THE EFFECTS OF BILATERAL AND REGIONAL INVESTMENT AGREEMENTS ON THE FDI INFLOWS INTO ASEAN COUNTRIES

by

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TABLE OF CONTENTS

Page

List of Tables. vi

List of Figures vii

Abstract…… viii

Chapter 1 Introduction 1

1.1 Introduction 1
1.2 Motivation and Relevance 2
1.3 Research Questions 4

Chapter 2 Literature Review 8

2.1 Definition of Terms – Foreign Direct Investment 8
2.2 International Investment Agreements (IIAs) 18
2.3 Trends in FDI Flows to Developing Countries 22
2.4 Theoretical Framework on FDI 22
2.5 Host country determinants of FDI 26
2.5.1 Market-related factors 28
2.5.2 Factors of production 29
2.5.3 Openness to trade 31
2.5.4 Exchange rate 31
2.5.5 Institutions 32
2.5.6 FDI policy 35
2.5.7 International Investment Agreements 39
2.6 Discussion of earlier research on the effects of IIAs 39

Chapter 3 ASEAN 51

3.1 Background on ASEAN 51
3.2 Why Is the FDI Issue Interesting for ASEAN? 55
3.3 Investment Cooperation and the ASEAN Investment Area 58
3.4 Recent Changes and Progresses Made Under the AIA 65
3.5 Patterns and Trends of FDI in ASEAN 67
3.6 Some Political Economy Aspect of ASEAN and Its Policies With Respect to FDI and Regional Economic Cooperation 73
3.7 Summary 79

Chapter 4 Methodology 80
4.1 Introduction 80
4.2 The Panel Data Analysis 80
4.3 Model Specification 82
4.4 Testing and Estimation 87
Chapter 5 Variables and Data Sources 93
5.1 Dependent Variables 93
5.2 Explanatory Variables 95
5.3 Handling of Missing Data 113
5.4 Summary 113
Chapter 6 Empirical Results 115
6.1 Results and Interpretations 115
6.2 Empirical Results: Determinants of Aggregate FDI 116
6.3 Additional Empirical Results: Determinants of Intra-ASEAN FDI 139
6.4 Summary of the Findings 143
Chapter 7 Final Conclusions and Policy Implications 147
7.1 Conclusions 147
7.2 Policy Implications 149
7.3 Future Research Direction 153
Appendixes… 156
List of References 164

LIST OF TABLES

Table Page
1. Key investment-related issues of some IIAs 1
2. FDI from Developing and Transition Economies, 1985-2004 5
3. Description of Literature on IIAs as Determinants of FDI 10
4. List of investment-related agreements in ASEAN 15
5. Phase-out Timeframe of Temporary Exclusion List 20
6. Cumulative Number of BITs Signed and Ratified by Countries, 1985-2005 25
7. Cumulative Number of North-South BITs vs. South-South BITs, 1985-2005 30
8. Variables, Descriptions and Expected Signs 40
9. Summary descriptive statistics of the study variables 50
10. The Correlation Matrix 75
11. Baseline Model, (logged FDI flows in constant (2000) dollars) 100
12. Comparison of Results, 1980-1995 vs. 1980-2005, Baseline Model 125
13. Baseline Model vs. Model 2 that controls for exchange rate 128
14. Comparison of Models (logged FDI flows in constant (2000) dollars) 132
15. Model 4, BITs ratified vs. BITNS, BITSS 134
16. Model 4, No interaction term vs. Interaction term 140
17. ASEAN Countries' Share in Global FDI Flows 147
18. Intra-ASEAN FDI 148
19. INFRA (natural log of telephone lines and mobile phone subscribes per 1,000 inhabitants) vs. INFRA2 (road density per capita) 170
20. BITNS, BITSS, and AIA on the overall FDI inflows, 1980-2005 GDPPC (Current 2000US$) vs. GDPPC (PPP) 172

LIST OF FIGURES

Figure Page
1. Number of BITs concluded, cumulative and year-by-year, 1990-2004 .....……1
2. Total Net Resource Flows to Developing Countries, by Type of Flow, 1990-2005 (Billions of dollars) 5
3. FDI Outflows from Developing and Transition Economies.....10
4. Cumulative FDI Outward Stock of Developing Countries and Cumulative South-South BITs and DTTs, 1990-2003 15
5. Net FDI Inflows into ASEAN, 1995-2005 (Billions of dollars).....20
6. FDI in ASEAN by Source Country, 1995-2004 (percentage) 25
7. Cumulative BITS signed by 10 ASEAN Countries.....30
8. Cumulative North-South BITs and South-South BITs in ASEAN, 1980-2005 40

ABSTRACT

THE EFFECTS OF BILATERAL AND REGIONAL INVESTMENT AGREEMENTS ON THE FDI INFLOWS INTO ASEAN COUNTRIES

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The competition for foreign direct investment (FDI) has resulted in many developing countries resorting to international investment agreements (IIAs) as a legal mechanism to encourage FDI based on the basis that these international commitments are more credible than domestic policy choices for the cost of reneging on them is more costly. IIAs are legal instruments that contain a set of rules governing FDI and specifying the rights and obligations of foreign investors, investing countries and recipient countries. The proliferation of IIAs over the years illustrates the belief of the policymakers in the efficacy of these policy instruments in helping to attract FDI. However, there is still very limited empirical evidence to support the claim of their positive role. The aim of the research is to contribute to the existing empirical literature on FDI by incorporating international FDI policies that to date have not yet been thoroughly studied. It employs Dunning's ownership-location-internalization (OLI) framework to investigate the extent to which investment agreements play a role in attracting FDI inflows from within

ASEAN and outside ASEAN to the countries and compare these influences with those of other macroeconomic and institutional factors over time. The analysis is undertaken using a panel data set covering ten ASEAN countries over the period 1980-2005. The findings demonstrate that BITs or the bilateral type of IIAs made with developed countries have a positive impact on FDI inflows into ASEAN countries and confirm the crucial role played by the quality of domestic institutions. The results are robust to changes in model specification. The empirical results also indicate that BITs function as a complement rather than a substitute for domestic institutional quality. However, there is no evidence that the ASEAN Investment Area, which is a regional type of IIA made among ASEAN nations serves to stimulate intra-regional or inter-regional FDI flows to the region.

CHAPTER 1

INTRODUCTION

1.1 Introduction

During the past several decades, there has been a significant shift in developing countries' attitude towards FDI. This shift in developing countries' stance towards FDI is closely related to the changes in national and international policies on FDI as well as the pattern of capital flows itself. In the earlier period, developing countries worldwide had a cautious view toward FDI. They were quite hostile towards multinational investment because the investment raised many concerns among them. They were leery of the fact that foreign interests would have a control over their natural resources and possibly have political and economic influences on their countries. Many developing countries especially those with unpleasant experience of colonialism questioned whether it was just another form of exploitation in the modern era. As such, various controls and restrictions over the entry and operations of foreign companies were imposed in many countries with an aim of excluding FDI from certain industries for the benefit of their domestic companies.

Today, by stark contrast, developing countries now generally welcome FDI and have liberalized their FDI regimes to a considerable degree. Flows of FDI have seen a

dramatic rise due to increasing openness of host economies. Countries around the world have increasingly recognized the significance of FDI and its impact on their countries. Governments have thus implemented various policies trying to influence FDI decisions to support their overall economic development goals.

While a host economy's economic fundamentals have always played a key role in attracting FDI, many governments have now relied on investment treaties as important legal mechanism in encouraging and governing FDI. This has resulted in a proliferation of rule-makings on investment at bilateral, regional and multilateral levels. International agreements of relevance to FDI have increased substantially both in number and geographical coverage over the past decade. For example, the number of bilateral investment treaties (BITs), which are legal instruments that contain a set of rules governing FDI and specifying the rights and obligations of foreign investors, investing countries and recipient countries rose from 470 treaties in 1990 to reach 2,495 in 2005, with the parties including both developed and developing countries (UNCTAD 2005). Over 2,700 other double taxation treaties and 232 international agreements containing investment provisions have been concluded. This trend shows no sign of abating.

1.2 Motivation and Relevance

The sharply increasing number of those international investment agreements (IIAs) over the years reflects the belief of those governments in the efficacy of this type of policy instrument. The preambles of thousands of those signed treaties all state that their purpose is to promote FDI. It was clear that those developing countries that sign

IIAs with other countries were expected to see significant FDI inflows due to the protections for foreign investors that the agreements provide. But do those agreements actually fulfill their stated objectives or not? As it takes tremendous investment in terms of time and effort from the countries participating in drafting, negotiating, signing and complying with those BITs, it is worth investigating whether or not empirical evidence confirms the significance of those international FDI policies or more specifically the signing of bilateral investment treaties and regional investment agreements. The aim of this dissertation is to gain better understanding of how ASEAN countries can make themselves relatively more attractive as location for FDI through various factors with particular focus on the BITs and the AIA Agreement, which are ASEAN's individual and collective effort respectively to stimulate inward FDI.

Despite the great number of BITs concluded, the evidence on their effectiveness is still limited. Even though there exists a large body of literature on the determinants of FDI, few studies have empirically estimated the impact of IIAs as a determinant of FDI. Most literature that is available today consists of studies that discuss and assess the impacts of the substantive provisions contained in the IIAs from a legal perspective. They do not provide answers to the questions as to whether or not those IIAs are worth doing in the first place. It demands quantitative evidence on the subject, which will be a central focus of this dissertation.

1.3 Research Questions

This dissertation examines the effects of international investment agreements at bilateral and regional levels on the inflows of FDI into ASEAN countries. The emphasis will be placed on a set of policies of the host governments that can potentially influence FDI flows, namely international FDI policies. The reasons this topic is worth investigating are manifold.

First, as stated earlier, even though studies on the influences of potential determinants of FDI are plentiful, only a very limited proportion has empirically investigated the impact of investment agreements that are directly aimed at attracting FDI. Of the few studies that have been done on the subject, their findings are not conclusive and often conflicting. There are various key issues that have not been addressed by those studies. First, most studies conducted on this subject paid attention to only the IIAs made with a developed country but ignored the IIAs made between developing countries, which are rapidly increasing and becoming a greater part of the IIA universe. The growing importance of the South-South IIAs as well as the North-South IIAs demands a clear understanding of their impact on FDI inflows.

Further, the studies only touched on the impacts of IIAs at the bilateral level in the form of BITs but one common area overlooked is IIAs made at a regional level. There is one study that investigated the impacts of IIAs at the regional level but this study as well as others each contains its fair share of shortcomings preventing policymakers and readers from applying to their own situations facing developing countries in a useful way (Banga 2003). Specifically, most studies have no concern for the role of social variables

such as the quality of institutions which is potentially a crucial determinant of FDI for developing countries and directly related to why there is a need to have IIAs in the first place. For IIAs are negotiated and signed by developing countries with weak institutions in the hope that those IIAs will bypass the need for an overall reform and help stimulate inward FDI to the countries, and the conclusions arrived by those studies that do not take account of the interplay between institutions and the IIAs will have limited application for developing countries deciding to rely on IIAs as a mechanism for FDI promotion. Our study will investigate the impacts of IIAs made between North-South countries and South-South countries as well as a regional investment agreement and look at the relationship of the quality of domestic institutions with the IIAs for developing countries.

The geographical coverage of interest in this study is the ASEAN (Association of Southeast Asian Nations) countries. Southeast Asia is one of the few regions that have long supported regional cooperation in promoting FDI. One of their efforts was a creation of their regional investment agreement called "ASEAN Investment Area" (AIA). As one of the proclaimed goals of the AIA is to promote FDI flows into and within ASEAN, this dissertation will also seek to investigate whether this regional investment agreement as well as other BITs conducted by the member countries have differential impact on intra-regional and inter-regional FDI inflows or not as well.

In light of the fast-changing process of globalization and increasing trade liberalization, many scholars assert that the determinants of and motivations for FDI in developing countries could have changed (Dunning 2002; Nunnenkamp 2002). Although traditional market-related determinants are still dominant factors, they argue that there

could be other non-traditional factors that have gained importance as determinants in just the same way that some formerly important factors may have lost their relevance. For example, in the past when there was not much trade liberalization as today, tariff jumping was a major motive of MNEs for investing in other foreign locations. However, now that developing countries have liberalized their import regimes as part of trade liberalization under the WTO, it has reduced the relevance of market access through FDI for many products (Nunnenkamp 2002). This argument is supported by the UNCTAD econometric analysis that host country market-related variables "explain less of the variation across countries in more recent years than in earlier periods" (UNCTAD 1998, P. 140). Therefore, there is a need to look at the recent shifts in the relative significance of policy variables in determining the location of multinational activities. Further, particularly for developing countries, it could be argued that treaties play a more important role as a credible mechanism for commitment relative to other traditional FDI determinants considering the fact that developing countries exhibit various characteristics that are markedly different from developed countries. A case in point is Thailand whose national constitutions have an average life span of a little over four years as they are repeatedly abolished by military coups, but treaties and international obligations are always upheld. This suggests that for developing countries, treaties can play a more salient role as commitment device that may be even more credible than the supreme law of the land. Intrigued by this perspective, the dissertation will test the relative importance of various FDI determinants and to see if the importance of the traditional market-related

determinants still holds compared to those of non-market-related determinants in today's world that has undergone various changes through globalization.

Specifically, this dissertation seeks to answer the following questions. First, how successful are international FDI policies that aim at bringing more inward FDI? Do IIAs matter and what are their effects on the FDI inflows to ASEAN over time? The dissertation will distinguish between the North-South agreements and South-South agreements and investigate whether the IIAs with developed and developing countries have differential impact on FDI inflows or not.

Second, how important are those FDI policies vis-à-vis other determinants such as the quality of institutions? Does FDI that originates from within the same region respond any differently to those factors than what aggregate FDI does? This dissertation will contribute to the empirical literature by incorporating other non-market-related variables such as the availability of investment agreements to the current understanding of traditional variables. An understanding of the effects of selective FDI policies will help improve the practice of investment agencies in many countries and prevent governments from expending valuable resources in wasteful activities and help them form a more efficient FDI policy.

