ASEAN countries' imports dropped, but not as much as the GDP decline, and imports bounced back in 2000. Hence, the imports to GDP ratio also rose after the crisis reaching 62% in 2000. The upshot is that the ASEAN countries have grown more dependent on trade, particularly on exports, after the Asian financial crisis.

Table 1A. Total Exports of ASEAN to its Trading Partners, By Country of Destination and Year During 1993-2000 ($million)

	1993	1994	1995	1996	1997	1998	1999	2000
Total exports	**209,626.5**	**250,818.9**	**296,696.7**	**330,617.2**	**351,570.1**	**326,011.8**	**354,293.1**	**410,986.1**
Total GDP				**723,468**	**694,045**	**473,216**	**546,071**	**577,776**
Exports/GDP				**0.4570**	**0.5066**	**0.6889**	**0.6488**	**0.7113**
Country of Destination								
ASEAN	**43,681.1**	**58,571.5**	**70,178.9**	**80,973.7**	**85,351.8**	**69,312.9**	**74,698.9**	**90,440.8**
ASEAN /total	**21.14%**	**23.74%**	**23.65%**	**25.04%**	**24.91%**	**21.89%**	**21.90%**	**23.20%**
Dialogue Partners	**122,711.1**	**140,528.8**	**167,737.7**	**189,713.1**	**211,577.8**	**194,068.9**	**217,140.5**	**242,699.3**
Hong Kong				10,571.0	20,069.2	16,162.7	16,843.2	21,559.9
South Korea	6,125.9	7,005.1	8,574.4	9,446.7	10,667.8	7,813.0	10,878.3	14,145.2
China	4,528.7	5,303.8	6,200.9	7,474.1	9,167.9	9,202.6	9,564.1	12,222.7
India	1,484.0	1,989.5	2,821.1	3,722.8	4,473.2	5,217.9	5,577.2	6,182.9
HK+Kor+Chi+India	**12,138.6**	**14,298.5**	**17,596.3**	**31,214.6**	**44,378.0**	**38,396.2**	**42,862.8**	**54,110.7**
HK+Kor+Chi+India %	**5.87%**	**5.79%**	**5.93%**	**9.65%**	**12.95%**	**12.13%**	**12.57%**	**13.88%**
Japan	**129**	**34,299.6**	**42,680.7**	**43,150.3**	**42,008.6**	**34,716.8**	**37,628.6**	**51,982.8**
Japan/total	**14.98%**	**13.90%**	**14.39%**	**13.34%**	**12.26%**	**10.96%**	**11.03%**	**13.34%**
EU-15	**31,391.5**	**35,196.4**	**44,285.9**	**46,926.0**	**46,086.7**	**46,143.6**	**55,651.3**	**57,555.0**
EU-15/total	**15.19%**	**14.26%**	**14.93%**	**14.51%**	**13.45%**	**14.57%**	**16.32%**	**14.77%**
Belgium	1,419.0	1,893.8	2,353.5	2,739.8	2,861.0	1,683.7	1,442.5	1,676.6
Denmark	318.5	458.4	666.3	674.0	923.6	314.1	500.3	344.9
Finland	156.7	210.6	263.5	418.2	610.7	309.5	317.1	435.5
France	2,460.2	2,898.2	4,236.5	4,915.9	4,663.4	1,404.1	1,397.9	3,357.7
Germany	6,414.3	7,618.0	10,217.6	10,728.5	9,714.2	4,014.8	5,500.0	6,192.9
Greece	264.5	283.4	442.3	1,073.9	456.6	212.5	168.0	161.1
Ireland	638.2	933.1	1,539.6	1,732.5	2,420.5	492.7	665.5	2,614.0
Italy	1,683.7	1,926.7	2,687.5	3,796.4	2,112.7	1,441.4	3,392.2	1,355.5
Luxembourg	17.7	20.9	28.5	48.2	0.0	0.1	0.5	0.7
Netherlands	4,508.3	5,693.1	7,587.8	7,703.4	8,151.9	5,626.3	6,885.3	7,092.5
Portugal	133.4	133.7	191.5	237.5	145.8	92.0	89.7	1,960.6
Spain	824.8	1,122.1	1,670.5	3,328.3	1,844.8	1,234.7	1,118.4	1,300.2

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Sweden	297.2	333.3	379.1	882.8	422.9	266.6	2,199.4	511.2
United Kingdom	11,971.5	11,374.0	11,761.7	8,275.7	11,368.0	11,091.9	14,617.9	10,904.4
Canada	1,958.7	2,155.1	2,239.8	1,988.2	1,881.9	2,314.7	2,248.2	2,271.4
USA	**42,008.2**	**49,370.7**	**54,993.7**	**59,515.5**	**70,030.4**	**64,620.0**	**70,003.4**	**67,685.0**
USA/total	**20.33%**	**20.01%**	**18.54%**	**18.41%**	**20.44%**	**20.41%**	**20.52%**	**17.37%**
Australia	3,696.5	4,511.8	5,179.1	6,106.0	6,418.4	7,120.3	7,854.1	7,973.4
New Zealand	565.3	696.8	762.2	812.5	773.8	757.4	892.2	1,121.0
Others	**40,244.9**	**47,664.5**	**58,780.1**	**52,674.5**	**45,740.5**	**53,269.0**	**49,227.5**	**56,618.2**
Total	**206,637.2**	**246,764.7**	**296,696.7**	**323,361.3**	**342,670.1**	**316,650.8**	**341,067.0**	**389,758.3**

Source: ASEAN Trade Statistics Database based on period average exchange rate, converted to millions of US$ using the period average exchange rate. Myanmar figures are calculated using the exchange rates as used in the IMF-WEO Database of October 2001
Note: Thailand exports for 2000 cover only quarter 1 to quarter 3.

Table 1b. Total Imports of ASEAN from its Trading Partners, by Country of Origin and Year During 1993-2000 (in $mill.)

	1993	1994	1995	1996	1997	1998	1999	2000
Total Imports	**226,300.2**	**271,295.8**	**325,494.3**	**357,862.1**	**364,871.8**	**268,817.9**	**294,129.2**	**360,148.4**
Total GDP				**723,468.2**	**694,045.0**	**473,216.5**	**546,070.6**	**577,776.1**
Imports/GDP				**0.4946**	**0.5257**	**0.5681**	**0.5386**	**0.6233**
Country of Destination								
ASEAN	**38,763.3**	**46,911.9**	**53,602.1**	**64,211.2**	**64,621.2**	**51,604.9**	**56,781.4**	**69,150.7**
ASEAN/total	**17.36%**	**17.55%**	**16.83%**	**18.31%**	**18.15%**	**19.89%**	**20.32%**	**21.26%**
Dialogue Partners	**141,819.6**	**170,537.0**	**202,006.8**	**226,698.9**	**237,205.0**	**167,840.6**	**174,167.9**	**198,449.3**
Hong Kong				5,355.9	8,671.2	6,386.9	7,000.1	8,145.0
South Korea	7,148.1	9,035.5	11,345.6	13,294.4	14,857.4	9,267.4	12,109.9	14,470.7
China	4,336.4	5,759.0	7,129.7	9,217.6	13,482.9	11,211.5	12,184.2	16,840.1
India	1,429.6	1,547.0	1,838.4	2,843.8	4,395.5	1,750.4	2,082.4	2,978.5
HK+Kor+Chi+India	**12,914.1**	**16,341.5**	**20,313.7**	**30,711.8**	**41,406.9**	**28,616.3**	**33,376.7**	**42,434.2**
HK+Kor+Chi+India %	**5.78%**	**6.11%**	**6.38%**	**8.76%**	**11.63%**	**11.03%**	**11.94%**	**13.04%**
Japan	55,702.9	67,302.5	78,535.2	73,310.1	71,264.2	46,693.7	51,244.1	61,404.9
Japan/total	**24.94%**	**25.18%**	**24.65%**	**20.91%**	**20.02%**	**18.00%**	**18.34%**	**18.88%**
EU-15	31,822.4	38,729.3	46,392.8	57,380.5	51,009.8	33,256.1	34,675.5	36,934.8
EU-15/total	**14.25%**	**14.49%**	**14.56%**	**16.37%**	**14.33%**	**12.82%**	**12.41%**	**11.35%**
Austria	505.5	517.6	760.6	1,032.9	909.1	856.2	416.6	531.1
Belgium	1,195.0	1,640.8	2,313.0	2,641.2	2,408.4	705.7	613.2	901.0
Denmark	419.7	461.6	628.4	1,074.9	681.4	191.4	142.0	198.1
Finland	780.1	863.2	873.0	1,386.2	1,451.6	701.4	597.6	759.8
France	3,632.1	4,873.1	7,081.7	7,236.2	7,763.5	1,705.2	1,718.1	2,152.6
Germany	7,014.6	10,309.5	15,040.1	16,739.9	14,821.5	5,001.9	4,538.7	4,656.6
Greece	36.9	83.0	124.8	326.4	107.5	26.8	40.8	27.3
Ireland	226.2	513.1	830.5	1,288.5	1,068.3	641.3	1,144.6	957.2
Italy	2,384.7	3,230.6	4,589.6	7,795.0	4,738.2	1,292.9	1,082.0	1,157.1
Luxembourg	29.4	37.5	51.1	13.0	1.6	0.4	0.6	1.9
Netherlands	2,004.1	2,442.9	3,056.1	3,176.0	3,151.2	1,085.7	1,048.9	2,058.4
Portugal	58.5	78.4	94.6	168.1	116.9	21.8	1,221.2	12.6
Spain	638.8	729.3	1,219.2	3,087.2	1,370.5	368.6	431.9	413.2
Sweden	1,224.6	1,436.2	1,613.7	3,056.2	2,714.9	739.0	1,091.4	1,104.8
United Kingdom	11,672.1	11,512.6	8,116.4	8,358.8	9,705.0	5,820.8	6,463.3	6,751.6
Canada	1,552.8	1,717.0	2,290.8	2,445.6	2,568.0	1,766.7	2,078.0	2,035.2

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USA	**33,712.7**	**39,201.7**	**46,435.1**	**53,011.4**	**61,695.0**	**50,942.2**	**45,962.0**	**46,315.3**
USA/total	**15.10%**	**14.67%**	**14.58%**	**15.12%**	**17.33%**	**19.63%**	**16.45%**	**14.24%**
Australia	5,392.1	6,447.0	7,173.4	8,688.8	7,963.9	5,702.1	6,081.4	8,345.2
New Zealand	722.6	797.9	865.9	1,150.8	1,297.1	863.5	750.1	979.6
Others	**42,727.9**	**49,792.7**	**62,945.9**	**59,696.1**	**54,145.6**	**40,011.5**	**48,510.7**	**57,705.0**
Total	**223,310.8**	**267,241.6**	**318,554.8**	**350,606.2**	**355,971.8**	**259,456.9**	**279,459.9**	**325,304.9**

Source: ASEAN Trade Statistics Database based on period average exchange rate, converted to millions of US$ using the period average exchange rate. Myanmar figures are calculated using the exchange rates as used in the IMF-WEO Database of October 2001
Note: Thailand exports for 2000 cover only quarter 1 to quarter 3.

The concern about FTAA is that it will decrease the demand for ASEAN exports from the United States. This concern may be valid. Our data show that while intra-ASEAN trade is of growing importance, ASEAN countries' major export markets are the U.S., Japan, and the EU. To facilitate our discussion, we present ASEAN countries' bilateral trade patterns in Figures 1a, 1b, 2a, and 2b, which show, respectively, in pie charts ASEAN countries' exports destination and imports sources in 1996 and 2000.

Figure 1a: Share of Exports of ASEAN by Country of Destination, 1996

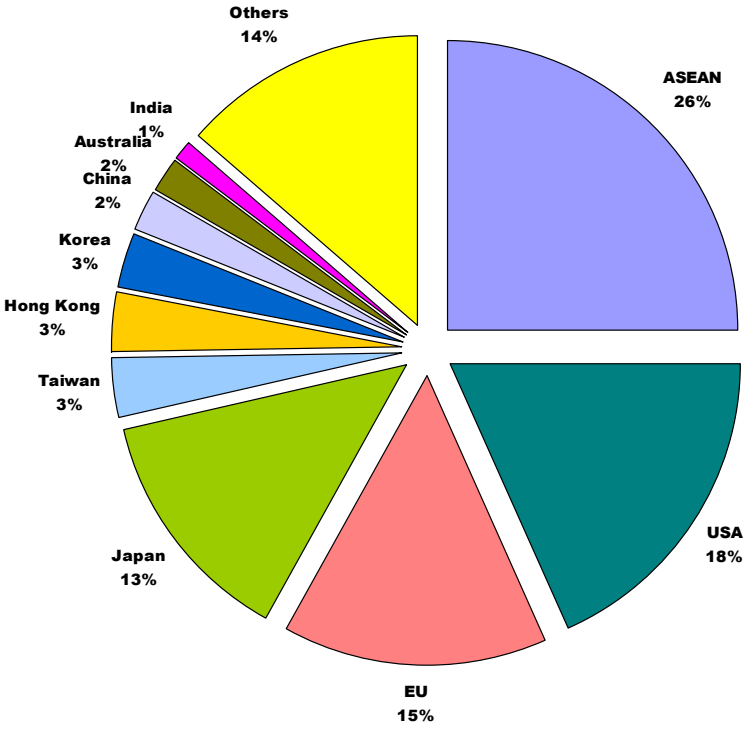


Figure 1b. Share of Exports of ASEAN by Country of Destination, 2000

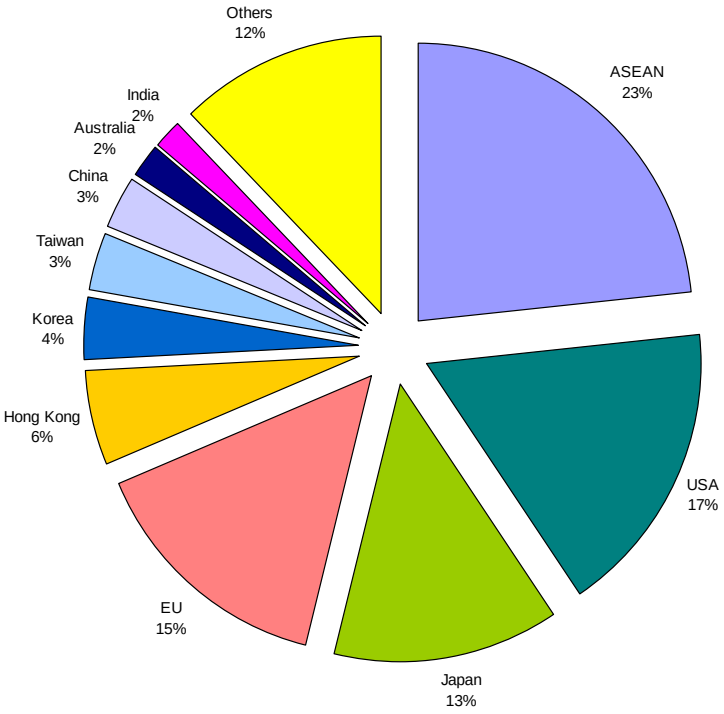


Figure 2a. Shares of Imports of ASEAN by Country of Origin, 1996

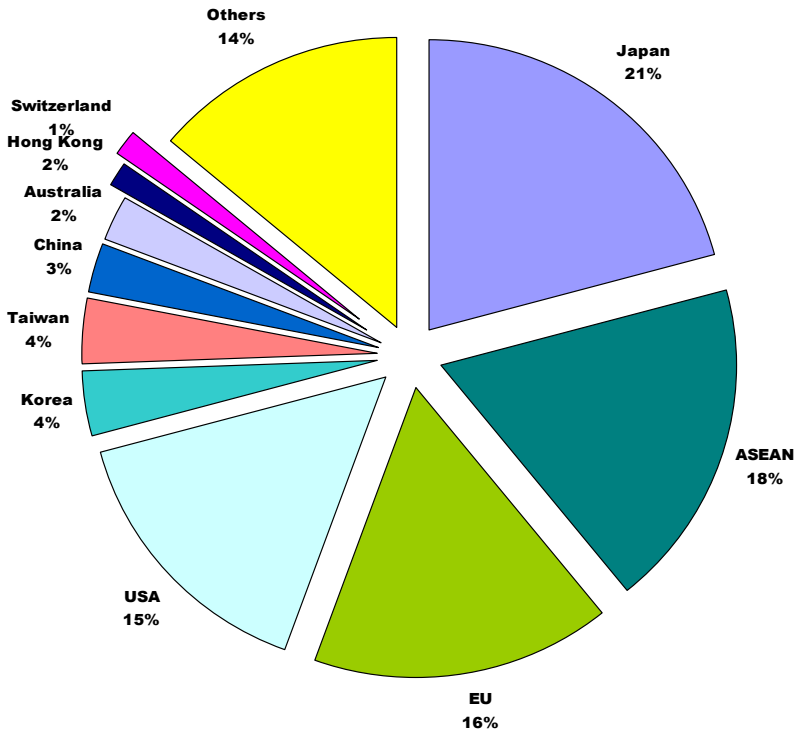
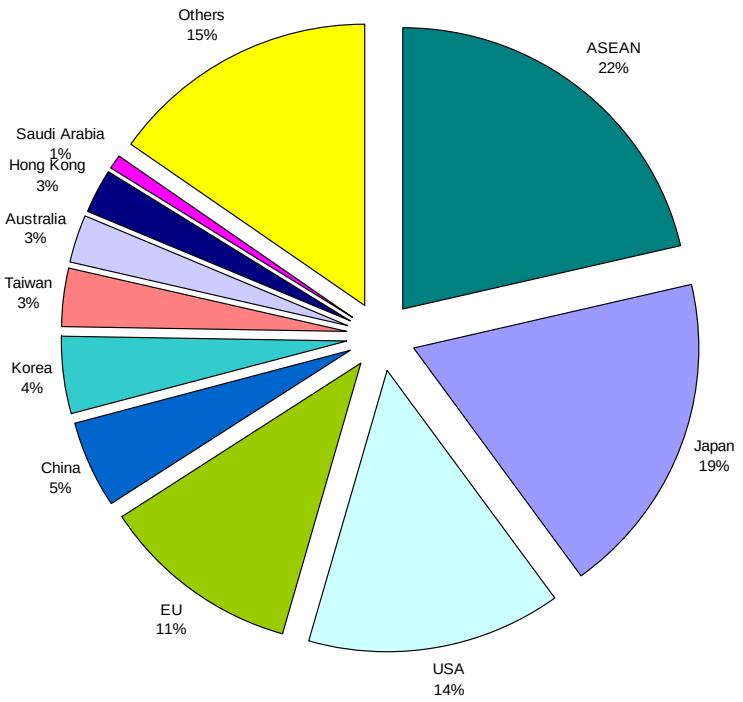


Figure 2b. Shares of Imports of ASEAN by Country of origin, 2000



The figures illustrate the following. First, the ASEAN trade patterns are rather consistent before and after the crisis (1996 vs. 2000). Second, intra-ASEAN trade is the most important trade pattern in the region. In terms of exports, intra-ASEAN exports were 26% of total exports in 1996. The figure dropped only slightly to 23% in 2000 in spite of the smaller GDP in the region. In terms of imports, intra-ASEAN imports grew from 18% of total in 1996 to 22% in 2000, reflecting the drop in purchases from developed countries. Third, developed countries were the next most dominant exporting and importing trade partners. Among them, the most significant was exporting to the U.S., which accounted for 18% of the total in 1996 and 17% in 2000. Developed countries were also the most significant import suppliers.In 1996, imports from Japan, EU, and the U.S. accounted for 21%, 16%, and 15% of the total, respectively. In 2000, reflecting weakened purchasing power, imports from Japan, EU, and the U.S. dropped to 19%, 11% and 14% of total, respectively. Fourth, in recent years trade with the rest of Asia grew, with China being the reason for the increase. The third panel in Tables 1a and 1b show the pattern most clearly. The importance of the China (including Hong Kong), South Korea, and India together as exports markets

matched that of Japan and EU in 2000. In terms of imports sources these countries were as important as the EU and United States.

Many of the ASEAN economies, notably Singapore, Malaysia, Indonesia, and Brunei are heavily dependent on inward FDI as a source of financing, access to external markets, and technology transfer. This external orientation of their economies implies that ASEAN economies have some structural vulnerability to external shocks. We use "inward FDI stock/GDP" ratios to measure these countries' reliance on inward foreign direct investment, as shown in Table 2.