CHAPTER 2

LITERATURE REVIEW

2.1 Definition of Terms - Foreign Direct Investment

The working definition of FDI is investment of foreign assets by a foreign entity to acquire a lasting interest in an enterprise in a host economy by gaining some management control of the invested enterprise. The direct investment relationship is assumed when such foreign equity ownership meets the threshold of ten percent (Bende-Nabende 1999; Reinert and Goldin 2005). FDI may involve either creating an entirely new enterprise as so-called 'greenfield investment' or acquiring all or parts of the ownership of existing domestic enterprises via merger and acquisitions. The definition of FDI includes both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises such as reinvestment of earnings into the enterprise and the provision of long-term and short-term intra-company loans between parent and affiliated enterprises (UNCTAD 1999).

2.2 International Investment Agreements

In the past, foreign investors found themselves subject to undue risk due to a possible, unilateral action by host governments that could jeopardize the investment. Without a clear protection of property rights, foreign investors lacked assurance in their

investment and many times were subject to unfair treatment with no legal recourse. As such, the legal architecture for the protection of foreign investment was created thereafter in the form of international treaties.

The term "investment agreement" refers to a legal instrument that contains a set of rules governing FDI. Any proposals that will be considered an IIA must be aimed at defining the investment rights and obligations of foreign investors, investing countries and recipient countries (World Bank 2003). Countries have entered into one or more IIAs in various ways to liberalize, promote, protect or regulate international investment flows. However, the scope of IIAs from one to another can vary dramatically depending on how broadly the terms such as "investment" and "investors" are defined in any particular agreement. The scope and breadth of coverage of IIAs are not only determined by subject-matter coverage, but also by geographical and temporal coverage as well (UNCTAD 1999). Whether they are bilateral or regional in nature, IIAs typically contain the gradual decrease or elimination of measures and restrictions on the entry and operations of foreign firms and application of positive standards of treatment with a view to eliminate discrimination against foreign enterprises. Though with exceptions, modern BITs appear to have broad uniformity and share common features. In general, IIAs typically contain provisions that can be classified into the following three broad topics: scope and definition of investment, investment liberalization, and investment protection. Additionally, some IIAs also contain provisions that promote investment (UNCTAD 2006). Each of the four topics (scope and definition of the investment, investment

liberalization, investment protection and investment promotion) mentioned here can be further explained as the following:

a. Scope of the agreement

The standard provisions define the subject matter coverage of an IIA by classifying what are to be considered “investment” and “investors”.

b. Investment Liberalization

Investment liberalization provisions are those that reduce or eliminate government measures that restrict entry, establishment and operation of cross-border investment. Some of the key substantive issues often found in investment liberalization provisions of an IIA are such as right of establishment, transfer of funds and performance requirements (UNCTAD 2006).

c. Investment Protection

The key substantive issues under the category of investment protection commonly found in IIAs are standards of treatment, expropriation and dispute settlement mechanism. The following discusses their principles.

Three common standards of treatment in IIAs are the "most-favored-nation" (MFN) standard, the national treatment standard and the standard of "fair and equitable" treatment. These treatment standards are meant to ensure nondiscrimination for investment. The national treatment standard guarantees no less favorable treatment to foreign investors than that granted to domestic investors. The MFN standard guarantees no less favorable treatment to foreign investors than that granted to investors of any third country.

As for expropriation, most IIAs recognize the right of the host country to expropriate, under the conditions that they are "for a public purpose, non-discriminatory, in accordance with due process and accompanied by compensation" (UNCTAD 1998; UNCTAD 2006, p. 48).

A dispute settlement mechanism (DSM) is also an essential issue for IIAs particularly from the perspective of investors. Normally, as treaties are legal agreements between member states, the actors who can enforce the laws would be only the states party to the treaty. However, some treaties do provide for the possibility settling disputes between foreign investors and host countries without the involvement of the investor's home state. DSM provisions provide a way for the parties involved to settle the issue when the host country is alleged to have violated the treaty in question. Most BITs in the early days contained only the state-state arbitration, but by 1990, almost all new BITs provide for investor-state arbitration for most issues that might arise under the treaty, allowing foreign investors to argue the case without needing to first obtain the support from their home country governments (Tobin and Rose-Ackerman 2006).

d. Investment promotion

Investment promotion provisions are provisions that require or encourage member countries to coordinate to promote investment flows among themselves through a number of means such as through creation of facilitation programs, etc. It is the least popular topic included in IIAs.

Table 1 summarizes the key investment-related issues in IIAs that were just described. It covers some important IIAs and shows the nature of each agreement by many topics and sub-topics are included in each IIA.

Table 1. Key investment-related issues of some IIAs

Agreement	Scope	Liberalization			Legal Protection							Promotion	
	Definition of investment/investor	Admission: Rights of establishment	Transfer of funds	Performance requirements	Treatment after entry: National Treatment	Treatment after entry: Most Favored Nation	Fair and Equitable Treatment	Expropriation	Intellectual Property Rights	Dispute settlement: State-State	Dispute settlement: Investor-State	Promotion	Framework / future negotiation
NAFTA	•	•	•	•	•	•	•	•	•	•	•		
MERCOSUR Colonial Protocol (1994)	•	•	•	•	•	•	•	•	•	•	•		
COMESA (1993)	•	•	•				•	•		•			
CARICOM (1971/2001)	•	•	•		•	•			•	•		•	
Investment and Free Movement of Arab Capital Among Arab Countries (1970)			•		•	•		•				•	
Australia-United States BIT (2003)	•	•	•	•	•	•	•	•	•	•			
Japan-Singapore BIT (2002)	•	•	•	•	•		•	•	•	•	•	•	
ASEAN Investment Area (1998)	•	•			•	•				•		•	

Source: (UNCTAD 2006)

Typical BITs drafted by a developed country are rather similar in provisions as they are based on the 1967 Draft Convention on the Protection of Foreign Property and on existing BITs (Salacuse and Sullivan 2005). Some differences however exist between actual BITs as they are modified by the parties involved. Special notes should be given to the BITs in which both parties are developing countries (South-South BITs). Although the South-South BITs may not differ from other BITs so much in their common objective of promoting and facilitating investment, differences lie in the depth and breadth of the coverage on investment issues. Particularly, South-South BITs tend to involve greater degree of cooperation activities in areas besides investment issues such as trade and labor aimed at addressing the development concerns of the parties involved in a way that is more prominent than other BITs in general (UNCTAD 2005m).

The rationale for IIAs

The proliferation of IIAs has been propelled by a number of causes. Chief reasons among them were the competition for FDI and the belief of policymakers in the efficacy of IIAs as well as external pressure from the demand by foreign investors for credible property rights protections (Elkins, Guzman et al. 2004; Kobrin 2004). Before IIAs were conceived, the only available legal tool at disposal for foreign investors was to rely on customary international law. A view shared among the capital exporting countries at the time was that foreign investors were entitled to have their property protected by customary international law and that the taking of a foreign investor's property by a host state required compensation that was "prompt, adequate, and effective" under the

requirement that has become known as the Hull rule[1]. However, this view was not shared by all countries particularly the capital-receiving, developing countries. On the one hand, there is a universally accepted principle that the state has the right to exercise their sovereignty over economy activity that takes places within its territory, but on the other hand, it was not clear whether there also exists an external, international standard of treatment to which foreign investors are entitled such as the Hull rule. As such, this put investors who relied solely on the protection of their investment granted by weak customary international law under great risk and uncertainty. Although host countries have an incentive to offer fair and equitable treatment to investors and in many cases have promised such protection by domestic legal rules, once the investments have already been made, investors would have had sunk significant costs, the host countries will find it difficult to credibly commit to their prior position since it is to their own advantage to exploit or even expropriate the assets of foreign investors. This dynamic inconsistency problem presented a need for IIAs that can provide substantive legal rights which can be enforced in a domestic or international judicial forum for the protection by domestic laws alone is inadequate and is a weaker commitment device compared to international treaties made between states. The main goals of instruments such as BITs are protection from non-economic risk and coordination of other instruments that reduce risk and investment promotion is the byproduct of these goals. Interestingly, although nationalizations and expropriations were quite common in the 1960s and 1970s, there was a substantial

[1] It was named after Cordell Hull, the American Secretary of State, who put forth this requirement in the 1940s.

decline of outright expropriations of foreign investments starting in the 1980s, which was about the same time that BITs flourished (Minor 1994).

IIAs can then be viewed as instruments that reduce transaction costs for the investor, thereby raising the expected the rate of return on investment (Elkins, Guzman et al. 2004). The two competing theories for the potential effects of IIAs are the commitment effect and the signaling effect. As countries commit themselves to the obligations set forth in the agreements, they are bound by the agreements, which can be arbitrated, and enforced. When disputes arise and if the investor-State dispute settlement mechanism is present in the IIA, investors can bring the claim to a neutral arbitral body such as the International Centre for Settlement of Investment Disputes (ICSID) for determination of awards, by which the government must abide (UNCTAD 2003). The foreign investors can bypass or avoid national systems and proceed straight to the international arbitration, where they are entitled to choose one of the three panelists as well as to co-select another panelist. In this regard, IIAs can be viewed to function as a credible commitment device. Alternatively, though not mutually exclusive, a country may look to increase investment by sending a meaningful signal to investors that it will well respect the rights of the foreign investors. From a signaling perspective, if the signal is credible enough, the IIA being concerned could influence investors from all countries, not necessarily limited to the countries that are party to the agreement as in the case of the commitment effect.

The proliferation of IIAs

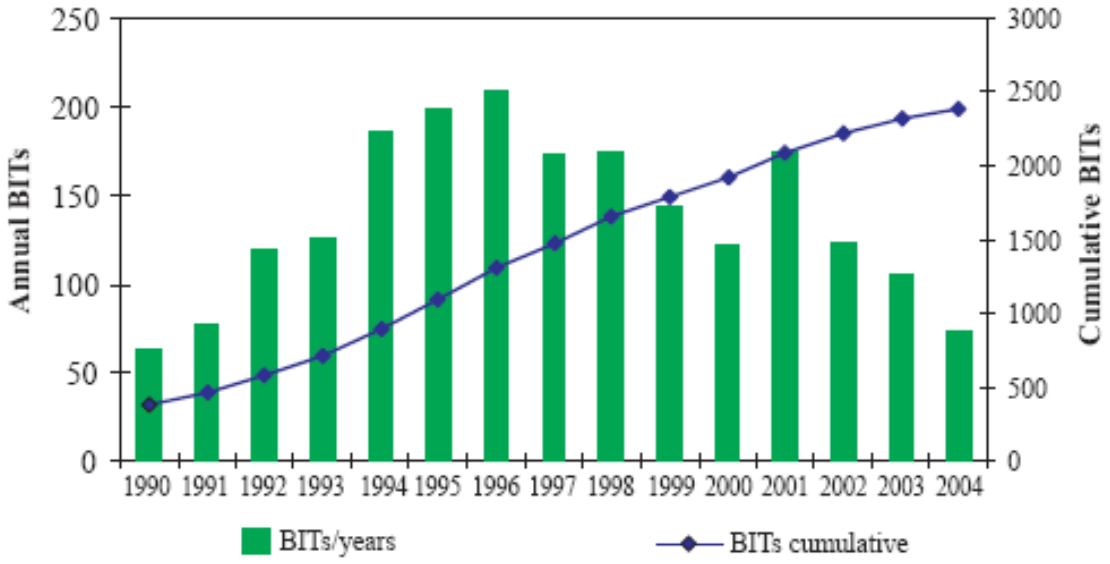

Figure 1. Number of BITs concluded, cumulative and year-by-year, 1990-2004
Source: UNCTAD (www.unctad.org/iia)

IIAs can be created at three levels: bilateral, regional/plurilateral and multilateral. The predominant form of IIAs is the bilateral type referred to as BITs. BITs have now become an important part of the regulation of worldwide investment flows. The first BIT was signed between Germany and Pakistan in 1959 and entered into force in 1962 (Hallward-Driemeier 2003; Tobin and Rose-Ackerman 2006). The number rose sharply starting in the 1990s. In 2005, 70 BITs were concluded, and this brought the total number of BITs to almost 2,500, linking countries from all regions and various levels of development. In the earlier period, almost all the earlier BITs were between rich OECD countries and developing countries but these days it is the signing between developing countries that most contributes to the rise (Hallward-Driemeier 2003). In the past 5 years

alone, the share of South-South BITs almost doubled from 14 percent to 26 percent (UNCTAD 2006).

A less popular form of IIAs is a regional or plurilateral one, in which only a limited number of countries are allowed. For some treaties such as the 1970 Agreement on Investment and Free Movement of Arab Capital among Arab Countries and the 1993 Colonia Protocol on the Promotion and Regional Protection of Investment with MERCOSUR (the Southern Common Market), they are just stand-alone investment agreements (Schiff and Winters 2003). Other treaties, however, are part of broader preferential trade agreements or regional integration agreements that have provisions governing trade and other topics including investment. The European Union is the clearest example. Other regional integration arrangements involve shallower integration, but contain provisions that affect FDI in important ways. The North American Free Trade Agreements (NAFTA) and the Common Market for Eastern and Southern Africa (COMESA) are the examples, both of which contain investment provisions.