Table 2 – Inward FDI stock/GDP ratios of ASEAN countries

Country	**1980**	**1985**	**1990**	**1995**	**2000**
Brunei	0.4	0.8	0.7	12.1	74.4
Cambodia	2.4	2.0	3.4	12.1	48.7
Indonesia	13.2	28.2	34.0	25.0	39.6
Laos	0.3	--	1.5	11.6	32.2
Malaysia	20.7	23.3	23.4	32.3	58.8
Myanmar	12.7	11.3	11.1	17.2	24.7
Philippines	3.9	8.5	7.4	8.2	16.6
Singapore	52.9	73.2	77.9	71.5	103.8
Thailand	3.0	5.1	9.6	10.4	20.0
Vietnam	0.2	1.1	4.0	28.5	46.7
Average Asia	13.0	16.3	14.8	17.0	31.6
Average developed world	4.8	6.2	8.1	8.9	17.1
Average developing world	10.2	13.9	13.0	15.3	30.9

Source: UNCTAD

Two important general patterns emerge from an inspection of this table. First, ASEAN countries have become much more inward FDI-dependent in the 1980s and 1990s relative to the rest of Asia and relative to other developing countries (but not more than some Latin American countries like Argentina, Brazil, Columbia and Mexico). In 1980, only three ASEAN countries exceeded Asia's average inward FDI stock/GDP ratio (13%): Indonesia (13.2%), Malaysia

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(20.7%), and Singapore (52.9%). By 2000, seven ASEAN countries have managed to do so and some have surpassed the Asia average (31%) by a huge margin. These countries are Brunei, Cambodia, Malaysia, Singapore, and Vietnam which have an inward FDI stock/GDP ratio of, 74.4%, 48.7%, 58.8%, 103.8%, and 46.7%, respectively. In contrast, developed economies' average ratio in 2000 was only 17.1%.

The second pattern is that in recent years the flow of inward FDI has noticeably declined. Table 3A shows the year by year inward FDI flows. ASEAN countries are falling behind in attracting foreign direct investment. ASEAN countries have lost ground principally to China, but also to Korea before 2001 and to Latin American countries like Mexico and Brazil (and, to a lesser extent, to Argentina and Chile as well). In Table 3B we show the ASEAN countries' inward FDI as percentage shares of gross fixed capital formation. The table supports the notion that ASEAN countries in 1996 to 2000 are falling behind in using inward FDI to support investment, as compared to some Latin American countries as well as some Asian countries like Korea, Hong Kong (China) and Taiwan (China).

Table 3A – Inward FDI flows, by country and economy 1990-2001 (million of dollars)

	90	91	92	93	94	95	96	97	98	99	00	01
ASEAN countries												
Malaysia	2,333	3,998	5,183	5,006	4,342	5,816	7,296	6,513	2,700	3,532	5,542	554
Singapore	5,575	4,879	2,204	4,686	8,368	8,788	10,372	12,967	6,316	7,197	6,390	8,609
Indonesia	1,093	1,482	1,777	2,004	2,109	4,346	6,194	4,677	-356	-2,745	-4,550	-3,277
Thailand	2,444	2,014	2,114	1,804	1,322	2,004	2,271	3,627	5,143	3,562	2,448	3,759
Philippines	530	544	228	1,238	1,591	1,459	1,520	1,249	1,752	737	1,489	1,792
Other Asian countries												
China	3,487	4,366	11,156	27,515	33,787	35,849	40,180	44,237	43,751	40,139	40,772	46,846
Hong Kong	1,728	538	2,051	1,667	2,000	6,213	10,460	11,368	14,776	24,591	64,448	22,834
India	162	141	233	574	973	2,144	2,591	3,613	2,614	2,154	2,315	3,403
Korea	788	1,180	727	588	809	1,776	2,325	2,844	5,412	10,598	10,186	3,205
Taiwan (China)	1,330	1,271	879	917	1,375	1,559	1,864	2,248	222	2,926	4,928	4,109
Developing Nations - South/Central America												
Mexico	2,549	4,742	4,393	4,389	10,973	9,526	9,902	13,841	11,612	11,915	13,162	24,731
Brazil	989	1,103	2,061	1,292	2,149	5,475	10,496	18,743	28,480	31,362	33,547	22,457
Argentina	1,836	2,439	4,045	2,555	3,116	5,609	6,949	9,162	7,281	24,147	11,152	3,181
Chile	590	523	699	808	1,772	2,956	4,633	5,219	4,638	9,221	3,674	5,508
Columbia	500	457	729	959	1,667	2,956	4,633	5,219	4,638	9,221	3,674	2,018

Source: World Investment Report 1998, 2001, 2002

Table 3B: **Share of inward FDI flows to gross fixed capital formation by country and economy 1996-2000 (data are in percentages)**

	Inflow					
	96	**97**	**98**	**99**	**00**	**Growth 1996-2000***
ASEAN countries						
Malaysia*	17.0	14.7	14.0	22.2	16.5	-2.9%
Singapore*	24.6	29.4	20.8	42.4	19.8	-19.5%
Indonesia*	9.2	7.7	-1.5	-9.0	-12.2	-232.6%
Thailand*	3.0	7.1	20.5	13.9	10.5	250.0%
Philippines*	7.8	6.2	12.7	4.0	9.2	17.9%
Other Asian countries						
China	14.3	14.6	12.9	11.3	10.5	-26.6%
Hong Kong (China)	21.7	19.8	30.0	60.2	144.9	567.7%
India	2.9	4.0	2.9	2.2	2.3	-20.7%
Korea	1.2	1.7	5.7	8.3	7.1	491.7%
Taiwan (China)	3.0	3.4	0.4	4.4	6.8	126.7%
Developing Nations - South/Central America						
Mexico	16.7	18.0	13.6	12.3	12.2	-26.9%
Brazil	7.2	11.8	18.6	28.2	28.4	294.4%
Argentina	14.1	16.1	11.5	47.2	24.2	71.6%
Chile	23.2	23.2	22.4	59.9	23.1	-0.4%
Columbia	14.8	25.8	15.2	12.8	22.4	51.4%

Source: World Investment Report, 2002

3. Tripartite "threats"

It should be stressed that we use the term "threat" in a guarded manner. While the 1997 financial crisis clearly constituted a negative factor, FTAA and the rise of China represent both an opportunity – an increase in demand for exports from ASEAN, for example – and a threat. We focus on the threat dimension here for analytical tractability and to save space.

The external orientation of the ASEAN economies exposes them to shocks generated in other economies. One impending shock is the possible formation of the FTAA in 2005, but two other substantial shocks have already jolted the region.

One is the 1997 financial crisis; the other is the rise of China as an export powerhouse and as an attractive FDI recipient. These two shocks have already forced substantial changes in FDI flow patterns in Asia. The effects of the FTAA on ASEAN are cumulative in nature and operate on the margin. To this extent, FTAA may exert a more substantial influence on the region not necessarily because FTAA looms larger in absolute terms but because it could be the straw that breaks the camel's back.

FTAA

The FTAA is a proposed free trade zone encompassing all currently democratic countries in the Americas. This ambitious project, scheduled to commence in 2005, would create a market of over 800 million people with a combined GDP of $13 trillion. Currently 34[4] countries participate in the negotiations which are to conclude no later than January 2005. The declared objective is trade and investment liberalization within the established trade governance stipulated by the WTO and other existing regional agreements. The current negotiation groups include: market access, agriculture, government procurement, investment, competition policy, intellectual property rights, services, dispute settlement, and subsidies, antidumping and countervailing duties. In addition, there are consultative group on smaller economies and technical committee on institutional issues.

The impact of the FTAA on ASEAN would depend on a number of factors. On the positive side, the FTAA, if successful, represents a greater agglomeration of previously separate economies. Growth in the region could mean a greater market for goods and services produced in ASEAN economies. However, Latin America and ASEAN produce low-skilled goods that compete with one another. If FTAA is indeed formed as a regional free trade agreement with a common tariff policy, FTAA members (including the North American members) will find trading with one another relatively more attractive than trading with countries outside FTAA. This is the classic trade diversion effect. It is unclear how large this trade diversion effect is but it is not trivial, given that about 17% of ASEAN exports go to the United States (see Figure 1b) and exports

[4] The 34 countries include: Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, the U.S., Uruguay, and Venezuela. A ministerial declaration is found in http://www.ftaa-alca.org/ministerials/quito/mini_e.asp.

account for about 71% of GDP (see Table 1a). That means exports to the United States alone account for about 12% of ASEAN GDP.

Following the trade diversion is the diversion of production facilities; that is, FDI will flow more towards the FTAA regions than before. Similar to some of the Latin American countries, ASEAN countries are highly dependent not just on domestic market FDI, but on export-oriented FDI. We cannot be certain about the magnitude of the FDI-diversion effect of the FTAA, due in part to the fact that a critical dynamic depends on the number of regional integration frameworks at work. If there is only one regional free trade agreement, competition for capital can be "biased" in favor of the region with the agreement. With the bi-regional free trade agreement, competition for capital may be more even. That said, two features of export-oriented FDI should accentuate the concern that it may move to FTAA countries following the FTAA. First, it is highly mobile and sensitive to differences in factor costs. Second, it is sensitive to proximity considerations. This sensitivity can stem from that (i) the greater the distance the greater will be the institutional differences in customs, culture, language and the like, and (ii) the greater the distance the greater the information costs as well as control and coordination costs, etc. To the extent that FTAA makes intra-regional trade more attractive, firms in the United States and Canada may redirect export oriented FDI away from ASEAN towards Latin America. The same logic applies to EU firms which cater to the American markets.

There is solid empirical justification for this prediction. It is well established in the gravity model of trade and FDI that geographic proximity is an important variable explaining trade patterns and investment decisions of multinational corporations (MNCs). The FTAA may lead to a geographic reorganization of proximity-sensitive production assets away from ASEAN countries.[5] Production sensitive to intellectual property rights (IPR) protection can also be affected. For MNCs, IPR protection is an important consideration in making location/production choices. To the extent that FTAA succeeds in securing stronger IPR protection in the region, IPR-sensitive FDI may gravitate toward FTAA region and away from ASEAN.[6]

Financial crisis

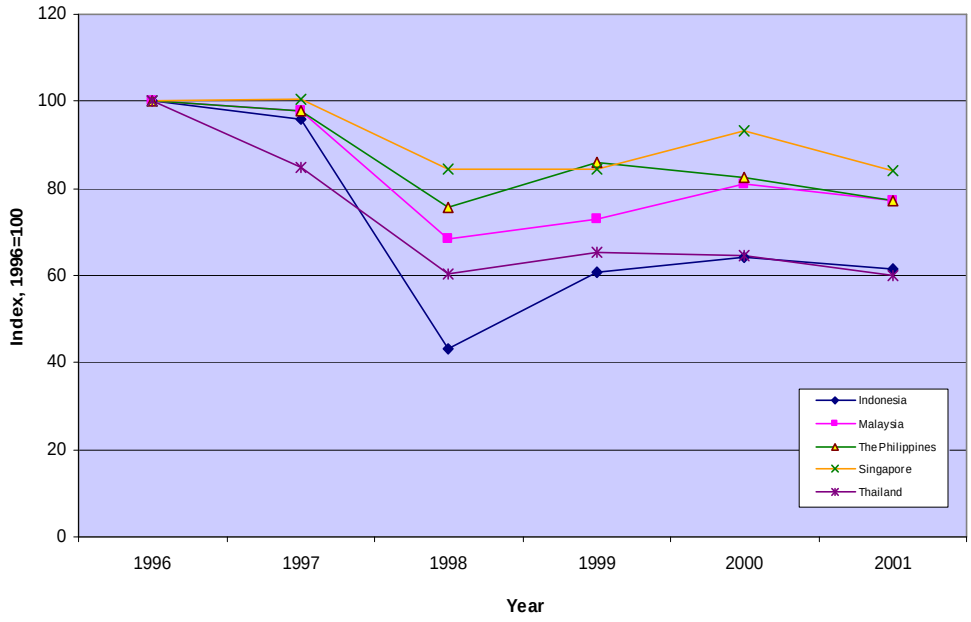
In 1997, all the ASEAN countries were severely affected by the financial crisis. Figure 3 illustrates the slow recovery of ASEAN countries. The figure shows the infamous sharp contraction in 1998 of the five main ASEAN

[5] For details, see Markusen (2004).

[6] While not all FTAA countries have strong IPR protection to benefit from this effect, some may; for example, Chile is such a candidate, as indicated in Henisz (2004).

economies – Indonesia, Malaysia, Philippines, Singapore, and Thailand. These economies recovered somewhat in 2000, but plummeted again in 2001 at the onset of the new global recession. As of 2001, these countries have not yet re-attained their 1996 GDP per capita.

Figure 3. GDP per Capita in US Dollar in ASEAN 5 During 1996-2001, as Compared to 1996



The macroeconomic effect came from the reduced investment incentives as a result of the initial shocks. The sharp drop in national output also tightened the investment liquidity constraints in the ASEAN nations. The mutual feedback between output and investment has effected a prolonged recession. The microeconomic conditions in some of the ASEAN countries remain problematic. Six years after the crisis several key ASEAN countries remain mired in structural conditions of financial crisis. Indonesia, Thailand, the Philippines, and Malaysia have some of the highest levels of non-performing loans in Asia (measured as a ratio of total outstanding loans); they remain vulnerable to future financial crisis.

A plausible postulation is that the prolonged recession is related to poor governance, which we shall turn to in Section 4. It suffices here to cite the World Bank, which in its recent review of East Asian economies noted that while governance in East Asia is rated as better than in Latin America, it is significantly

poorer than in Central and Eastern Europe and the quality of governance in East Asia has remained static over the past six to seven years.[7]

Another long-lasting effect of the 1997 financial crisis is a sharp drop of FDI inflows into several of the ASEAN economies. Among the ASEAN economies most successful in attracting FDI in the 1980s and 1990s Indonesia is hit the hardest. In fact it has experienced a net decline in inward FDI since 1998. Malaysia and Singapore have not regained their pre-crisis levels of FDI inflow in absolute terms and relative to GDP (see Table 3A).

The China Factor

The impact of the 1997 financial crises is magnified by a major structural change in Asia – the rise of China as an economic powerhouse. China, like many ASEAN economies, notably Singapore and Malaysia, relies heavily on FDI and is heavily export-oriented.[8] It is well known that China has posted rapid productivity growth since the early 1990s. [9] China's rise has caused a productivity shock in the ASEAN economies.

While a larger Chinese economy is probably good news to ASEAN in the long run, its most immediate implication is a negative earnings shock.[10] Because Chinese productivity growth may have outstripped that in ASEAN, factor earnings in the latter must fall. ASEAN countries and China compete for similar target markets – i.e., United States and Europe. (See Table 1a and figures 1a and 1b.) This means their goods' prices have to be roughly at par. Competition compresses prices towards marginal costs of production, causing prices to be

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[7] See World Bank, "East Asia increases integration, outpaces the rest of the world in growth," from http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20133935~menuPK:34466~pagePK:64003015~piPK:64003012~theSitePK:4607,00.html.

[8] See Table 3, for example.

[9] Chang (2003) reports that China's state-owned enterprises registered 11.8% annual growth in total factor productivity from 1997 to 2000. Demurger *et al* (2002) show that China's provincial per capita GDP growth rate in 1995 constant price from 1992 to 1998 ranges from 6.4% (Qinghai) to 13.8% (Zhejiang) per year (Table 5, last column). According to the China Statistical Yearbook (2002), the 1996 to 2001 GDP growth is 41% while the per capita GDP growth is 35.3% in the same period. All these are very high numbers, especially when pitched against the negative per capita GDP growth from 1996 to 2001 of the leading ASEAN countries as depicted in Figure 3.

[10] The growth of the Chinese economy exerts two factors: a demand pull effect which serves as a growth engine for the region and possibly beyond, and the terms of trade effect that we describe in the text. While we cannot at the moment have enough data to support assertion of which force dominates, in recent years, we do not observe that the demand pull effect dominates the terms of trade effect. The economic logic of our argument is not affected by the possibility that the demand pull effect eventually becomes dominant.

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inversely proportional to productivity and directly proportional to factor prices. Also, given a good's price, productivity and factor earnings are inversely related. Together, these relationships imply that an increase in productivity in a large country like China can lower goods prices on the world market and the factor earnings of countries that do not experience commensurate productivity growth. Even for developed countries which import Chinese output, the earnings of their factors that compete with the relatively well-endowed Chinese factors (e.g., unskilled labor) can be negatively affected.[11]

We can bring exchange rate into the picture. Rather than a nominal decline in factor earnings, lower factor prices in an ASEAN economy (that competes with China) might manifest through depreciation in its exchange rates – the amount of domestic currency needed to exchange for one unit of foreign currency. All in all, we can call this "terms of trade" effect, which in the current context means that after the productivity increase in China more units of the ASEAN economy's domestic input services are required to trade for the same amount of foreign input services.

The point is that a faster productivity growth in China relative to ASEAN implies that factor earnings in ASEAN must fall to reflect their relative productivity loss. This "terms of trade" effect is stronger the greater the amount of trade between the more rapid productivity-growing country and the laggards. Between 13% and 15% of ASEAN's trade is with China.

In summary, the above discussion raises the point that ASEAN countries are struggling with a slow recovery from the Asian financial crisis and deflationary effects due to China's influence. The aftermath of the Asian financial crisis is heightened investment liquidity constraints. The deflationary effects due to the China factor further limit the ASEAN countries' ability to regain income growth. Cumulatively, these events may raise the need for more FDI inflows, on top of already substantial FDI inflows. Herein lies the basis of the legitimate concern for FTAA, which, if successful, may divert FDI away from ASEAN.

4. Institutions, economic growth and FDI in ASEAN

[11] One can produce the results formally. In a one factor two countries two goods trading model, the increase in productivity of one country reduces the real factor wage of the other country. In a typical Heckscher-Ohlin model (two factors two goods two countries model), if the increase in productivity does not change the pattern of comparative advantage, the factor employed relatively more intensively in the importing sector of the non-productivity increasing country will experience a decline in earnings while the other factor will experience the opposite.

Our starting position is that poor institutions limit a country's economic potentials. We focus on three institutional dimensions in this paper: the role of the state in the economy, property rights protection and corporate governance. In this section, we show that: (1) there is well-established – both theoretically and empirically – research in the economic literature that illustrates the high costs associated with poor institutions; (2) ASEAN countries as a whole are relatively under-developed institutionally, and (3) the poor institutional environments, while not a deterrent to FDI inflows, reduce the economic contributions of FDI.

Institutions and economic growth

We shall argue that the institutional inefficiencies of many ASEAN economies are of three sorts. First, the role of the state remains substantial in the ASEAN economies. Even Singapore, with its efficient bureaucracy and transparent legal system, still has a large albeit steadily weakening state-controlled sector. Second, property rights protection, especially of small and ethnic minority entrepreneurs, remains insecure in some of the ASEAN countries. Government policies and regulations are not neutral in their treatments of firms. Third, corporate governance remains opaque and not responsible to public shareholders. The purpose of this section is to highlight the large body of literature that illustrates how these three sources of institutional inefficiencies may harm economic growth.

He, Morck, and Yeung (2003) report results that "state activism" crowds out entrepreneurial activities, perpetuates dominance of large firms, and drags economic growth. Apart from the well-known firm-level sources of inefficiencies – those of the SOEs, there are other mechanisms whereby state activism undermines growth potentials. One is weak property rights protection.Several empirical papers have convincingly demonstrated that economic growth, as measured by per capita GDP growth, and productivity growth, are both positively correlated with the rule of law (see Levine 2002 and Durnev et al 2004). The mechanism is that secure property rights promote economically efficient investments while insecure property rights deter them.

One linkage between property rights protection and economic performance that has received a lot of analytical attention is corporate governance, and corporate governance is particularly weak in ASEAN. Corporate governance is the confluence of financial development with property rights protection. Good corporate governance provides property rights protection to public investors. When capital users behave in a trustworthy manner they induce investors to entrust their savings to them. This is the essence of the law and finance literature initiated by La Porta et al (1997, 1998). The consequence of good property rights protection for outside investors is informed asset prices (Morck, Yeung, Yu

(2000), well developed capital markets (La Porta et al (1998, 1999)), good capital allocations (Durnev, Morck, Yeung (2000, 2003) and good economic development, especially when measured by productivity growth (Levine, 1997, Durnev et al 2004).

The recent literature traces the absence of good corporate governance to a political economy dynamic. (Morck, Stangeland, Yeung (2000), Rajan and Zingales (2003), Durnev et al (2004), Morck, Wolfenzon, Yeung et al (2004)). The focus of the literature is on concentrated ownership structures, capital market dysfunction, and crony capitalism conspiring to undermine investor confidence and thus limit capital available to efficient domestic entrepreneurs. Public policies in economies bereft of good corporate governance are often geared towards protecting the established and advancing the politically favored.[12] There are

[12] To understand the points, we start our discussion with concentrated ownership of corporate assets as described in Morck, Stangeland, Yeung (2000). Consider a wealthy tycoon having $1 billion in a holding company. Then, she instructs the holding company to invest $0.5 billion each in two subsidiaries and each subsidiary raises $0.5 billion outside money. The wealthy tycoon now controls both subsidiaries worthy of $2 billion assets with 50% voting rights in each. She strengthens her control of the subsidiaries by placing family members as executives. Repeating the scheme again, she controls $4 billion. Doing the same thing four more times, she controls $64 billion of corporate assets, but her own money accounts for only 1.56% of what she controls. This ownership structure is known as pyramids and exposed, e.g., in La Porta et al (1999) and Morck, Stangeland, and Yeung (2000). In pyramidal groups, agency problems are expectedly severe and yet the tycoon retains full control in every layer of subsidiaries which makes it hard to "fire" her. She becomes an entrenched controlling manager with vast incentive to "using other people's money" to pursue self-interests. She will also be tempted to conduct transfers from the bottom layer to the top layer; in the example above, each $1 transferred brings her full ownership of a $1 that costs her only $0.0156.