As for a multilateral investment agreement, currently there is no comprehensive agreement on investment at the WTO level. There has been very little multilateral progress on this front over decades. The four sets of agreements under the auspices of GATT that relate to investment issues are Trade-Related Investment Measures (TRIMs), General Agreement on Trade in Services (GATS), Trade-Related Intellectual Property Rights (TRIPs) and Agreement on Subsidies and Countervailing Measures (SCM). Among the key investment-related agreements are GATS and TRIMS, both which only deal with investment on an issue or sector-specific basis. The GATS regulates FDI

policies of member countries insofar as FDI represents a mode of supply of services (commercial presence), while the TRIMs agreement prohibits a number of operational measures on investment that violate the GATT national treatment and the prohibition of quantitative restrictions. The current set of the WTO rules that deal with investment issues is rather limited in scope as it is primarily confined to performance requirements in the Agreements on Trade-Related Investment Measures (TRIMs), which covers goods only, and to the provisions of the GATS through commercial presence as the third mode of supply of a service. The proposed dissertation will focus on the first two types of IIAs, namely the bilateral and the regional IIA.

2.3 Trends in FDI Flows to Developing Countries

FDI is one of different types of resource flows to an economy. Official net flows (e.g. grants and concessional loans) and private net flows (e.g. FDI, portfolio investment, bonds, commercial bank lending, and remittances from overseas workers) constitute total resource flows (Reinert and Goldin 2005). During the 1970s and 1980s, official net flows used to account for the bulk of external resources available to developing countries. FDI, which is part of private net flows to developing countries, was low when compared with aid and concessional loans. In the 1970s, FDI made up only 12% of all financial flows to developing countries and portfolio investment was virtually nonexistent then (Singh 2001). With the increased economic liberalization and innovation in financial instruments, private flows have doubled while official flows have remained stagnant,

resulting in dramatic decrease in their share of total flows (World Bank 2003; World Bank 2005).

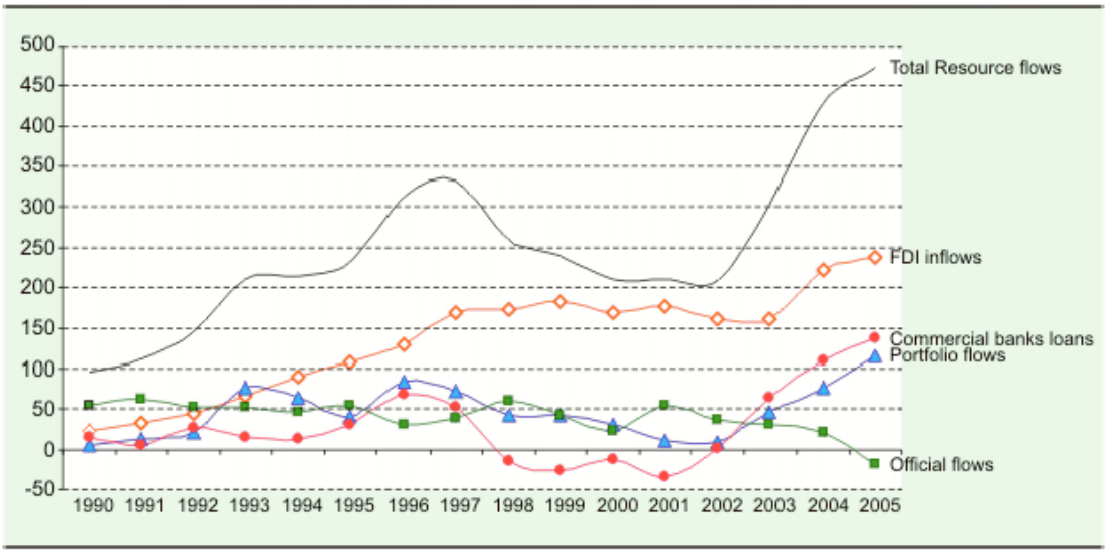

Figure 2. Total Net Resource Flows to Developing Countries, by Type of Flow, 1990-2005 (Billions of dollars)
Source: UNCTAD, World Investment Report 2006.

Of all types of flows, FDI has shown the biggest increase both in terms of shares and values. The share of FDI in total net flows grew from 24 percent in 1990 to well over 80 percent in 2001 (Kokko 2002). As FDI today accounts more than half of all resource flows to developing countries and has been several times larger than official flows in recent years, it has now become a dominant source of external financing for developing countries.

Another significant development related to FDI in the last several decades has been the growing proportion of FDI going to developing countries, with their values as

well as shares of global inflows increasing from 8.3 billion in 1980 (15 per cent of global FDI inflows) to $250 billion in 2004 (37 per cent of global FDI inflows) (Singh 2001; UNCTAD 2005; World Bank 2005). For those FDI flows that go into developing countries, they are still quite concentrated in only a limited number of countries most of which are in East Asia and Latin America. Developed countries have continued to provide majority of global FDI outflows, with Europe and North America supplying at least 75% of the total since 1991 (Asian Development Bank 2004). While developed countries remain the major source of FDI, outflows from developing countries and transition economies have also risen. From a negligible amount in the early 1980s, it rose to $83 billion in 2004 and continued its impressive rise to $133 billion in 2005, representing almost 20% of world outflows. The outward FDI stock from developing countries reached more than $1 trillion in 2004, with a share in world stock of 11%. This number grew to $1.4 trillion in 2005, representing a share in world stock of 13%.

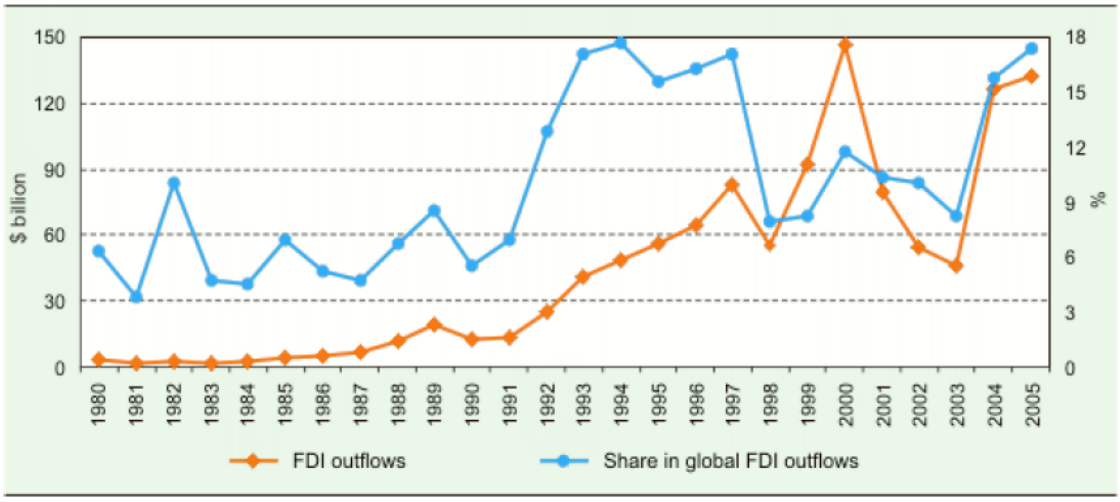

Figure 3. FDI Outflows from Developing and Transition Economies, 1980-2005
Source: UNCTAD, World Investment Report 2006.

Of these flows originating from developing and transition economies, a South-South dimension is clearly dominant as over seventy five percent of them went to other developing and transition economies. Least-developed countries such as the Laos and Myanmar have high dependence on South-South FDI, which accounts for well over 40% of the total FDI inflows to their countries (UNCTAD 2006). Even after excluding flows to and from offshore financial centers such as the British Virgin Islands and the Cayman Islands, the value of South-South FDI flows still show significant increase from about $2 billion in 1985 to $60 billion in 2004 (UNCTAD 2006). The bulk of the South-South flows were intra-regional in nature, dominated by intra-Asian FDI flows, which accounted for more than four fifths of all flows during the period 2002-2004 (UNCTAD 2006).

Table 2. FDI from Developing and Transition Economies, 1985-2004

Year	*Total* *FDI from all developing and transition economies*	FDI from developing and transition economies excluding offshore financial centres		
		Total	To developed countries	To other developing and transition economies
1985	*4.3*	3.8	1.9	2.0
1986	*5.1*	5.0	2.9	2.1
1987	*6.7*	6.3	4.2	2.1
1988	*12.1*	11.6	6.8	4.8
1989	*19.6*	15.2	6.7	8.5
1990	*12.7*	11.6	5.0	6.5
1991	*13.7*	10.7	3.7	7.0
1992	*24.8*	23.0	5.1	18.0
1993	*40.8*	34.1	2.6	31.5
1994	*48.6*	39.3	4.1	35.2
1995	*56.0*	46.3	4.6	41.8
1996	*64.8*	50.5	5.0	45.5
1997	*82.7*	54.5	11.0	43.5
1998	*54.9*	16.3	1.1	15.2
1999	*91.9*	38.7	7.5	31.2
2000	*146.9*	73.3	24.7	48.6
2001	*79.4*	46.5	10.7	35.9
2002	*54.4*	43.5	12.2	31.2
2003	*46.3*	36.6	9.6	27.0
2004	*126.8*	60.8	1.0	59.8

Source: UNCTAD, World Investment Report 2006.

2.4 Theoretical Framework

A burgeoning literature has provided explanations on FDI, which can be classified into two strands of research: international trade theory and theory of multinational enterprise. Early studies on FDI have their roots in international trade theory. The other strand of literature is theory of multinational enterprise. It focuses on finding an answer to a question that international trade theory does not explain – as to why companies invest abroad and shift their production to a foreign location. Before 1960 the prevailing explanation of international capital movements relied exclusively upon a neoclassical financial theory of portfolio flows, which suggest no role for the MNEs. Through the contribution of Stephen Hymer's seminal dissertation (1960), his pioneering conceptual insight helped break away from the confines of neoclassical-type trade and financial theory and move toward an analysis of MNEs based upon industrial organization theory. Hymer's great insight was in focusing attention upon MNEs as the institution for international production rather than international exchange. Until Hymer articulated the process of FDI as an international extension of industrial organization theory, it was not clear why a firm engages in FDI activities. An explanation for the existence of MNEs came forth in the form of internalization theory, which suggests that a firm will choose to internalize when it perceives that the net benefits resulting from the ownership of domestic and foreign productions are greater than what the firm will receive from external trading relationships (Rugman 1980; Dunning 1992). Hymer introduced the concept of firm-specific advantages. For a foreign firm to be able to enter a host country, compete with the local firms and operate its business profitably the foreign firm must

possess some inherent, special advantage (ownership advantages) such as superior technology or managerial skills, brand name or scale economies that can help offset the increased costs of operating business in another country.

John Dunning developed Hymer's ideas further and proposed the OLI framework, which helps analyze the determinants of international production (Dunning 1981). The three advantages – ownership (O), location (L), and internalization (I) advantages together provide the economic rationale for producing products in foreign countries. The O advantages relate to a firm's ownership of tangible and intangible assets such as brand recognition, technical knowledge and management skills that are generally available to others and how these possessions provide the firm with a competitive edge over competitors in a host country. Such ownership advantage creates an incentive for the firm to exploit it in a foreign location. The L advantages explain why an MNE decides to set up a value-adding unit in a host country rather than its home country. These L advantages may come from a reduction in transportation and communication costs once the firm has established a production facility inside the host country as opposed to having to ship from the home country. L advantages may also come from decreased input prices. Other factors associated with L advantages include investment incentives and disincentives from host country governments, artificial trade barriers and cross-country cultural, language, and business differences (Dunning 1992).

From the perspective of a firm, FDI involves the decision of which activities should be kept internal and which should be licensed to be produced by other producers in a foreign country. It will be considered FDI only for what the firm chose to internalize.

Firms can have different internalization strategies and thus decide to invest in a foreign country for entirely different reasons. Based on internalization theory, a firm will choose to internalize when it perceives that the net benefits resulting from the ownership of domestic and foreign productions are greater than what the firm will receive from external trading relationships (Dunning 1992).

The presence of various market imperfections such as transaction costs or government-imposed trade barriers are important reasons influencing MNEs to internalize rather than to rely on export or to license to market (Rugman 1996). An MNE can choose an appropriate entry mode by examining the independent and joint influences of the three advantages. The eclectic paradigm suggests that MNEs will decide to invest in a host country only in so far as they perceive that they possess the necessary O advantages to do so, and that the L advantages of a host country and the I advantages for internalizing cross-border markets for the intermediate products trade between the home country and host country favor FDI.

This framework is useful for a country that seeks to attract more FDI from MNEs. The more O, L, and I advantages that MNEs perceive they could derive from investing in such a location, the more likely they will bring inward FDI into the country to acquire production capability. However, locational determinants are the only ones that host governments can influence directly (UNCTAD 1998; Baniak, Cukrowski et al. 2002).

Traditionally, the theory of multinational enterprise and the international trade theory have been developed separately. As for the international trade theory itself, this area has been dominated by the Heckscher-Ohlin model or a general equilibrium model

that essentially says that the basis for trade resided in different relative factor endowments between countries (Heckscher, Ohlin et al. 1991). Since various restrictive assumptions (e.g. perfect competition, no product differentiation, constant return to scale) upon which the model rests are only partially matched in actual markets, it follows that the model has limited explanatory power in the real world. Particularly important for this research is the fact that neoclassical economic theory pays little attention to the actions of the firms (Markusen 2002). The only explanation of FDI that the neoclassical economy trade had to offer was in terms of capital movements from rich to capital poor countries, which was not consistent with the empirical evidence. Recent efforts by international trade economists, however, have helped to address some of the deficiencies of the neoclassical trade theory. The so-called "new trade theory" of the 1980s allowed for economies of scale, product differentiation, and consequent imperfect competition (Dixit and Stiglitz 1977; Helpman and Krugman 1985; Krugman 1991; Krugman and Venables 1996). Further contributions by Markusen (Markusen 1995; Markusen 2002) helped to bridge some gaps between the international trade theory and the theory of multinational enterprises by taking international production into consideration. His industrial-organization approach to trade, in its most developed form referred to as the "knowledge-capital model", which is a hybrid approach that includes both vertical and horizontal investments in the same general equilibrium framework gives an answer as to how and when horizontal MNEs, vertical MNEs, and national firms prevail over each other due to trade costs and different factor intensities (Markusen 2002). For example, with the presence of high transport costs, the model predicts that horizontal direct investments

would dominate in countries that are relatively similar in size, per capita income, and relative factor endowments (Markusen 2002).