The pyramidal structures also have negative impact on an economy. Elite tycoons and families use pyramidal structures and family members as executives to control a vast amount of corporations – they wield real economic power. Morck, Stangeland, and Yeung (2000) show that these groups have privileged access to capital and yet conduct little innovations. These groups exert high influences in public policies and institutional developments to preserve their status quo; a state's government could even be their explicit capture. Morck and Yeung (2003) point out that the controlling owner of pyramidal groups has an advantage in influencing the government. First, she has little difficulty in organizing lobbying efforts, unlike groups with many constituents. Second, she can use lower layer firms in her pyramid, which she owns little but control, to pay for lobbying costs and yet she can receive lobbying benefits in any firms inside her pyramid and then siphons the benefits to firms she has a large cashflow claim. Third, being a member of a dynastic family, she can formulate more credible tacit agreement with a government than a stand alone firm's executive whose future is less certain. A possible outcome is that economies with prevalent pyramidal family structure tend to have greater entry barriers, less developed financial markets and less open; the end result is poor growth. Morck, Wolfenzon, and Yeung (2004) survey a large literature that supports these claims. See also Rajan and Zingales (2003).

indications that ASEAN countries could be in such an undesirable equilibrium, a topic we will return to in Section 5.

Institutional inefficiencies in ASEAN

Our overall argument is that the institutional quality in ASEAN has been poor, even after the Asian financial crisis. The World Bank's measures of institutional quality show a lack of improvement in East Asia since the financial crisis. An alternative set of measures in fact shows a deterioration of institutional quality among ASEAN countries in recent years. One measure is the rule of law index devised by International Country Risk Guide (scale of 0-6 with higher value denoting better institutional quality). The average for the following ASEAN countries, Brunei, Indonesia, Malaysia, Myanmar, Singapore, Thailand, and Vietnam, was 4.45 in 1996; the average in 2001 was 3.46. Another measure is the Heritage Foundation Economic Freedom index, with lower score indicating better institutional quality. The average for the same group of ASEAN countries rose from 2.48 in 1995 to 2.71 in 2001.

We can decompose the institutional environment in ASEAN into three inter-related dimensions. The first dimension has to do with state activism – either in a regulatory or a managerial sense – in ASEAN. The second dimension refers to the poor property rights protection and the third dimension has to do with corporate governance. The discussion below suggests that the ASEAN economies – with a notable exception of Singapore – are performing poorly along these three dimensions and their vulnerability to external shocks may be more severe than otherwise would be the case.

Several ASEAN countries still have a substantial state-controlled sector. This is documented by a careful analysis by Claessens, Djankov and Lang (2000). As of the mid-1990s, the four ASEAN countries, Singapore, Malaysia, Indonesia, and Thailand had the highest ratio of state controlled firms among the nine Asian countries they examined.[13] Using 10% of voting rights as the definition of ultimate control, the authors of this study classify 23.6% of Singaporean firms, 18.2% of Malaysian firms, 10.2% of Indonesian firms, and 7.5% of Thai firms as state-controlled in their sample. In contrast, the same measure yields 3.7% of firms in Hong Kong, 1.1% in Japan and 5.1% in Korea as state controlled. This finding is quite telling of a seemingly greater managerial role of the state in ASEAN as compared with other states in East Asia.[14] Thailand, widely regarded

[13] Their study covers 2,980 publicly traded corporations in the following nine Asian economies: Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

[14] We focus more on the managerial role of the state here. It should be noted that state activism can be strictly regulatory in nature, without state ownership. In the context of ASEAN and unlike

as a more laissez-faire economy in ASEAN, in fact has more state-controlled firms than Korea, an economy typically regarded as more "statist" in East Asia.

The substantial state involvement in Singapore deserves a fuller illustration. Singapore has one of the world's most efficient institutional environment and yet there are still problems in its state sector. The Singaporean government operates an investment arm, Temasek Holdings, which in turn owns more than 40 firms and, in 2001, these Government-Linked Companies (GLCs) accounted for 20% of domestic market capitalization.[15] The output of the public sector amounted to some 22% of Singapore's GDP. This is a lower bound estimate of the size of the public sector because it only incorporates those first-tier firms in which the government has at least 20% of the voting shares and does not include affiliates and subsidiaries owned by the GLCs themselves. Quoting a 1993 Ministry of Finance report, a study by the US Embassy in Singapore estimates that "the public sector and GLCs are a major component of the 'Singapore Company,' accounting for about 60% of her GDP."

While Singapore's state-controlled sector is profitable and is well managed, there are resource costs of having such a large state sector. There is evidence that GLCs have crowded out private firms due to the implicit guarantees on their debt repayments and have crowded out private entrepreneurship. In a 1999 survey many private sector firms felt that Singapore's business and commercial laws favored both GLCs and MNCs. An index of "total entrepreneurial activity" developed by London Business School and Babson College ranked Singapore in 19th place out of 21 countries. There is, however, evidence that Singaporean government has recognized the crowding out effect of a large state sector. In recent years, the government has made divestments in a number of business areas.

Vietnam has the largest and a deeply problematic state sector. As of 2002, SOEs accounted for 40% of Vietnam's GDP and 30% of 5,000 or so SOEs were in the red (Machida 2003). The privileged access to financial resources on the part of SOEs compounds the drag to the economy. According to the World Bank, the total SOE debts amounted to 32% of GDP in the late 1990s and required ongoing

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Korea and Japan, the state activism is also manifested in the substantial degree of state ownership of firms and to this extent ASEAN countries are different from Korea and Japan. We thank a referee for pointing out this distinction and for suggesting the work by Johnson (1982) that discusses this distinction in great detail. To some extent, Wade (1990) also looks at the similar distinctions in the context of Taiwan.

[15] The following is based on US embassy in Singapore, "Singapore: Government-Linked Corporations Face the future," available from http://www.usembassysingapore.org.sg/ep/2001/GLC2000.html.

financial support from the government as a large portion of these debts was non-performing.[16]

Although the direct ownership role of government in other ASEAN countries is less pronounced than in Singapore and Vietnam, historically, SOEs in Indonesia and Malaysia played a more important economic role than even in India. During the 1978-1991 period, the output of SOEs in India accounted for 12.1% of GDP. In comparison, SOEs accounted for 14.8% of GDP in Indonesia and 17% in Malaysia during the same period.[17] (The state sector in Thailand and the Philippines was considerably smaller.) In more recent years, the importance of SOEs has probably declined as a number of governments in ASEAN have launched privatization initiatives. Lack of data availability makes it difficult to precisely illustrate the current state ownership in ASEAN countries, although the sizable public sector employment in Malaysia and the Philippines – around 20% – points to an active role of government in the economy.

In Malaysia, part of the reason why the SOEs have played a historically important role in the economy is that SOEs served as a mechanism to transfer wealth from the politically-disadvantaged, but economically efficient, ethnically Chinese to the politically-favored Malays. It is well documented that the Malaysian government discriminates severely against ethnic Chinese businesses under its New Economic Policy (NEP) affirmative action program for Malays. One aspect of the NEP mandates that Chinese entrepreneurs transfer a substantial portion of their equity to Malays once their businesses exceed a certain size.

The government set up holding companies in response to this equity-transfer mandate of the NEP. Because the Malay businesses did not have sufficient capital to purchase the Chinese-owned assets, the government set up holding companies explicitly to facilitate the transfer. These firms were categorized as "off-budget enterprises" or later as "non-financial public enterprises." These firms enjoyed virtually unlimited supplies of interest free finance. The mandate of these enterprises was to purchase shares or assets from non-Malay groups and to hold them on behalf of the Malay groups. The massive expansion in the state sector in the 1970s and 1980s represented an enormous exchange of assets, in which the state paid cash for existing production assets built up by the Chinese firms. These investments generated little net increase in production and employment (Drabble 2000, p. 245). In addition, the policy also induced inefficient segmentation of Chinese entrepreneur's businesses – by

[16] Cited in Chand, Duncan, and Quang (2001).

[17] The figures are from Table A.1 from World Bank (1995).

segmenting a single business into less economically viable segments, an issue we will return to later.

The second institutional problem in ASEAN is poor property rights protection and under-development of rule of law, with Singapore, again, being a prominent exception. This is demonstrated in cross-country survey data, which show that ASEAN countries lag behind in the "rule of law," "judicial efficiency" but are high in "corruption." One source of data is the International Country Risk Guide. Because FTAA is the subject of concern, we compare ASEAN countries with four future members of FTAA, Argentina, Brazil, Chile, and Mexico. Except for Singapore, ASEAN countries scored lower on indices on the rule of law, corruption, and judicial efficiency. (Lower value means worse performance.) For example, the average rule of law index in 2001 for Indonesia, Malaysia, Myanmar, Philippines, Thailand, and Vietnam was 3.19 compared with 3.42 for Argentina, Brazil, Chile, and Mexico. On the corruption index, the four Latin American countries also outperformed ASEAN (excluding Singapore). Their average score was 5.6 compared with 4.41 for Indonesia, Malaysia, Philippines, and Thailand. There is a similar discrepancy between the two groups of countries on judicial efficiency. (It should be noted here that Singapore outperformed substantially Latin American countries on all three indices.)

Let us use the example of Malaysia's NEP to put the above finding in context. One of the effects of the NEP was to weaken the property rights security on the part of the Chinese entrepreneurs and led to a substitution of efficient Chinese investments with less efficient Malay or government investments, as noted above. Some Chinese entrepreneurs simply chose to leave the country, draining the country of indigenous entrepreneurial talents and capital while creating business opportunities for the less efficient Malay firms. Those who remained in the country resorted to a number of coping mechanisms. One is the pyramid scheme in which Chinese entrepreneurs set up many small separate businesses in order to avoid detection, sacrificing economy of scale in the process. The other coping mechanism is divestment in the fixed and large-scale manufacturing projects by the Chinese firms, who were the principal savers in the country (Drabble 2000, p. 240). Both mechanisms, while allowing the Chinese-run businesses to survive, reduced the capabilities of the Chinese-run firms.[18]

The case of Robert Kuok illustrates how the lack of property rights protection drained Malaysia of local entrepreneurial resources.[19] Robert Kuok, a

[18] It should be noted there that our analysis does not the question the social objective behind NEP – to bring greater parity between the Malays and the ethnic Chinese. We do want to highlight the economic costs of the *specific policy instruments*, such as divestiture requirement, chosen to advance this social objective.