The great contribution by Markusen (2002) is that it registers his model in the trade theory's portfolio of models as one that is capable of accounting for the presence of multinationals. However, there are still a number of limitations in his model (Feenstra 2004). First, various supposedly important factors for FDI such as the existence of policies or the regulation of the home and host countries governing FDI, the availability of infrastructure in the host country do not have much relevance in this model (Ietto-Gillies 2000). Additionally, the issue of internalization as to why a firm should decide to internalize its operation instead of licensing it to other foreign firms can still be better explained by the industrial organization approach.

While there is a large body of theoretical work on FDI and there is not yet an agreed model providing the basis for empirical investigation (Caves 1996; Buckley and Casson 2002). A review of the empirical literature on FDI finds that Dunning's eclectic paradigm has been widely used in recent literature to examine the empirics of the FDI phenomena as it provides a taxonomic framework for estimating equations (Bevan and Estrin 2000). It appears that the Dunning's eclectic paradigm is the proper model for investigating the questions set for this paper.

2.5 Host country determinants of FDI

The substantial interest in FDI has resulted in vast literature that empirically investigates the fundamental factors that drive FDI behavior. There are internal firm-

specific factors that motivate a firm to become an MNE in the first place and there are location-specific factors of the host country that attract FDI from MNEs. Firm-specific factors are ignored in this study because they cannot be influenced by host country governments. The proposed dissertation will focus on location-specific advantages of the host country as determinant of FDI that accounts for the geographical distribution of FDI inflows across developing countries.

Most empirical studies on the FDI determinants recognize that principal economic determinants of the FDI and their relative importance can differ from case to case depending on various aspects of investments that are involved such as the motive for the FDI (e.g. resource seeking, market seeking, efficiency seeking or strategic asset seeking), the mode of entry or expansion of the FDI (e.g. greenfield or sequential FDI), the sector of investment, and the size of investors (small and medium-sized MNCs or large MNCs) (UNCTAD 1998; Dunning 2002; Kinoshita and Campos 2004).

Resource-seeking FDI is investment motivated by the needs to acquire resources. The resources MNEs seek could be in the forms of physical resources such as raw materials and agricultural products; supplies of cheap labor; or soft assets such as management expertise and technological capability. Factor cost considerations become a predominant concern for this type of FDI. MNEs with resource seeking motivation should likely be attracted by economies that are more abundant in natural resources and/or have cheaper unskilled labor and available pool of skilled labor.

As for market-seeking FDI, whose purpose is to serve the local markets and/or regional markets of the host countries, factors such as market size and market growth, and access to regional and global markets should be key drivers for this type of FDI.

The efficiency-seeking FDI seeks to achieve an efficient allocation of international economic activities of a firm. MNEs can improve their cost structure by locating certain economic activities in a foreign country. Such benefits are essentially the economies of scale and scope as well as risk diversification. This type of FDI may be influenced by factors such as costs of factors of production adjusted for productivity differences, trade policy, membership to a regional integration agreement, and business facilitation measures of a host country. In sum, different motivations can influence a different outcome for MNEs in choosing their investment locations.

The two main approaches to empirically identify the determinants have been formal quantitative analyses and survey-type studies. The literature on the FDI determinants is wide and deep. The purpose of this section is to review some of the factors that have received much attention from literature and that are relevant to our research.

2.5.1 Market-related factors

Traditional FDI determinants that are well established in the literature are market-related factors. Market size is universally accepted as the leading determinant of FDI inflows. It has been confirmed by numerous empirical studies (Dunning 1980; Kravis and Lipsey 1982; Schneider and Frey 1985; Culem 1988; Wheeler and Mody 1992; Culem 1998; Billington 1999; Chakrabarti 2001; Agiomirgianakis, Asteriou et al. 2003; Amaya

G. and Rowland 2004; Asiedu 2006). Though there are disagreements on the methodological aspects of some of the studies, their findings support the claim of the significant role played by market-related variables such as GDP, population, GDP per capita and GDP growth. A survey by Chakrabarti (2001) that examines the robustness of the correlation between FDI and a whole range of economic indicators finds market size to be among the most robust variables for explaining FDI inflows.

Other than the current market size, a growth potential of a market also has a positive effect on FDI (Schneider and Frey 1985; Chen and Khan 1997; Culem 1998; Lee 2005). The simple explanation behind this is that there are more opportunities in an expanding market than a static or a contracting one of the same size.

However, the market size could be less influential if the FDI is undertaken with resource seeking motivation or is export-oriented in nature whereby MNEs use the host country as a production base to take advantage of the lower cost structure of the host and export the intermediate or final products to home or third countries (Agarwal 1980; Hara and Razafimahefa 2003).

2.5.2 Factors of production

Other economic fundamentals that are recognized with varying degrees of significance are availability of skilled manpower, cost of labor, cost of capital, availability of infrastructure in the host countries. Historically, the availability of natural resources has been an important host country determinant of FDI. A number of empirical studies have shown that natural resource endowment promote FDI especially for resource-seeking FDI (Asiedu 2006). According to UNCTAD (2001), the majority of

FDI to the least developed countries is investment with natural resource seeking motivation. In general, other things being equal, the presence of rich natural resources in a host country should have a positive effect on FDI.

Again, how significant a role played by a certain variable always partly relies on the motive of the investment. The cost of labor is a rather controversial factor. The standard hypothesis is that the relatively low wages in developing countries will have a positive effect on efficiency-seeking and resource-seeking FDI. Labor force characteristics have been widely used as one of the explanatory variables for FDI. A selection of measures for labor force characteristics that have been used in the past are wage rates, labor costs adjusted for productivity, skills and education attainment of the workforce (Kirkpatrick and Shimamoto 2005). Schneider and Frey (1985), and Taylor (2000) found that lower wages promote FDI as hypothesized. Other studies, however, either found that that low wage is not statistically significant indicating it is not an important determinant or have a wrong sign on the regressions (Wheeler and Mody 1992; Kirkpatrick and Shimamoto 2005). The lack of unanimity may partly be explained by the different data set used in the studies, which cover different countries, which in turn attract FDI with different kind of motivations (Calhoun, Yearwood et al. 2002).

It appears that it is insufficient for developing countries to focus on offering low wages alone to attract the FDI from investors as the quality of the workforce comes into play. The overall empirical evidence on labor costs is still ambiguous (Lee 2005).

2.5.3 Openness to Trade

An openness of the economy is one of the traditional variables considered to affect FDI inflows. The level of the openness is often measured by the trade (import plus export) share of the GDP. The magnitude of its determinative power may depend on the type of investment as to whether it is domestic market-oriented or export-oriented. Culem (1998), Nonnemberg and Cardoso de Mendonca (2004), Lee (2005) and Taylor (2000) find a significantly positive relationship between trade openness and FDI. While the literature may have not reached a consensus yet because openness to trade did not generate the empirical results that are consistent across studies, however, based on a sensitivity tests study by Chakrabarti (2001), it appears that the openness to trade is the most robust variable in explaining FDI along with the market size (Lee 2005).

2.5.4 Exchange Rate

The literature has investigated two key aspects about the exchange rate for their determinative effects on FDI: movement of the host country's currency value and exchange rate volatility. Exchange rate movements have been recognized to be an important factor for FDI. The hypothesis is that a depreciation of the host country currency attracts FDI because it renders the shares of host country's firms relatively less expensive, which increases the chances of mergers and acquisitions by MNEs. Additionally, currency depreciation would make the cost of producing the products in the host country lower, thus making the firm more competitive. On the other hand, depreciation would lower the relative purchasing power of the host country's consumers. The stream of revenues would also be lower in terms of home currency. Empirical

findings on the relationship between exchange rate movements and FDI appear to provide evidence of the depreciation of the host currency vis-à-vis the home currency and FDI (Froot and Stein 1991; Klein and Rosengren 1994; Bayoumi and Lipworth 1998; Sazanami, Yoshimura et al. 2003; Blonigen 2005).

Fewer studies examined the impacts of exchange rate volatility on FDI. The assumption is that large volatility in real exchange rates would discourage FDI because it introduces increased risks to MNEs. Exchange rate volatility has been found by various empirical studies to discourage FDI (Bénassy-Quéré, Fontagné et al. 2001; Chakrabarti 2001; Hara and Razafimahefa 2003; Kiyota and Urata 2004). However, there are also studies that report the positive relationship of exchange rate volatility and FDI (Cushman 1985; Goldberg and Kolstad 1995). This is possibly due to many differences among those studies such as the measure of volatility and the country sets that are studied among other aspects. In sum, one still cannot draw a clear cut conclusion from the literature as this subject requires further investigations.

2.5.5 Institutions

Another frequently noted factor is the quality of institutions. Different authors have defined institutions differently. According to Nobel Laureate Douglass North (1990), one of the leading contributors to the literature:

> Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct) and their enforcement characteristics.

> Together they define the incentive structure of societies and specifically economies (p. 360).

According to this perspective, institutions are the rules of the game, a way to reduce uncertainty, which is an integral part of human interaction. Together with the technology employed, they determine the transaction and transformation costs that add up to the costs of production as well as the profitability in engaging in a certain economic activity. One gets efficient institutions by a polity which has built-in incentives to create and enforce efficient property rights.

As to how this concept relates to FDI, the basic notion is that a country that has efficient bureaucracy with less corruption and fair judicial system should be able to attract more FDI than a country that does not have the same condition or has more corruption (World Bank 2001; Campos and Kinoshita 2002; Asiedu 2006). Less-developed countries tend not to have well-developed legal institutions. Rare but possible events such as coup d'état or government prejudiced intervention in private sector can result in severe loss to a foreign firm. Recognizing that their operations are subject to risk of unfair treatment or at the extreme subject to risk of expropriation, a foreign firm would decide to not have invested in that country in the first place. Poor quality of institutions and corruption increase the cost of doing business and would likely diminish FDI. Poor institutions also lead to sub-optimal infrastructure, which in turns leads to reduced FDI.

While there is a general consensus on the significance of institutions, estimating the magnitude of the impacts is a difficult matter because the factor itself is difficult to quantify. Most importantly, there is no single, universally accepted definition of

institutions in the literature. As North (1990) suggests, "the specification of exactly what institutions are is the key to much of the analysis" in virtually all studies related to institutions. Institutions have been noted to cover political as well as economic and social spectrum. The way that has been done is to use composite indices developed from response surveys to proxy for the quality of institutions. Various indicators that are relevant include institutional quality (the enforcement of property rights), political risks (riots, coups, civil wars), characteristics of political regimes (constitutions, the presence of check and balance system and the separation of powers), social capital (the extent of civic activity and organizations), and social characteristics (ethnic or religious tensions, differences in social background) (Aron 2000). These indicators are often used to capture the features of institutions, although each likely has differential influences on the outcome.

Most studies focus on the effects of institutions on long-run economic growth in general rather than on FDI and argue that good institutions raise economic growth (World Bank 2001; Campos and Kinoshita 2002; Rodrik, Subramanian et al. 2004). There are a number of studies that look into the linkages between the quality of institutions and FDI. Jun and Singh (1996) analyze political risk on the FDI inflows data sample of 31 developing countries and find that countries with higher political risk attract less FDI inflows. Busse and Hefeker (2005) look at the linkages between components of political risk, institutions, and FDI inflows by employing 12 different indicators in their study covering 83 developing countries between the period 1984 to 2003. One of the key findings is that government stability and law and order are the most important sub-

components of political risk and institutions that attract FDI. Their conclusion resonates well with overall evidence that the quality of institutions is one of the key determinants of FDI (Jun and Singh 1996; Busse and Hefeker 2005; Asiedu 2006).

2.5.6 FDI Policy

Government policy on FDI includes a group of policies a host country uses to govern and influence FDI. They can range from an outright prohibition of FDI to various kinds of incentives offered to the investors to influence them to behave in certain manner deemed beneficial to the host country. At one end of the spectrum, there are rules and regulations that govern the entry, the operations, and the exit of foreign investors as well as the standards of treatment accorded to them (UNCTAD 1998). At the other end of the spectrum or the incentive side, the three main categories of incentives are regulatory incentives, fiscal incentives and financial incentives. Fiscal incentives are measures designed to reduce the tax-related burden of a firm, and financial incentives are defined as direct contributions from the host-country government to the firm, which includes grants, subsidized loans, loan guarantees, etc. (Banga 2003). Despite the fact that FDI policies are a country's most direct attempt to influence FDI, the literature on FDI policies is still sparse possibly due to the wide range of the policy space and difficulty in measuring complex FDI policies.

The importance of FDI policy can be illustrated by the mere fact that FDI cannot enter a country if it was not allowed by the host country. A long list of studies on FDI determinants does not incorporate all these policy areas into their model but instead choose to proceed to estimation by controlling for only 5-7 economic variables outlined

in the previous overall economic policy category. By not controlling for national FDI policies, which are a country's direct and explicit attempt to draw more FDI, the result could be an artificially high impact of the subject of their studies. For example, FDI may flow into a country not because that host country forges a BIT with another country, but because the host country has good national FDI policies in place.

FDI policies have many sub-components. In a cross-country study on the effectiveness of FDI policies that analyze a panel data set of 153 countries over seven years, Lee (2005) find that restrictive FDI policies impede FDI. Specifically, the regression results show that a one-point decrease in the foreign investment barriers index[2] led to an increase in per capita FDI inflows by $1.22 or an increase of $46 million in FDI inflows into a country of the average population size (Lee 2005).

As for the incentives, which are part of the national FDI policies, Cleeve (2006) finds tax holidays to be the most important element that has played an important role in bringing more FDI to Sub-Saharan African. Overall, the empirical evidence on the effects of fiscal incentives is mixed. Traditionally, tax and fiscal incentives have been found to have either little or insignificant impact on FDI flows (UNCTAD 1992, Chia and Whalley 1995). Many scholars recently suggested that, although FDI policies used to

[2] The index captures the extent of government barriers to foreign investment. It has scores from 1 to 5. It was taken from the composite index called "Index of Economic Freedom" developed by the Heritage Foundation. The specific index used in this case was based on the following factors:

"1) the existence of a policy code that defines the country's investment laws and procedures;
2) the encouragement of foreign investment through fair and equitable treatment of investors;
3) restrictions on access to foreign exchange;
4) equal treatment under the law for both foreign and domestic firms;
5) restrictions on payments and capital transactions; and
6) restrictions on foreign ownership of specific industries." (Lee 2005, p. 372)

play only a secondary role in attracting FDI as more traditional factors played a primary role, changes and other driving forces such as globalization may have rendered those FDI policies become more significant determinants of FDI (UNCTAD 1998; UNCTAD 1998; Clark 2000; Taylor 2000; Dunning 2002; Kokko 2002; Lee 2005). Yet, there is little empirical evidence that supports this a priori argument of the significantly positive effect of fiscal incentives. In fact, numerous recent econometric studies that have focused specifically on ASEAN economies found that incentives had no significant impact on investment decisions (Manasan 1998, Fletch 2002, FIAS 1999, OECD 2004). Specifically, Aldaba (2006) studies the experience of the Philippines, and suggests that for a country with relatively weak fundamentals; tax incentives, no matter how generous, will not be able to compensate for the deficiencies in the investment environment (UNCTAD 2000; Fletcher 2002; Aldaba 2006). The general conclusion that can be derived is that taxes are generally not the primary determinant of FDI.

2.5.7 International Investment Agreements

As to IIAs, first, it is important to understand that an IIA can vary greatly from one another. In some BITs forged by developed countries like the United States, the foreign investors are granted some special rights whereas in other BITs, foreign investors are granted only fair and equitable treatment. However, by and large BITs tend to be rather similar in their provisions (Neumayer and Spess 2005). The provisions in IIAs protect investors from the signatory states to whom binding commitments are made after the IIAs have been ratified. However, host countries may hope that, in addition to the commitment to protect the foreign investment through the legally binding treaties, the

treaties also send a signal of strong protective investment environment of the host to foreign investors from third countries as well. Based on this fact, not only can a signing of IIA be expected to have an impact on inward investment from the signatory countries, but it potentially could also have an effect on investment from non-signatory countries as well.

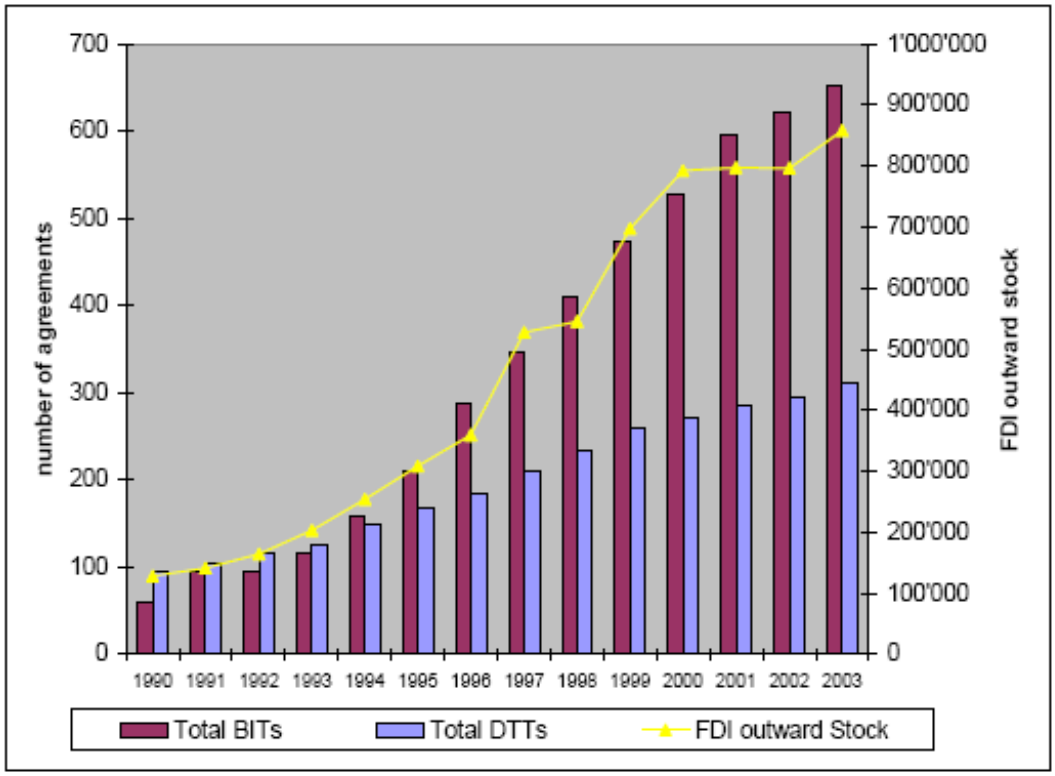

Figure 4. Cumulative FDI Outward Stock of Developing Countries and Cumulative South-South BITs and DTTs, 1990-2003
Source: UNCTAD (www.unctad.org/iia)

2.6 Discussion of earlier research on the effects of IIAs

Several studies attempt to investigate the impacts of IIAs on FDI inflows. Their findings and various approaches embarked can be summarized as follows.

An early study by UNCTAD (1998) performed both a cross-section analysis and a panel data analysis of the impact of BITs on FDI. In the cross-section study, the authors analyze inward FDI that goes into a particular country in 1995 based on the total number of BITs signed at that point in time and conclude that BITs play a "minor and secondary role" in attracting FDI (UNCTAD 1998, p. 122). In their panel data study of bilateral FDI flows from 14 home countries into 72 host countries during the period from 1971 to 1994, the authors find a positive but weak relationship between the signing of BITs and FDI. However, questions have been raised about the validity of the finding due to various methodological issues. For example, there are discrepancy problems in their data collection method. The study does not control for the effects of other influences such as FDI policies and the trend of growing global FDI flows (Cosbey 2005; Salacuse and Sullivan 2005).

Hallward-Driemeier (2003) performs a slightly more rigorous test by utilizing a panel data analysis and incorporating more explanatory variables into the model. Her test employs bilateral FDI outflows data from 20 OECD countries to 31 developing countries from the period 1980 to 2000 (Hallward-Driemeier 2003). The study confirms the determinative effects of traditional factors like market size and macroeconomic stability but does not find any statistically significant effect of BITs on FDI. Unlike the UNCTAD study, Hallward-Driemeier controls for the effect of the trend of growing global FDI

flows and finds that, while FDI covered by BITs grew significantly over the studied period, the increase cannot be attributed to the BITs. Further tests suggest that BITs act more as complement rather than substitutes for the quality of domestic institutions.

There are at least three weaknesses associated with the Hallward-Driemeier study: first, it was based on the assumption that BITs were used by developing countries solely as a commitment device to compensate for their weak property rights protection when in fact these BITs may have been utilized for other purposes. The assumption could possibly result in a mis-specification of the model used in her study. Specifically, she relies on dyadic research, consisting of 537 country pairs, which is based on the assumption that a BIT has an effect as commitment device only on one developed country that is signatory to that BIT, but completely neglects the signaling effect of the BIT that could have on other non-signatory countries, which is a well-established concept in the literature. Therefore, Hallward-Driemeier's modeling could not capture the potential positive spillover and, as a result, may underestimate positive effect of BITs on FDI inflows. The fact that the study finds no evidence of BITs impact on FDI may be attributable to this critical omission. Secondly, the test used only bilateral FDI outflows from 20 OECD countries. Although approximately 85% of FDI inflows originate from OECD countries, a more complete test would be to examine all the FDI inflows including those originating from developing countries, which are on the rise. Third, her study only controls for 7 locational variables (GDP, GDP per capita, inflation rate, trade over GDP, and the gap in average years of education between the source and host pairs, one dummy variable to capture political and economic changes in Eastern Europe and another to represent

NAFTA membership), which seem to be not enough. Not controlling for other factors such as potential market size, the quality of domestic institution, and the availability of infrastructure, which have been regarded by the literature as important FDI determinants would bias upwards the importance of a BIT, which could actually have been influenced by those omitted factors.

In contrast with Hallward-Driemeier, a more recent work by Neumayer and Spess (2005) uses a larger panel covering 119 countries from 1970 to 2001. They want to answer the same questions as to whether or not BITs promote FDI and whether they act as substitutes or complements to domestic institutions. On the first question, they find a significantly positive effect of BITs on FDI inflows to developing countries. The evidence seems to suggest a signaling effect of BITs because they have a positive effect on FDI not just from signatory countries but from all countries. On the second question, they find an opposite answer to Hallward-Drimeier's study, namely that BITs appear to function as substitutes for good domestic institutional quality. The result is robust to different model specifications. The policy implication is that BITs are worth the effort because they pay off in the form of increased FDI inflows, but the marginal value of signing more BITs is diminishing.

In spite of the rigorousness of their research method, they yet again exclude BITs signed between developing countries from their studies citing that FDI flows between developing countries are rare so the issue is not addressed.

Salacuse and Sullivan (2005) do the same study on different data set. They look at US investment response to US BITs in 31 developing countries from 1991-2000 and

differentiate between 3 types of BITs – US BIT, OECD BITs (excluding US), and South-South BITs. The regressions show strong evidence of positive effect of the US BITs on the FDI flows to developing countries (Salacuse and Sullivan 2005). The limitation is that this study is only concerned with the bilateral FDI flows between the US and developing countries so it is hard to make generalizations of the effects of BITs in general especially the cases in which the United States is not involved. The study also does not control for various important policy effects such as NAFTA, WTO membership, which were controlled in the earlier Hallward-Driemeier study and displayed significantly large impacts on FDI. In addition, the study fails to include China, which received substantial investment from the US but had no US BIT (Salacuse and Sullivan 2005).

In another study, Tobin and Rose-Ackerman (2006) analyze the impact of BITs on the FDI inflows to 137 countries from 1980 to 2000, with data averaged over five-year periods. In an earlier paper by the same authors, they found little evidence that BITs attract FDI (Tobin and Rose-Ackerman 2005). However, the authors have improved their methodology and in a later study they report a significant, positive relationship between BITs (entered into force with a high income country) and FDI inflows to developing countries (Tobin and Rose-Ackerman 2006). The authors confirm Neumayer and Spess (2005)'s finding that the marginal benefit of an extra BIT falls as more countries sign BITs. Even though these two studies seem to provide the most convincing evidence on the positive effects of BITs on FDI, there are still many things left to be desired. First, the common issue with these two studies is that they only consider the BITs that developing countries signed with OECD countries but omit the BITs between developing countries

themselves. According to the authors, they only consider the BITs with OECD countries based on the presumption that "they are the ones with the potential to have an impact" (Tobin and Rose-Ackerman 2006, p.13). As pointed out throughout this dissertation, South-South IIAs are becoming more widespread these days but the extent of their importance has not yet been examined in these empirical studies. Second, even though both studies attempt to offer a good model specification, they failed to control for the important factor that may have a role in determining FDI outcome – that is national FDI policy including fiscal incentives such as tax holidays and tax concessions among other things. The national FDI policy represents a group of measures that are the host country government's most direct attempts to influence the FDI outcome. Not controlling for the effect of national FDI policy could lead to upward bias toward the usefulness of BITs. This causes our doubt in the conclusiveness of their findings.

Banga (2003)'s study is probably the only one that takes into account of the effects of these selective government policies. Her study examines the impact of bilateral and regional investment agreements on FDI. The novelty of this study lies in her meticulous modeling and controlling for national FDI policies not found in other studies. There are studies that use indirect indices to measure host country policies toward FDI. For example, Lee (2005) uses a specific index developed by the Heritage Foundation that measures a country's policies toward FDI. With Banga (2003)'s modeling however, the effects of FDI policies such as tax concessions and tax breaks are observed in her study. Although there are questions as to how the sum score used in her study could accurately capture the qualitative nature of the FDI policies that are not always granted across the

board, but rather, granted for only limited sectors or geographical areas or come with other conditions placed on the multinationals, she finds that BITs as well as national FDI policies have an positive impact on FDI inflows. In her study, she distinguished between the BITs signed between developing countries and the BITs signed with developed countries and determined that the latter are the ones that significantly increase the FDI inflows to 15 developing countries in Asia.

With respect to regional investment agreements, however, the result is inconclusive as she finds that different regional investment agreements have different impacts. As to AIA, she does not find that it affects FDI inflows noting that the agreement may be too new to show an effect at the time of the study having the data available only up to year 2000. However, the model specification used in her study can be further improved. First, her study did not control for the effect of institutional variables, which should not be neglect in a study of this kind that deals with developing countries and deal with BITs grounded on the assumption that the BITs act as commitment device to either substitute or complement the domestic institution. Additionally, the conclusions reached by this study should be taken with some caution because the main thrust of AIA is to promote FDI from ASEAN sources first (by liberalizing investment regulations and granting national treatment to the investors only from ASEAN countries and subsequently expand the national treatment to non-ASEAN investors). However, this study uses the data of total FDI inflows and does not differentiate between FDI inflows originating from ASEAN and non-ASEAN sources, which may partly explain why she does not find a significant effect of AIA.

One final issue that could mar the results of Tobin and Rose-Ackerman (2006), Neumayer and Spess (2006), and UNCTAD (1998) studies is that these three studies pool wealthy and poor countries together even if there are strong theoretical reasons to believe that FDI going into developing countries is a function of different set of factors than FDI going into developed countries. Blonigen and Wang (2004) demonstrate empirically that pooling data from both types of countries into one large sample and assuming similar relationships when their experiences could in fact be systemically different may result in various estimation problems. As such, it is more appropriate to distinguish between developed and developing countries and based on this reason, our study will focus only on the developing ASEAN economies.