[19] This account of Robert Kuok is based on Gomez (1999).

Fujianese dubbed "the most enigmatic" of the Chinese businessmen in the post-colonial Malaysia, ran a major trading operation in salt, sugar and rice in the 1950s and 1960s. At the height of NEP in 1975 when the government enacted Investment Coordination Act mandating Chinese business divestitures, he made Hong Kong his corporate headquarters and settled there. Geh Ik Cheong, chairman of one of the subsidiaries in Kuok's business empire, expressed the sentiment that explained Kuok's decision when he was quoted as saying, in 1993, "A lot of the opportunities here (in Malaysia) have attracted many up-and-coming Bumiputera companies. We haven't always felt comfortable competing with them. So as a group we have taken the step to expand internationally."

A direct result of poor property rights protection is the lack of trust in government. There is some systematic evidence that ASEAN countries in general and Malaysia in particular do poorly when it comes to trust in government. In the survey prepared for the World Bank's report, Voices of Firms, only 32.9 percent of surveyed managers in ASEAN economies believe that firms in their industry report 100 percent of their sales for tax purposes, as compared with 38.7 percent in Latin America and 49.2 percent in the OECD. Tellingly, Malaysia has the lowest proportion of firms reporting taxable income honestly (13 percent) among the six ASEAN countries covered in the survey.

Previous research reveals two plausible reasons why firms under-report their income. One is to evade taxes. High tax rates, according to this logic, drive firms' activities underground. However, our evidence suggests that high tax rates are not the reason why firms in ASEAN under-report their taxable income. Relative to mangers in Latin America and in OECD, managers in ASEAN complain less about high taxes, reporting an average score of 2.90, compared to 3.35 in Latin America and 3.05 in OECD. (Higher scores mean more complaints about tax burdens.) Tax considerations do not appear to be an overriding factor. Another reason for going underground is a lack of property rights security. Entrepreneurs who feel insecure about their property rights under-report their income because tax payments can reveal their financial situation to rapacious officials. Our opinion is that ASEAN countries score low on this dimension principally because of lack of confidence in property rights security. This interpretation is consistent with the fact that a country scoring also very low on this count is widely known for its lack of property rights protection. China is a case in point. In the survey, only 11.9 percent of Chinese managers believed that 100 percent of income was reported for tax purposes (similar to Haiti, another country with notoriously poor property rights protection).

The third institutional problem in ASEAN has to do with corporate governance. There is now a rather large empirical literature that suggests that ASEAN countries are lagging in corporate governance development. Claessens et

al (2000) document that East Asian countries have a high concentration of corporate control in the hands of a few elite families. Their sample includes ASEAN countries like Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Claessens et al (2002) documents for these countries that entrenched controlling shareholders with little actual ownership are linked to low firm value, indicating abuses of outside shareholders by the entrenched controlling shareholders.

Very often, the tycoons are politically connected and politicians serve the tycoon's interests. Claessens et al (2000) document the "connections" for Indonesia and the Philippines. Fisman (2001) shows that relatives of President Suharto controlled most major firms in Indonesia prior to his overthrow and their business' fortunes rose and fell as rumors about Suharto's health turned positive and negative. Johnson and Mitton (2003) show that in Malaysia the imposition of capital control in 1998 actually benefited firms connected with the then Prime Minister Mahatir.

As a consequence, many ASEAN economies, with Singapore being a possible exception, are not innovative and unlikely to be internationally competitive. The poor institutional environment also renders them susceptible to shocks. It has been argued that the Asian financial crisis which started in Thailand (and spread to Indonesia, Malaysia, other ASEAN nations, and to the rest of Asia including South Korea) was caused by the poor institutional environment and corporate governance in the region (Johnson et al (2000)). Also, Johnson, Mitton, and Buranapin (2001) show that in the fall of 1997, Thai finance houses controlled by families and those with a higher proportion of family members on their boards were more likely to fail. Within family-run finance houses, those run by multiple families were also more likely to fail. Substantial family ownership, an endemic phenomenon in ASEAN countries, is a reliable indicator of poor corporate governance.

Institutions and the two roles of FDI

We show in Section 2 that ASEAN countries are dependent on exports and FDI. Also, in Section 3, we describe that the tripartite threats for ASEAN countries. The China factor and the aftermath of the Asian financial crisis in 1997-1998 hammer ASEAN countries' economic growth. The FTAA can lead to competition for export market shares and diversion of FDI away from the ASEAN countries. Hence, the FTAA can further dim the ASEAN countries' growth prospects. In this context, institutional weaknesses as described above exacerbate the ASEAN countries economic problems.

It should be explicitly stressed that we do not claim that only countries with good institutions can attract FDI. The experience of ASEAN is a case in

point. As shown previously, many ASEAN economies are among the most FDI-dependent economies in the world, as measured by FDI stock/GDP ratios, despite the fact that they have poor institutions. At least as far as the ASEAN experience is concerned, poor institutions appear to be compatible with high FDI inflows.

Our contention is that institutions affect the *composition* of FDI inflows, not so much the volume of FDI inflows. We distinguish between two types of FDI. Both promote economic growth but via different mechanisms.[20] One way FDI promotes growth is to complement domestic sources of growth, such as local entrepreneurship and investments by domestic firms. An example of this is the provision of technology, skills, and capital that are not available locally. These activities build up domestic entrepreneurial capabilities that loosen the grip of entrenched domestic dominant players. The so-called spillover effect of FDI works through this mechanism. A critical condition for this mechanism to work is that the domestic economy's regulatory and market institutions, financial markets in particular, do not stifle entrepreneurial activities.

The other way FDI can promote economic growth is to substitute for domestic entrepreneurship and domestic investment. FDI is more likely to play this role in an economy that has substantial financial and legal constraints on domestic entrepreneurs while remaining relatively open to FDI. While the substitution effect of FDI is also positive on economic growth, it is a less powerful mechanism compared with the complementary FDI. In particular, returns are capture by foreign owned entities and FDI could be merely a capturing of market opportunities that domestic players could have captured but for the institutional inefficiencies and constraints.

The distinction between the complementary and substitute role for FDI can be illustrated by a stylized example. Suppose a domestic entrepreneur learns valuable skills working in a foreign firm. With these skills, she can start her own business, perhaps, as a supplier to her former employer. (The domestic entrepreneur may not start her business from scratch. The essence of the development is that a foreign owned subsidiary may sign up a local firm as a supplier and transfer skills to it.) Whether she succeeds in such a venture depends on her access to financing and on the security of her property rights. If the local financial and legal systems are efficient, she can then launch her venture and profit from her skills. In this case, FDI has played a complementary role in that the FDI stimulates the "growth" by spurring entrepreneurial activities.

If the local financial and legal systems are inefficient, our local entrepreneur fails to launch her business venture directly either because of lack of capital or the fear that corrupt officials and existing "crony" business will

[20] Huang (2003) developed and applied this framework to China.

confiscate or squeeze her earnings. Her only option may be to seek foreign financing and property rights protection a foreign firm can provide. If this financing is *via* FDI, the new business is foreign-owned, and the entrepreneur is essentially an employee. Anticipating the outcome, potential entrepreneurs may not be sufficiently motivated to invest in acquiring skills in the first place, creating an entrepreneurial shortage locally.[21] FDI can still come in but mainly to replace the local entrepreneurship rather than providing valuable technology and managerial skills. The positive contributions of FDI are thus reduced.

The two principal implications we can draw from this conceptualization of FDI – that the contributions of FDI depend on its institutional environment and that FDI can either substitute for or complement local entrepreneurship – are consistent with much of the empirical evidence in the FDI literature. For one thing, the findings on the general economic benefits of FDI have been, maybe surprisingly, non-uniform. Using cross-country national level data, Carkovic and Levine (2002) show that the exogenous component of FDI does not exert a robust independent influence on growth. FDI and growth are both affected by national income, school attainment, domestic financial development and openness to trade. Adjusting for the endogenous influence of these usual determinants of growth, they find no robust causal link running from FDI to economic growth. To the extent that FDI does exert a positive effect on growth, the mechanism centers on productivity enhancement via raising the competition level. (See, e.g., Aitken, Harrison and Lipsey 1996 and Chung, Mitchell, and Yeung, 2003). To extend this logic, this specific benefit of FDI would be limited if an institutional environment actively constrains competition.

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[21] The logic may run as follows. Due to the lack of property rights protection and other institutional restrictions, the shadow returns of production factors, including capital and labor, are above the returns appropriable from domestic firms' perspective. Also, domestic cost of capital is artificially high because investors' are not able to protect their rights. Foreign firms with better ability to protect property rights and to overcome institutional restrictions then find that their appropriable returns are above that of the domestic firms. By the same token, their willingness to supply capital exceeds that of domestic interests (especially when enough internal capital is available). Oftentimes, these economies also run policies biased in favor of foreign interests, e.g., special tax breaks for foreign owned firms. The consequence is that foreign owned firms have an arbitrage opportunity – the actual returns to their employed factors of productions exceed their market costs – and the arbitrage opportunity is available to them because of institutional and policy biases and their abilities to overcome institutional restrictions that dampen factor returns in the first place. (For a formal theoretical and empirical development of the idea in the context of poor intellectual property rights protection, see Zhao (2004).) The result is that foreign ownership displaces domestic ownership in activities that otherwise can be fully domestically engineered and owned. The resultant foreign owned activities do not raise domestic economic growth as much as the counterfactual where institutional distortions are absence.

Two strands of FDI literature explicitly incorporate the role of institutions. One, as in Aitken and Harrison (1999), shows that FDI in locations with poor institutional environment (e.g., Venezuela) may have a negative effect on the productivity of domestically-owned firms. Also, FDI in locations with weak institutional environment has a poaching effect on domestic firms in that foreign firms may have absorbed away productive workers from domestic firms. In contrast, in highly developed economies, as a proxy for good institutions, FDI is able to raise factor earnings across the board, i.e., independent of whether a factor is employed in domestic firms or foreign owned subsidiaries. Alfaro (2002) shows the growth augmenting spillover effect of FDI to be highly visible only in countries with well developed financial systems – that is, where FDI can serve as a complement to, rather than a substitute for, local entrepreneurship.