Table 3 provides a summary of the empirical studies that have just been discussed.

Table 3. Description of Literature on IIAs as Determinants of FDI

Author (s)	Topic	Variables	Findings	Limitations
UNCTAD (1998)	Effects of BITs on FDI	Dependent Variable Bilateral FDI data of 133 countries in 1995 Explanatory Variables Number of BITs	BITs do not play a primary role in increasing FDI. The effect is weak.	- Various methodological issues (e.g. discrepancies in data, etc.). The study does not control for the effects of other influences such as FDI policies and the trend of growing global FDI flows.
Hallward-Driemeier (2003)	Effects of BITs on FDI	Dependent Variable Bilateral FDI outflows from 20 OECD countries to 31 developing countries from 1980-2000 • Level of FDI flows • Ratio of FDI/GDP • Share of source countries' FDI sent to host Explanatory Variables • Number of BITs • Size of the home country • Size of the host country • GDP per capita of the host country • Macroeconomic stability (proxied by inflation rate) • Openness to trade (trade over GDP) • Gap in average years of education between the home and host pairs • Dummy variable to capture political and economic changes • Dummy variable for NAFTA ratification	The coefficient on the BITs is negative and insignificant. Little evidence that BITs have increased FDI and they are only effective in countries with high quality of institutions and strong local property rights. The evidence suggests a signaling effect of BITs. BITs complement rather than substitute for strong domestic institutions.	- Dyadic research ignores the signaling effect of BITs. - FDI flows originating from developing countries are excluded. - Various key potential determinants such as GDP growth, institutions, and infrastructure.

Author (s)	Topic	Variables	Findings	Limitations
Salacuse and Sullivan (2004)	Effects of US BITs on FDI	Dependent Variable US FDI flows to 31 developing countries from 1991-2000 Explanatory Variables • Presence of a US BIT • Number of BITs signed with OECD countries (excluding US) • Number of BITs signed with developing countries • GDP • GDP per capita • Inflation • Real effective exchange rate • Population • Rule of law	Find strong evidence that BITs promote investment. BITs have a signaling effect.	- Cross-sectional analysis - Some omitted potential determinants are wage and quality of infrastructure.
Banga (2003)	Effects of national FDI policies and IIAs on FDI to developing countries	Dependent Variable FDI flows to 15 developing countries in South, East and Southeast Asia for the period 1980-1981 to 1999-2000 Explanatory Variables • Log of real GDP • Growth rate of real GDP • Labor cost/ Labor productivity • Log of secondary enrolment ratio • Real effective exchange rates • Ratio of external debts to exports • Budget deficit/GDP • Transport & communication/GDP • Electricity consumed/GDP • Real domestic interest rates • Percent change in annual exchange rate • Sum of scores on incentives • Sum of scores on removal of restrictions • Number of BITs	BITs have a significant, positive effect on FDI, but it is only BITs with developed countries. AIA does not show an impact on FDI.	- Some key potential determinants such as institutions are ignored. - The interaction effect of BITs as to whether they are a substitute or complement cannot be assessed with institutions factor excluded.

Author (s)	Topic	Variables	Findings	Limitations
Neumayer and Spess (2005)	Effects of BITs on FDI to developing countries	Dependent Variable FDI flows (in constant US$ 1996) to 119 countries for the period 1970-2001 Explanatory Variables • Total number of BITs signed with OECD countries, weighted by the share of OECD FDI outflows / total world FDI outflows • Natural log of per capita income • Log of population • Log of economic growth rates • WTO membership dummy • Numbers of bilateral trade agreements has with US, EU, Japan • Inflation rate • Trade openness • Secondary enrollment • A measure of natural resource intensity • Political stability and institutional quality o POLCON (Political constraints) index by Hnisz o ICRG (International Country Risk Guide) o ICRG's investment profile index o ICRG's government stability index o ICRG's law and order index	BITs have a positive effect on FDI inflows to developing countries. The result is robust to changes in model specification. Some evidence that BITs substitute rather than complement domestic institutions. (Countries with lower institutional quality benefits more from BITs).	- South-South BITs are ignored.
Tobin and Rose-Ackerman (2006)	Effects of BITs on FDI	Dependent Variable Five-year averages of FDI flows to 137 countries (in constant US$ 2000) for the period 1980-2003 Explanatory Variables • Total number of BITs entered into force that have at least one OECD member as a signatory • Their interaction level • The ICRG political risk index • Log of per capita income • Natural log of the population	BITs (with a high income country) have a significant, positive effect on FDI to developing countries. The marginal benefit of an extra BIT falls as more countries sign BITs.	- South-South BITs are not studied.

Author (s)	Topic	Variables	Findings	Limitations
		• Economic growth • Natural resources (a composite of natural fuels and ores) • Openness (trade over GDP per capita)		

2.7 Summary

In summary, the empirical investigations on the determinants of FDI inflows specially the investment treaties reveal mixed conclusions with different model specifications and variables used in different host country and time period studies. A number of factors have emerged as essential determinants of FDI that are robust across most studies and different model specifications. The literature confirms the significant role of explanatory variables such as market size (as proxied by GDP per capita and GDP growth), labor costs, openness and currency exchange rate. With respect to IIAs, the conclusions that can be developed from the empirical studies are more ambiguous and at times conflicting. While some studies find little or no evidence of positive impact of BITs on FDI, other studies claim to find impact of BITs on FDI to be positive and significant and robust across various model specifications. The deficiencies in those studies that have been identified will be addressed in this dissertation. At the end, their findings will be assessed and compared with the findings of this dissertation in succeeding chapters.

CHAPTER 3

ASEAN

This chapter provides quick background of ASEAN to readers. It sets the stage for readers with regard to the basic points of ASEAN as to why the FDI issue is interesting for ASEAN. For instance: Why is FDI important to ASEAN from a development perspective? Next, the chapter will go into details on the ASEAN Investment Area and its core substantive provisions as to what it means to ASEAN investors and non-ASEAN investors. Additionally, the chapter provides the readers with some basic statistics on FDI in ASEAN.

3.1 Background on ASEAN

Southeast Asia is one of the most diverse regions in the world. ASEAN consists of member countries with diverse historical experience, socio-cultural background, size, level of economic development, industrial structure, and trade orientation (Ito and Krueger 2000). Indonesia has more than 200 million people or the 4th largest population on earth, while Brunei has less than 400,000 people. On an economic aspect, Singapore is one of the world's most prosperous countries with strong international trading links and with per capita GDP equal to that of the leading advanced industrial countries, while

Myanmar, a military-ruled country, still suffers from government controls, miserable rural poverty and various bans on the part of the United States. An average Singaporean earns over 150 times more than an average Burmese earns based on GDP per capita figures in US dollars or over 17 times on the basis of purchasing power parity (World Bank 2005). Per capital income differences in ASEAN are larger than found in other developing country groupings (Narine 2002).

ASEAN was established in 1967 in Bangkok in response to political and economic considerations. The association originally consisted of five nations: Indonesia, Malaysia, the Philippines, Singapore and Thailand. All the signatory countries formed the regional cooperation as they saw the need to promote regional security in the face of a growing communist threat clearly dominant in the region at the time after the unification of Vietnam. The logic behind the formation was that their common objectives would be best achieved through mutual cooperation in the political, economic, social and cultural areas.

The main three objectives of ASEAN set by the founding five member states were to foster economic, social and cultural development of the region though cooperation, to safeguard the region's political and economic stability against power rivalry, and to serve as a forum to resolve intra-regional differences. Later, Brunei Darussalam, Vietnam, Laos, Myanmar, and Cambodia joined in 1984, 1995, 1997, and 1999 respectively (ASEAN. Secretariat. 1997). This ten-country regional grouping currently has a population of over 540 million, a total area of 4.5 million square kilometers or about forty percent the size of the United States, and a combined gross domestic product of

approximately US$800 billion (World Bank. and World Bank. International Economics Dept. Development Data Group. 2005). ASEAN is thus a formidable group of developing countries with rich natural resources, capabilities and market size, but that are at different levels of economic, social and political development.

Today ASEAN remains an intergovernmental organization that has the ASEAN Secretariat as its only standing bureaucratic organ. The ASEAN Secretariat is headed by the Secretary-General who is appointed on a five-year term to initiate, advise, coordinate and implement ASEAN activities (ASEAN Secretariat 1997). To compare the ASEAN with the European Union just to give a perspective, the EU has a whole set of institutions which include the European Parliament, the Council of the EU, the Court of Justice, and European Central Bank among other important bodies. By contrast, ASEAN does not have any supranational body with either executive, legislative or judicial functions.

ASEAN's focus has gradually shifted from primarily political cooperation to economic cooperation (Narine 2002). It started with a preferential trading arrangement (PTA) in 1977 to realize trade liberalization within the group (Tan 2004). The arrangement was negotiated on a voluntary, product-by-product basis. It was not considered a success because the ASEAN governments were not too keen to accelerate ASEAN into a free trade area due to the need to protect their domestic economies as their economies were not complementary (Tan 2004).

The call for deeper economic integration became clearer in the 1990s following successful attempts in other regions to integrate their economies such as in Europe and North America (Low 2004). To keep their region competitive, ASEAN then created the

ASEAN Free Trade Area (AFTA). Unlike the product-by-product approach of the PTA, AFTA was implemented through a scheme called 'the Common Effective Preferential Tariff (CEPT) scheme" that adopts a sectoral approach whereby product groups were selected for accelerated tariff reductions (Hew, Wah et al. 2004). Under the CEPT, products that are not excluded now have tariff rates below 5 per cent and are slated to have zero tariff rates by 2010 for the ASEAN 6 (excluding lesser-developed countries such as Vietnam, Laos and Myanmar) and by 2015 for the entire ASEAN (Davidson 2002; Asian Development Bank 2005).

In terms of its overall goal, ASEAN has now set its sight on its most ambitious goal ever, which is to create the ASEAN Economic Community (AEC). At the Ninth ASEAN Summit in October 2003, ASEAN leaders agreed to establish an ASEAN Community by 2020 (Bali Concord II). This envisioned community will be comprised of three pillars:

1. The ASEAN Security Community (focusing on regional political and security cooperation)
2. The ASEAN Economic Community (focusing on regional economic integration)
3. The ASEAN Socio-Cultural Community (focusing on regional socio-cultural cooperation)

This vision is in line with the regionalization approach taken by ASEAN, in which the member countries collaborate with one another to increase intra-ASEAN integration while at the same time implementing "open regionalism" that integrates

themselves into the global economy as their currently existing economic interests generally lie outside the region (Thanadsillapakul 2004).

3.2 Why is the FDI Issue Interesting for ASEAN?

ASEAN's share in global FDI inflows is disproportionately larger than its share in global GDP. While the region accounted for less than 2% of global GDP, it received about 5% of global FDI inflows during the period 1980-2005 (UNCTAD 2006). The contribution of FDI to the economies has been well discussed in the literature. The literature suggests that the benefits to host economy are quite uneven, both across and within countries and that the positive growth effects of FDI cannot be taken for granted[3]. Overall, the experience of ASEAN economies with respect to FDI have been generally more positive than negative (Blomstrom, Kokko et al. 2000; OECD 2004). ASEAN economies have benefited from the extensive presence of MNEs in their respective economies. Between 1980 and 2004, Southeast Asian economies grew at a respectable rate of about 5 percent per year. FDI has contributed significantly to the industrial and economic development of various ASEAN countries such has Singapore, Malaysia, and Thailand. It could be said that ASEAN economies have benefited from great influx of FDI since the late 1980s until the Asian financial crisis in 1997. From a resource flow perspective, FDI functions as an important resource flows to ASEAN countries that help

[3] Host country policies and the modalities of FDI are among the important factors in the distribution of these benefits, which tend to be maximized in countries that are transparent and open, have low barriers to trade, have few restrictions on operations, can offer an even and competitive playing field for MNEs and local players and there is a presence of local absorptive capability allowing indigenous firms and local community to capture the gain from FDI (Dunning 1992, Cave 1996).

support economic development. For example, during 1990 to 1997, FDI represented an annual average of 40% of the net resource flows to the ASEAN countries, with more than 50% for the cases of Malaysia, Myanmar and Vietnam (ASEAN Secretariat 2006).

FDI has played a significant role in pushing the export sector of those Asian economies such as Thailand, which pursued an FDI-led, export-oriented development strategy and later achieved a higher ratio of exports to GDP since 1980 than the world average. (Suksiriserekul 2000, Asian Development Bank 2001a). The presence of MNEs during this period has been credited with contributing to the growth in export competitiveness of ASEAN. The approach used by ASEAN countries is different from the one taken by countries such as Taiwan and South Korea who, instead of relying on FDI as the impetus for economic growth through export, relied on the promotion of indigenous firms and entrepreneurs to develop products to compete abroad (Dunning, Hoesel et al. 1996; Hoesel 1999).

In addition to the trade orientation associated with MNE investments, there are issues of externalities such as technology and productivity spillovers. Although very difficult to measure, general conclusions from ASEAN country studies is that overall, the spillover effects are positive, both economy-wide and for specific industries (Hiratsuka 2006; ASEAN Secretariat 2001a; Thompsen 1999). For example, Archanun (2003) found significantly positive spillovers from MNEs to indigenous firms in manufacturing sector in the case of Thailand and these positive spillovers were more likely to occur in competitive, less protected sectors in which the MNEs find it to be in their self-interest to invest in their subsidiary, making the subsidiary an integral part of its overall strategy

(Blomstrom, Kokko et al. 2000; Damijan, Knell et al. 2003). The experience of the computer/electronics industry in Southeast Asia has provided the evidence of how the MNE integrating the local affiliate to its global sourcing network can help provide a general boost to the economy (ASEAN Secretariat 2001a; UNIDO 2005; Thompsen 1999).

Besides the ASEAN-Five (Singapore, Thailand, Malaysia, the Philippines, and Indonesia), FDI also has considerable significance especially for the three transitional economies in the Greater Mekong sub-region (GMS) namely Vietnam, Lao and Cambodia. As transitional economies, they need substantial amounts of investment to accommodate their economic and other social, developmental goals as the financial resources made available by domestic savings, and external, official aids and grants alone are never inadequate. As such, attracting FDI has naturally become one of their important economic policy goals and the FDI policies have become an integral part of the economic policies. Although these countries still lack the capacity and infrastructure to take much advantage from the FDI, empirical evidence suggests that in the case of Vietnam, FDI has contributed to job creation, export expansion, as well as the GDP growth (Asian Development Bank 2006). A host of anecdotal evidence also indicates that FDI has created substantial employment opportunities in Cambodia and Lao in clothing and mining industries respectively (Asian Development Bank 2006).

3.3 Investment Cooperation and the ASEAN Investment Area

Early ASEAN cooperation on investment created prior to the ASEAN Investment Area (AIA) were the 1987 ASEAN Agreement for the Promotion and Protection of Investments, the 1996 Protocol to Amend the 1987 Agreement for the Protection of Investments, and the 1996 Protocol on Dispute Settlement Mechanism (Wee and Mirza 2004). Following is a summary table of relevant ASEAN agreements centered around direct investment and the AIA-related statements made by ASEAN.

Table 4. List of investment agreements in ASEAN

Investment Agreements in ASEAN
1. The 1987 ASEAN Agreement for the Promotion and Protection of Investments
2. The 1996 Protocol to Amend the 1987 Agreement for the Promotion and Protection of Investments
3. The 1996 Protocol on Dispute Settlement Mechanism
4. The 1998 Framework Agreement on the ASEAN Investment Area
5. The 2001 Protocol to Amend the Framework on the ASEAN Investment Area
AIA-related Statements
1. Sixth ASEAN Summit Statement on Bold Measures, Hanoi, 1998
2. Joint Press Statement of the First Meeting of the ASEAN Investment Area Ministerial Council, Phuket, March 5, 1999

3. Joint Press Statement of the Second Meeting of the ASEAN Investment Area Ministerial Council, Singapore, September 29, 1999
4. Joint Press Statement of the Third Meeting of the ASEAN Investment Area Ministerial Council, Chiang Mai, Thailand, October 4, 2000
5. Joint Press Statement of the Fourth Meeting of the ASEAN Investment Area Ministerial Council, Ha Noi, September 14, 2001
6. Joint Press Statement of the Fifth ASEAN Investment Area Ministerial Council, Bandar Seri Begawan, September 11, 2002
7. Joint Press Statement of the Sixth ASEAN Investment Area Ministerial Council Meeting, Phnom Penh, September 1, 2003
8. Joint Press Statement of the Seventh ASEAN Investment Area Ministerial Council Meeting, Jakarta, September 2, 2004
9. Joint Press Statement of the Eight ASEAN Investment Area Ministerial Council Meeting, Vientiane, September 27, 2005

Source: ASEAN Secretariat

The AIA is governed by two pieces of agreements. The original one was the Framework Agreement on Investment signed in October 1998, in the Philippines, and the later one that amended the original one was the Protocol to Amend the Framework on the ASEAN Investment Area signed in Vietnam in September 2001. Together they set forth the basis of the AIA. The AIA Agreement signed in October 1998 was regarded as a

significant milestone to increase the flows of FDI into ASEAN member countries. The objective was stipulated as to substantially increase the FDI inflows into ASEAN from both ASEAN and non-ASEAN sources by making the region itself a competitive, attractive location for investment and business operations. The AIA Agreement is focused on FDI alone. It does not cover portfolio investments and matters relating to investments already covered by other ASEAN agreements.

Based on the Framework Agreement in 1998, AIA entails, among others, the following activities:

(a) "Implementing coordinated ASEAN investment cooperation and facilitation programmes;

(b) Implementing a coordinated promotion programme and investment awareness activities;

(c) Immediate opening up of all industries for investment, with some exceptions as specified in the Temporary Exclusion List (TEL) and the Sensitive List (SL), to ASEAN investors by 2010 and to all investors by 2020;

(d) Granting immediate national treatment, with some exceptions as specified in the Temporary Exclusion List (TEL) and the Sensitive List (SL), to ASEAN investors by 2010 and to all investors by 2020;

(e) Actively involving the private sector in the AIA development process;

(f) Promoting freer flows of capital, skilled labour, professional expertise and technology amongst the member countries;

(g) Providing transparency in investment policies, rules, procedures and administrative processes;

(h) Providing a more streamlined and simplified investment process; and

(i) Eliminating investment barriers and liberalizing investment rules and policies in the sectors covered by the Agreement." (ASEAN 1998).

The most important substantive provisions of AIA are 1) the immediate opening up of all industries for investments by ASEAN investors and for all investors at subsequent time and 2) the immediate provision of national treatment (NT) and most-favored nation (MFN) treatment to ASEAN investors and the provision of NT to all investors at subsequent time.

These broad liberalizations (i.e. the immediate opening up of industries for investments and the immediate provision of NT/MFN to ASEAN investors) are subject to exceptions based on a negative list approach, consisting of a temporary exclusion list (TEL) and a sensitive list (SL) whereby ASEAN Member States can specify industries or measures affecting investments that they are unable to open up or to accord NT to ASEAN investors in the temporary exclusion list or the sensitive list. The industries and investment measures specified in the SL will not be subject to liberalization (until reaches the deadline limited by AIA) while those in TEL are to be reviewed every two years and to be progressively phased out at specific agreed dates and by the overall deadline set by AIA.

Originally, the deadlines set for the elimination of exceptions under TEL and SL for opening up of all industries were set at 2010 for ASEAN investors and at 2020 for all

investors. However, with the virtues of the 2001 Protocol to Amend the Framework on the ASEAN Investment Area and the subsequent AIA Council Meeting[4], the timeframe for phasing out TEL for investment by ASEAN investors in the manufacturing sector was advanced from 2010 to 2003 for all ASEAN countries except the new members (Cambodia, Lao PDR and Vietnam), and the timeframe for fully open to investments by non-ASEAN investors was advanced from 2020 to 2010. This means that since 1 January 2003, ASEAN investors have enjoyed national treatment in the manufacturing sector of the first seven member states. The details of the most current timeframe for implementation of duties under AIA are as re-encapsulated in table 5.

Table 5. Phase out timeframe of TEL

Year	Phase out of TEL	
	Manufacturing	Other Sectors
2003	ASEAN 6, Myanmar	
2010	Cambodia, Lao PDR, Vietnam	ASEAN 6, Cambodia
2013		Vietnam
2015		Lao PDR, Myanmar

Source: (Abd. Kadir 2007)

[4] Joint Press Statement of the Fourth Meeting of the ASEAN Investment Area Ministerial Council Ha Noi, September 14, 2001.

As for the NT/MFN treatment made available by AIA, it covers measures that affect investment in all various stages such as "admission, establishment, acquisition, expansion, management, operation, and disposition of investment" (AIA Art. 7(1)(b)).

Right from the beginning, AIA has made the combined NT/MFN treatment available to ASEAN investors but still allow TEL and SL exceptions to exist. Under AIA, member states have to completely remove TEL and SL exceptions by 2010 and subsequently extend NT to non-ASEAN investors by 2020.

As can be noted, besides a 10-year time differential between ASEAN and non-ASEAN investors implementation of NT, ASEAN investors can enjoy both NT and MFN treatment while non-ASEAN investors can only receive NT. The MFN treatment among the ASEAN countries provides that if investors or investments of any ASEAN member state receive more favorable treatment than those of other ASEAN member states, those of other ASEAN member states that qualify as "ASEAN investor"[5] shall receive the same favorable treatment as well. This means ASEAN countries commit to offer each other NT and MFN treatment[6], whichever is more favorable to investors from any member country, at pre-entry and post-entry stages of investment. The aim is to widen entry and establishment rights as far as possible, to enable investors from other ASEAN countries to obtain the same rights of access as the national or most-favored third country investor.

[5] The conditions are:

1. The investors must meet the minimum investment level threshold specified by the host country;
2. The industry must be in the published priority list;
3. The investors must show proof that foreign funds have been brought in for the entire amount of the investments, if required by the host country.

[6] However, NT/MFN treatment and opening up all industries for investment are also subject to the exceptions in the TEL and SL, as well as other exceptions under Art. 13 (General Exceptions), Art. 14 (Emergency Safeguard Measures), and Art. 15 (Measures to Safeguard the Balance of Payments).

Besides these core substantive provisions, there are a broad range of programs and action plans that the member states have to undertake in order to meet with their general obligations stipulated in the Agreement. There are three main groups of activities that the member states have to perform: cooperation and facilitation programs (specified in Schedule I), promotion and awareness programs (specified in Schedule II), and liberalization programs (specified in Schedule III).

Under the first group of activities, members are to take individual initiative to increase transparency of their respective investment regimes; simplify and expedite procedures for applications and approvals of investment projects; and expand the number of bilateral Double Taxation Avoidance Agreements among ASEAN members. The Schedule I also requires that members create various sets of central databases at ASEAN level such as database on ASEAN industries, suppliers, flow, and investment opportunities, all of which are essential information that should be disseminated to and be made useful by public. Some other cooperation and facilitation programs that are listed in Schedule I also include promotion of public-private sector linkages, improvement of the ASEAN Agreement for the Promotion and Protection of Investment, and examination the possibility of creating a Double Taxation Agreement at ASEAN level (Thanadsillapakul 2004).

The second set of programs is about promotion and awareness, which includes various activities such as joint investment promotion activities such as workshops or seminars, regular consultation among the investment agencies of ASEAN countries on promotion matters, investment-related training programs for officials of the investment

agencies of ASEAN, exchange of lists of promoted sectors/industries as well as consideration of possible ways that the investment agencies of member states can support the promotion efforts of other member countries.

Third, the liberalization programs require that member states unilaterally reduce and eliminate restrictive investment measures and undertake actions to liberalize the following: measures related to investment, rules on licensing conditions, rules relating to access to domestic finance and rules on repatriation of profits by investors.

Therefore, the AIA was structured to provide existing and potential investors with a number of benefits previously not possible once they qualify as an ASEAN investor. The direct benefits include greater investment access to industries and economic sectors as a result of the opening up of industries under the AIA; national treatment and MFN treatment among ASEAN investors; greater transparency and more information on the region's sectors, suppliers, and opportunities. The indirect benefits would be a move toward more liberal investment regimes and supposedly lower transaction costs in the region over the long run as a result of increased regional economic integration. This is to encourage investors to look at the ASEAN host economies increasingly from a regional perspective and adopt a more regional investment plan toward investing in ASEAN.

3.4 Recent Changes and Progresses Made Under the AIA

As for progresses made under the AIA, there have been considerable activities done on the first two pillars of the AIA (1. cooperation and facilitation programs and 2. promotion and awareness programs). For example, each member state has to prepare its

individual action plan to help promote ASEAN as an FDI location. The central statistics of FDI in ASEAN, the ASEAN Supporting Industry Database (ASID) and information portal have been set up as well as many regional investment information packets that have been published and distributed to investors. As of today, the ASID is now in operation and contains detailed information on more than 11,000 parts and components manufacturers in the region, which should help parts and components sourcing in ASEAN to be an easier task for all the parties involved as well as help attract the interested investors to invest in those supporting industries (Wee and Mirza 2004). The investment portal has been set up to function as a centralized place to provide comprehensive and up-to-date business and investment information of ASEAN.

Investment promotion efforts have been undertaken to promote both the investments originating from outside and within the region. A series of international forums, events and meetings were convened in ASEAN capitals with key participants and partners from key target countries such as the United States, Europe and Japan.

For the third pillar of the AIA (liberalization programs), which is probably the most important element, a number of activities have been undertaken, albeit in a gradual pace. In particular, the member countries have steadily opened up more industries to investors. Sixty-five activities led to the phasing out of industries and investment measures that have either been phased out of the TEL or transferred from the SL to the TEL, indicating that the member countries are being more open to investment and eventually those sectors will be completely open (Kadlr 2007). By 2006, there are 51 industries that have now been opened thanks to the AIA agreement (Kadlr 2007). On an

individual basis, some member countries also have introduced more favorable measures to improve their investment regimes. On average, there are 18 favorable national investment policy changes introduced annually during 1998 to 2005 (Kadlr 2007).

There were also short term measures offered in late 1998 to try to boost the FDI flows to the region during that period. Under the Statement on Bold Measures agreed in December 1998, the countries agreed to accord a set of privileges to qualified ASEAN and non-ASEAN investors on investment projects that were submitted between January 1, 1999 and December 31, 2000 and approved thereafter. The privileges include a minimum three-year corporate income tax exemption or a minimum of 30 percent corporate investment tax allowance; 100 percent foreign equity ownership; duty-free imports of capital goods; domestic market access; minimum industrial land leasehold period of thirty years; employment of foreign personnel; and speedy customs clearance (ASEAN Secretariat 1998).

3.5 Pattern and Trend of FDI in ASEAN

The upturn in the trend of inflows of FDI in ASEAN occurred in the late 1980s when the ASEAN-Five economies experienced a surge in inflows of FDI. Collectively, ASEAN countries were among the world's top recipients of FDI in the 1990s. Within ASEAN, Singapore was consistently the largest recipient of FDI inflows. Prior to the Asian financial crisis in 1997, it was normally followed by Malaysia, Indonesia and Thailand respectively. In 1997, the region as a whole received FDI inflows of 34 billion US dollars (ASEAN Secretariat 2005). After the 1997 Asian financial crisis, the number

went down sharply in 1998 to 22 billion US dollars, which is about 34 per cent decrease of FDI inflows, even though the amount of the world FDI inflows actually increased from nearly 500 billion US dollars in 1997 to over 700 billion US dollars in 1998 (UNCTAD 2006). As a result, the share of FDI that goes to ASEAN compared to global FDI inflows decreased from roughly 7 per cent in 1997 to about 3 per cent in 1998. The amount of net FDI flows continued to drop from 1999 to 2002. This brought down the number to just 18 billion US dollars in 2001 and further down to 13.8 billion US dollars in 2002.