The other research strand examines individual country experiences in detail. One looks at China, a country similar to ASEAN in that it has received a substantial volume of FDI while relatively poor in institutional quality. Huang (2003) argues that the huge inflows of FDI to China have mainly substituted for domestic entrepreneurship. FDI can provide capital and some legal security to local entrepreneurs in a socialist economy with a strong ideological bias against the private sector. The end result is that foreign firms are able to obtain domestic investment opportunities on the "cheap" side. Again in the Chinese context, Huang and Di (2003) analyze two broadly similar provinces except for their institutional and financial treatments of domestic private firms. They find that the province with more efficient institutions has performed better and relied less on FDI in quantitative terms – i.e., measured as FDI/provincial GDP ratios – but has drawn in more technologically-intensive FDI.

We have already alluded to the substantial FDI dependency in Vietnam. The case of Vietnam is a striking illustration of the substitution role of FDI in a poor institutional environment. After the reunification of the country in 1976, the Vietnamese government implemented a systematic program of "war communism" aimed at completely eliminating private property rights. In 1986, the government introduced *Doi Moi*, an economic program aimed at macro stabilization, gradual structural reforms, and a substantial opening to FDI and foreign trade, while maintaining thorough state control over the economy.

These reforms, while opening up the economy to foreign investors, did not fundamentally improve the regulatory and financial treatment of domestic private firms. Various authors have documented the poor treatment of domestic private firms in Vietnam. Based on survey data, McMillan and Woodruff (1999), for example, report that 91 percent of the surveyed managers answered negatively when asked whether or not the courts could enforce a contract. Further, as noted

by McMillan and Woodruff (1999, p. 1286, footnote 2), this ratio was higher than those in Ukraine (55%) and in Russia (58%).

In a business environment restrictive of domestic private firms, FDI inflows increased dramatically. Vietnam's inward FDI stock/GDP ratio increased from only 0.2% in 1980 to 46.7% in 2000. Contrast the rapid expansion of the foreign sector with an almost stagnant domestic private sector. According to Abrami (2002, pp. 5-7), who conducted detailed field research in Vietnam, private enterprises' growth faced severe liquidity constraints in the 1990s. In 1995, domestic private sector accounted for 3.1% of GDP; in 2000, the share went up only to 3.3%. Interestingly, during the same period, foreign firms' share of GDP more than doubled, from 6.3 % to 13.2%. But, these observations illustrate that "substitution FDI" is essentially allowing foreign firms with the financial capabilities and the ability to protect property rights to capture profitable investment opportunities.

In Malaysia, there are also indications that FDI has played a substitution role rather than a complementary role. We have already shown that NEP undermined the property rights security for the ethnically Chinese businesses. What is very interesting is that the enactment of NEP coincided with a rapid expansion of FDI in the Malaysian economy. In 1970, FDI accounted for 11 percent of gross capital formation; in 1974, the ratio reached 20 percent and remained around 14 to 15 percent until the 1983 debt crisis (World Bank 2003). Beginning in 1985, FDI rose substantially again, to 25 percent of gross capital formation in 1992. As FDI rose, private domestic investments fell (Salleh and Meyananthan 1997, pp. 295-296). In the late 1970s, the Chinese share of corporate equity fell below 30 percent for the first time in history, against 70 percent in 1970 (Drabble 2000, p. 244). According to one estimate, 60 percent of the domestic investment contraction was attributed to the Chinese reluctance to invest. Morgan Guaranty estimated that the total capital flight during the 1976-1985 period amounted to 30 billion Malaysian ringgit.

An instrument to enforce policy biases in favor of foreign firms is the divestiture requirement imposed by the 1975 Investment Coordination Act (ICA). Under the ICA, a non-*bumiputra* business was required to transfer 30 percent of its equity to *bumiputra* controls but this requirement was waived for foreign firms exporting 100 percent of their output. The Promotion of Investments Act, promulgated soon after the enactment of ICA, allowed foreign investors 100 percent ownership if they exported 50 percent of output or they sold 50 percent of their output to Foreign Trade Zones (Drabble 2000, pp. 245-246). An example of using FDI to bypass the indigenous Chinese capabilities comes from Malaysia's push into the automotive industry in the early 1980s. Joint ventures were established between foreign firms and the state-owned Heavy Industries

Corporation of Malaysia (HICOM). Proton, the national car project and a joint venture with Mitsubishi, completely sidestepped the eleven existing automobile assemblers—all owned by Chinese.[22]

This substitution of domestic with foreign capital led a number of scholars to speculate that the Malaysian state intentionally used foreign capital to counterbalance the Chinese business sector. Contracts were often awarded to Malay firms at substantially higher bids compared to what the Chinese competitors offered. Malay firms, which lacked execution capabilities and necessary business skills, then teamed up with Korean or Japanese firms to execute the projects. FDI was, in the words of Lee and Tan (2000, pp. 138-139), "an ethnic bypass strategy." Another Malaysian scholar, Hoong (1991, p. 175), would put it this way:

> [F]or many years, the country has fallen short in their supply [of capital and entrepreneurship] and courted foreign investors to bring in these vital resources. However, it should be noted that some amount of domestic capital and entrepreneurship has always been available. Unfortunately, in the past, their availability was more identified with one ethnic group and therefore they were not optimally utilized….

It would be useful to re-cap our contentions in this section. Our position is that institutional inefficiency hammers a country's ability to fully capture its growth opportunities. The institution inefficiencies we refer to are excess state activism, poor property rights protection, and poor corporate governance. These institutional inefficiencies discourage capital market development and business upstarts by the "non-connected." These institutional inefficiencies can end up inviting foreign enterprises to come in to obtain business opportunities that could otherwise be available to indigenous entrepreneurs. Also, this kind of FDI does not generate lots of growth stimulating spillovers in technology, managerial skills, and entrepreneurial development. We dub this "substitution" FDI. The implication is that while institutional inefficiency countries attract FDI, the growth generating FDI function becomes more limited and the foregone internally driven growth can be considerable. Our concern is that ASEAN countries suffer from institutional inefficiencies.

[22] This section on the auto industry is primarily based on Lim (1991) and Jomo and Gomez (1997, p. 357).

5. Our conjectures of the likely policy response to FTAA

The policy implication of our analysis is that a substantial task for ASEAN economies is to get their institutions right in preparation for FTAA-like external shocks. Doing so would generate three benefits in light of the potential trade and FDI diversion associated with the FTAA and, indeed, with the rise of China. First, the ASEAN economies might utilize domestic resources more fully and efficiently. Second, they might shift from using FDI as a substitute for domestic sources of growth to using it as a complement. Consequently, even though ASEAN may lose its share of inward FDI flows to FTAA and China, each captured FDI project will have a greater growth impact and ASEAN countries can have greater internally driven growth. The net effect might still be positive.[23] Third, as shown above, countries with poor institutions tend to be more vulnerable to external and macroeconomic shocks. This is highly relevant to ASEAN in the context of FTAA in 2005. FTAA represents a form of external shock, in the same way as the rise of China and the 1997 financial crisis.

Two policy responses to the pending formation of FTAA are theoretically feasible. One is to undertake institutional reforms so as to improve resource allocations and productivity. This represents a long term cure that attacks the root of the ASEAN countries' development problem. The other policy response – a short term cure – is to raise the business opportunities available to ASEAN firms. The principal mechanism here is to expand and secure their access to China's expanding market. In and of themselves, these two policy responses can complement each other; the empirical issue is whether ASEAN countries emphasize one set of policy responses over the other set.

We can only supply some educated guesswork as to ASEAN's likely policy responses. Our conjecture is that ASEAN countries will pursue the short-term option – enlarging market access – but not institutional reforms. Our conjecture is in part theoretical – based on the prior research on the preferences and behavior of large and politically-connected businesses. Our conjecture is also partly empirical; we draw three examples – the response of Malaysia to the 1997 financial crisis, ASEAN countries' systematic aversion to portfolio investments, and the recent response by ASEAN to the rise of China – as a predictor of the likely policy response of ASEAN to FTAA 2005.

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[23] Note, however, that Vail (2004) points out that the internal institutions in many Latin American countries are not better than ASEAN countries. The hope for these Latin American countries is that the formation of the FTAA would provide the impetus for improvement. That raises the interesting point that the two regions should be engaged in a competition on improvement of internal institutions.

As Morck and Yeung (2003) show elsewhere, existing business elites are not normally keen on changing their institutional environment – by improving property rights, improving corporate governance, and liberalizing capital markets.[24] After all, incumbent elites benefit from their existing institutional environment and want to preserve the status quo. However, they value market access. ASEAN countries are quintessential examples of political structures dominated by big family-owned business groups. Herein lies our theoretical conjecture that ASEAN countries are more likely to respond to FTAA by enlarging business opportunities and enhancing market access *in lieu of* institutional reforms.

Three well-documented policy responses in ASEAN illustrate our characterization that ASEAN countries have a captive political structure. They also provide some empirical basis for our prediction that their policy response is likely to favor the short-term cure. The first example is the imposition of capital controls by the Malaysian government in the wake of the Asian financial crisis in 1998. As Johnson and Mitton (2003) show, the most clear-cut effect of the imposition of the capital controls is that well-connected and elite firms benefited. Firms lacking in political connections were hurt. Capital controls, thus, were a mechanism used by the government to channel resources to the politically favored firms.

Complementary to Johnson and Mitton (2003), we would add that Malaysia's institutional quality declined between 1996 and 2001 across a range of indicators. The rule of law index, devised by International Country Risk Guide (with a scale of 0-6 and higher value indicating stronger rule of law), declined from 5 in 1995 to 3 in 2001. The political rights index, devised by Freedom House (with higher values denoting less political rights), rose from 4 in 1995 to 5 in 2001. The economic freedom index, devised by the Heritage Foundation (with higher values denoting less freedom), rose from 2.4 in 1995 to 3 in 2001. Thus we can go one step further in our conjecture: the short-term cure is not only adopted in lieu of a long-term cure but *at the expense of* the long-term cure.

Our second example is inspired by the imposition of capital controls in Malaysia. In imposing capital controls, the Malaysian government took specific steps to avail a special exemption to FDI. This is telling of the way the incumbents safeguard their interests. The established are particularly wary of those investors over whom they find it difficult to control. While FDI is stable and is partially amenable to elite controls (through, for example, joint ventures), portfolio investments are in fact more demanding of a country's institutions

[24] See Durnev, Li, Morck, and Yeung (2003), Morck and Yeung, (2003), and Morck, Wolfenzon, and Yeung (2004).

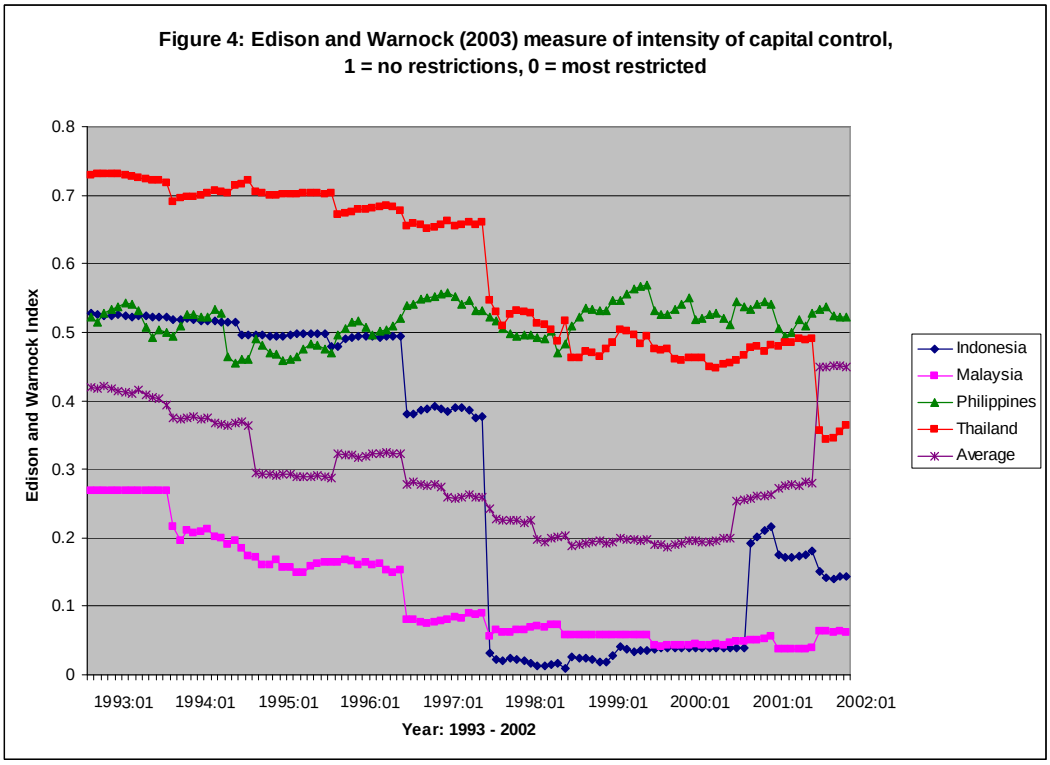
precisely because these investment decisions are highly sensitive to short-term events. Hausmann and Fernandez-Arias (2000) has argued that high FDI/total capital inflows can be an indication of a country's institutional weaknesses.

This logic predicts that ASEAN countries may have a systematic aversion against foreign portfolio investments. There is evidence that ASEAN countries have instituted high barriers to foreign investments in stock markets, especially for the countries hit hard by the Asian financial crisis. To establish the point, we use a carefully developed *capital market openness measure* provided by Edison et al (2002). It is a direct measure of the openness of each country's stock market to foreign investors, essentially reflecting the value of stocks that can be purchased by foreign investors as a percentage of total domestic stock market capitalization.[25] The index should assume values closer to one if a market is more open and closer to zero if it is more closed. For the period of 1993 to 2002, we compare the index for Thailand, Malaysia, Indonesia, and the Philippines to the average of these countries' peers in the Latin American countries and in other parts of Asia (Argentina, Brazil, Chile, Columbia, India, Korea, Mexico, Peru, Pakistan, Sri Lanka, and Venezuela).

The result is graphed in Figure 4. The graphs indicate the following. First, all countries had worsening stock market openness in the nineties. Second, the ASEAN countries' peers in Asia and in Latin America have reversed course and opened their stock market more in the 2000's. However, the four ASEAN countries, except the Philippines, have continued to reduce their stock market openness. At the end of 2002, Malaysia, Thailand, and Indonesia have more closed stock markets than their peers.[26]

[25] This measure is based on an "invest-able" index, reflecting the market as available to foreign investors, divided by a "global" index, reflecting the whole market. Both are from the International Finance Corporation (IFC). To control for "asymmetric shocks to investable and non-investable stocks", the measure is adjusted using price indices computed by IFC for the two categories of stocks. Since the stocks available to foreigners may trade at different prices than the stocks available to locals, the value of stocks available to foreigners can, in theory, exceed total domestic stock market capitalization. The index used in Edison *et al.* (2002) is actually one minus this openness ratio, and measures the intensity of capital controls.

[26] We should note, however, that the stock markets in Argentina and Brazil are as close as the Malaysia stock markets, according to the Edison and Warnock index.



The average is the average "Edison and Warnock Index" of Argentina, Brazil, Chile, Columbia, India, Korea, Mexico, Peru, Pakistan, Sri Lanka, and Venezuela.

Our third example has to do with the ASEAN countries' recent effort to increase intra-regional trade in conjunction with an apparent or even purposeful neglect toward institutional reforms. As noted before, since the Asian financial crisis, institutional quality in East Asia has not noticeably improved, at least according to the World Bank. In sharp contrast, also according to the World Bank, intra-regional trade among East and Southeast Asian countries has outpaced the growth of the world trade as a whole (World Bank 2003). Figures 2a and 2b also show the same contrast.

The most direct piece of evidence concerns ASEAN countries' concerted efforts to gain access to China's growing markets. In October 2003, the summit of ASEAN countries in Bali concluded a series of agreements with China to allow preferential market access for products from ASEAN countries in China by 2010. According to press reports, this move was eagerly embraced by both big conglomerates and political leaders in the region. At the Bali summit, the prime minister of Thailand, Thaksin Shinawatra, clinched side deals with the Chinese government to allow special market access for Thai products. Firms such as Charoen Pokphand, the huge ethnic Chinese business, stand to benefit from such

deals. (It should be noted that Thaksin Shinawatra himself came from a big business background.)[27] Political leaders are equally enthusiastic, e.g., President Gloria Arroyo of the Philippines is quoted by the World Bank as stating that combining the ASEAN and Chinese economies "would give birth to a market of 1.8 billion consumers or almost one-third of humanity" (World Bank 2003, p. 7).

The strengthened trade relationship between ASEAN countries and China, while providing some relief to the ASEAN region, is fraught with its own risks, if not coupled with institutional reforms. China's economy rests on a fragile financial sector, with non-performing loans estimated at 40% of the total banking assets. A financial crisis in China cannot be ruled out. Building up substantial economic ties with China may exacerbate the contagion factor. There are also geo-political risks with this strategy as well. The current tensions between China and Taiwan may exert a cascading effect in the region.

Our conjecture is that ASEAN countries will put the short-term cure ahead of the long-term cure when devising a response to the FTAA formation in 2005. Unless there is a substantial decline of the political entrenchment factor, there is little reason to believe that ASEAN countries will shift to a different policy trajectory at the time of the FTAA formation in 2005 other than the three examples we provided above. The formation of FTAA is likely to jolt ASEAN into a closer economic integration with China and very possibly with the United States[28] rather than, as our analysis suggests as the first-best option, embracing institutional reforms. Our analysis suggests that this does not bode well for the region.

6. Conclusion

In this paper we acknowledge the concerns on the part of ASEAN countries about the trade/FDI diversion effect that may be associated with FTAA. But we also acknowledge a number of caveats. One is that FTAA and the rise of China may also represent a market opportunity. Secondly, the magnitude of the trade/FDI diversion effect would depend on a number of dynamics outside the scope of this paper, e.g., whether or not there are multiple regional integration frameworks at work. Thirdly, one may wish to point to the fact that Latin American countries

[27] The coverage of the summit is numerous. Some samples include McDonald (2003) and "ASEAN business summit" (2003).

[28] Indeed, Singaporean government has embarked a comprehensive negotiation with the United States over market access.

have their institutional deficiencies as well, as identified in the paper by Vial (2004).

Because of these empirical uncertainties, the major aim of this paper is to provide an analytical framework that identifies an appropriate policy response *assuming* the trade/FDI diversion effect to be severe. For this reason, we did not go into the specifics and the details of the trade/FDI ties between ASEAN and FTAA other than noting that these ties seem to be quite important. We also did not draw sharp distinctions among ASEAN countries and examine the details of the country-specific dynamics. Our aim is not to explain the *variance* among ASEAN countries (although we note the significant exception of Singapore on several dimensions), but to focus on what these countries have in common.

The framework we propose is an institutional one and we believe that this framework can productively account for the spurt of economic growth experienced by many of the ASEAN countries in the past as well as identifying their current and future economic difficulties. These difficulties are associated with the three ongoing and potential external shocks – FTAA, the 1997 financial crisis and the China factor. We show that the quality of economic and legal institutions in many ASEAN countries is poor and the possibility that incumbent elites are privileged by these institutions.

Under these institutions, an economy could experience growth, but erratic growth, for the following reasons. First, even non-savvy rush of capital to elite-controlled firms can spur growth because sheer investment in capital can fuel growth. But there are costs to such growth as these investments may not adequately finance the cost of capital. The high non-performing loan ratios in Indonesia, Malaysia, and Thailand illustrate the point. More often than not, such high growth spurred by rushing of capital investment to elite-controlled firms is a prelude to economic collapse. Painful and slow recovery will ensue.

Second, in the absence of efficient domestic institution and investments, FDI could step in as a substitute. Indeed, the shadow returns to foreign firms are high precisely because the politically privileged businesses lack innovation, risk-taking and entrepreneurial talents while indigenous entrepreneurs with innovations and talents lack capital, "connections," and legal protection. Foreign firms are left with a wider field of opportunities than otherwise would be the case because inefficient institutional environments reduce the local firms' ability to grab economic opportunities.

We should also add another entirely fortuitous factor that worked in favor of ASEAN countries attracting FDI. In the 1970s and 1980s, much of the developing world shunned FDI and these ASEAN countries, by handing out generous tax and other incentives, won the FDI race handily. This is where the tripartite threats identified in this paper become highly relevant. Separately or

collectively, FTAA, the 1997 financial crisis and rise of China will and have reduced the supply of FDI capital to the region.

The logical upshot of our analysis is that a rational policy course for the ASEAN countries is to improve the quality of their institutions. As we have shown, except for Singapore, the institutional quality of ASEAN countries not only lags that of OECD countries but even that of some of the developing region of the FTAA. Improving institutions may or may not increase the total flows of FDI but it leads to a more efficient utilization of domestic resources and a shift of role of FDI as a substitute for domestic entrepreneurship to that of a complement to domestic entrepreneurship.

The demand for institutional improvement is clear, but so far the political supply has fallen short. Our tentative prediction is that ASEAN countries will put the bulk of their policy emphasis on securing market access for their elite business groups rather than undertaking the much-needed institutional reforms. This prediction is partially borne out by the lack of progress in institutional reforms since the 1997 financial crisis. This does not bode well for ASEAN as FTAA in 2005 may jolt the less-than-prepared region once again.

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