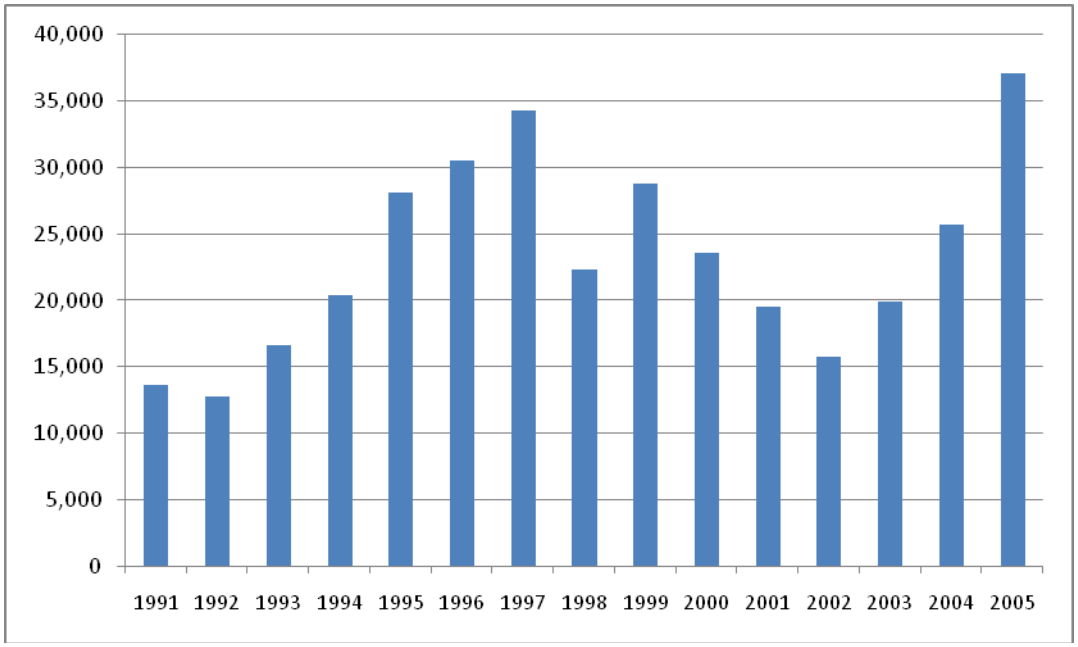

Figure 5. Net FDI Inflows into ASEAN, 1995- 2005 (Billions of dollars)

Source: ASEAN Secretariat.

The ASEAN was back on track and the FDI inflows steadily increased from that lowest point to reach 38 billion US dollars in 2005. This is a 48% year-on-year increase from the previous year and has finally superseded the peak level in 1997 pre-the crisis. As for the number of ASEAN's share of the global FDI flows, the number has steadily climbed back over the past several years to 4 per cent in 2005. It represents about 10 per cent of all FDI inflows that go into developing countries and transition economies. Although Malaysia, Singapore, and Thailand have since recovered from the financial crisis, Indonesia continues to struggle with economic growth and, at the same time, it continued to experience a net outflow of capital from 1998 to 2002. From 1995 to 2004, as shown in Figure 6, the European Union was the largest source for FDI inflows into ASEAN, contributing nearly 30 per cent of all FDI in ASEAN. This is followed by the United States and Japan which contributed 17.3 per cent and 13.7 per cent respectively over the same period.

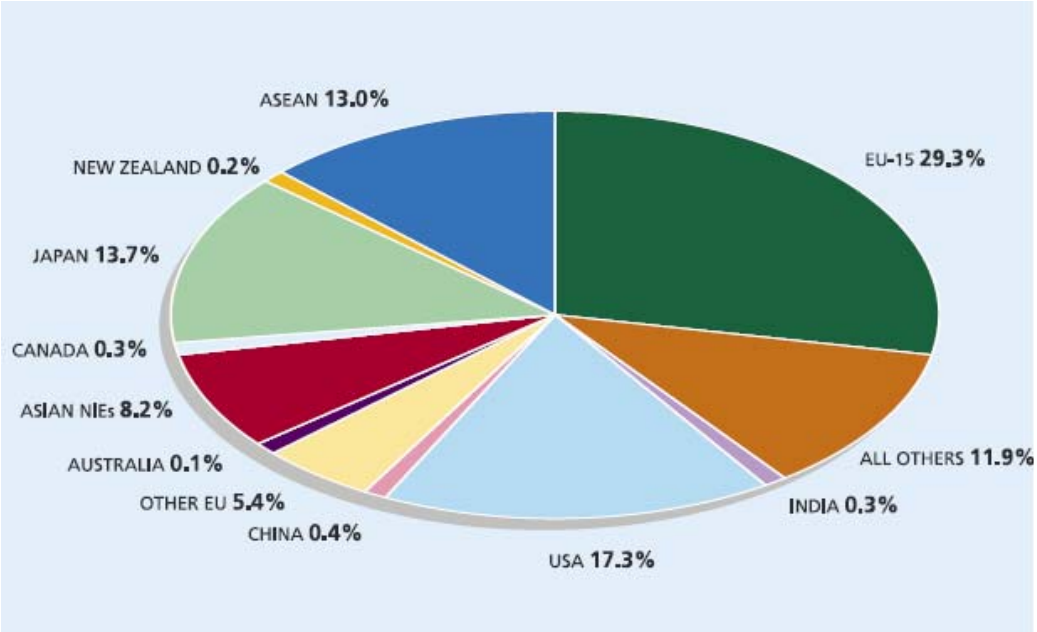

Figure 6. FDI in ASEAN by Source Country, 1995- 2004 (percentage)

Source: ASEAN Secretariat.

In terms of sectors, manufacturing, financial intermediation and services including insurance, trade/commerce were the main beneficiaries of FDI in ASEAN. Malaysia, Singapore, and Thailand are rather similar as their FDI in manufacturing is dominated by electronics, with represents a larger amount of investment than in any other manufacturing activities (Thompsen 1999; OECD 2004).

Intra-ASEAN FDI

Outward flows of investment from the older ASEAN members became increasingly apparent in the late 1980 due to the increasing prosperity in the region at that time, rising labor costs within the region, and the need to form strategic alliances (Tham

2000). ASEAN MNEs have started to move into neighboring ASEAN countries to find cheaper labor. These flows contributed to the increasing intra-ASEAN investment observed during the period.

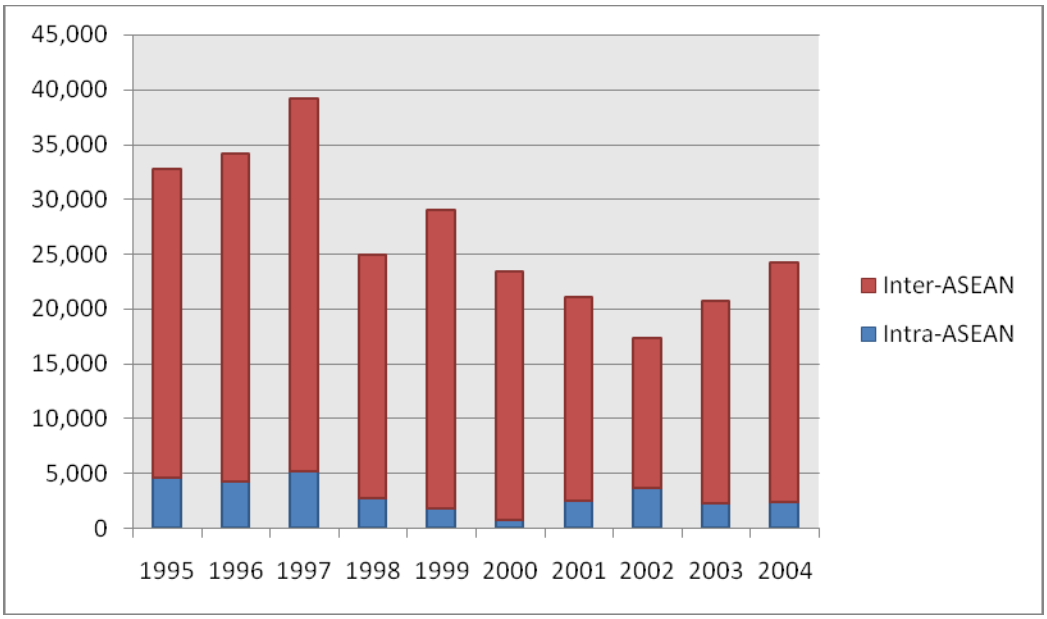

Figure 7. Composition of Inter-ASEAN and Intra-ASEAN FDI, 1995-2004

Source: ASEAN Secretariat.

However, the amount of intra-ASEAN inward investment started to contract in 1997 continuing to 2000 due in part to the financial crisis in 1997, to register a comeback in 2001. Despite the successful completion of the AIA in late 1998, the intra-ASEAN investment continued to fall between 1998 and 2000.

Table 6. Cumulative FDI in ASEAN Member Countries by Source, 1995-2004 (US$ Million)

Source Country	Host Country										
	Brunei	Cambodia	Indonesia	Lao PDR	Malaysia	Myanmar	The Philippines	Singapore	Thailand	Vietnam	ASEAN
ASEAN	1,405	98	1,888	269	7,989	1,047	1,355	7,145	6,176	2,939	30,309
REST OF THE WORLD	7,249	412	2,973	251	32,697	2,746	10,857	108,547	27,245	13,265	206,242
Total	**8,654**	**510**	**4,861**	**519**	**40,686**	**3,793**	**12,212**	**115,692**	**33,421**	**16,204**	**236,551**

Source: ASEAN Secretariat.

Table 6 shows that the importance of intra-ASEAN FDI as a source of investment to an ASEAN country varies considerably among the ASEAN members. How important is intra-ASEAN FDI as a source of investment compared to extra-ASEAN FDI? Intra-regional FDI flows represents around 13% of the total flows into ASEAN during the period 1995-2004. Intra-ASEAN FDI appears to be dominated by resource-seeking FDI concentrated in infrastructure and natural resource sectors as well as efficiency-seeking FDI targeting locations that have cheap labor (Hiratsuka 2006). In general, the intra-regional FDI is relatively more important for the newer ASEAN members such as Cambodia, Lao PDR, Myanmar and Vietnam than it is for the ASEAN-Five. The top recipients of intra-ASEAN FDI over the period 1995-2004 was Malaysia (nearly US$8 billion), followed by Singapore (US$7.1 billion), Thailand (US$6.2 billion) and Vietnam (US$2.9 billion). These four countries together have received a total of 80 per cent of all the inward intra-ASEAN investment for the same period.

3.6 Some political economy aspect of ASEAN and its policies with respect to FDI and regional economic cooperation

ASEAN's inception was originally for security, but the organization had slowly transformed into a regional grouping that also focuses on economic issues. The progress of ASEAN on economic cooperation and integration in the past earlier decades were often characterized as slow due to reluctant efforts by the member states, which seemed to put national interests above regional ones. However, the changing political and economic environments in Southeast Asia and the world at large have positively influenced the attitude of the ASEAN leaders and stimulated the need for greater economic cooperation within ASEAN. Recently, the pace seems to accelerate and the ASEAN leaders have set their sight towards turning a once loosely bound, regional grouping into a full-fledge economic, security and socio-cultural community under the envisaged ASEAN Community within 2020.

There are many forces that influence the policies of ASEAN countries towards forging stronger regional economic cooperation on FDI issues. One of the key forces influencing this outcome has to do with the increasing competition between regions. One aspect of the competition for external financial resources particularly direct investment is that it is not only limited to competition between countries, but also between regions as well. ASEAN is now well aware of the potential benefits that increased economic cooperation could bring. The cooperation on investment is a sub-set of a larger regional integration arrangement. This regional approach helps some member countries to negate their own certain disadvantages, such as small individual markets. Realizing that regional

integration and economic cooperation would help improve the competitiveness of regions and of the constituent countries in attracting FDI, the ASEAN countries have made a collective effort to attract FDI to ASEAN with the goal to replicate the experience of other regions in the past. For instance, the increase in FDI flows to the MERCUSOR countries and the increased FDI to Mexico, which can be attributed, in part, to NAFTA (ASEAN Secretariat 2001). The increase in FDI flows to Eastern European countries in recent years is also partly influenced by the EU enlargement process involving these countries. The common economic interests of ASEAN countries and the perceived benefits have driven them toward greater cooperation for if the promise of AIA is realized, it is likely to bring immense economic benefits to the region.

Besides the pressure for the ASEAN member countries to compete with other regions at a macro level, ASEAN businesses are also under pressure to compete with foreign firms. An increasing number of ASEAN-based companies have emerged as regional enterprises and have expanded the operations beyond their national boundaries, both within and beyond the region. They seek to enhance their own competitiveness in an international context. In recent years, as maintaining cost competitiveness has become a pressing concern, both indigenous ASEAN and foreign MNEs in higher cost ASEAN countries have been forced to relocate their operations (or parts of the operations) to neighbor countries with lower cost structure. Thanks in part to lowered costs of transportation and improvements in telecommunication, regional production networks have been developed as a result and this micro-level regionalization force is also very much at play in influencing ASEAN member states' stance on FDI. As a result of rapid

private sector development, some ASEAN countries are now significant sources of FDI for the region and this is a driving force for a stronger form of regional investment cooperation.

The fact that the ASEAN countries have agreed to create the AIA and be bound by it, thereby substantially limiting each member state's sovereign right to control the entry and establishment of FDI according to their own discretion indicates a good start and some commitment on the part of the ASEAN nations to use a regional approach to promote the region as a single investment destination. This policy commitment reflects a balance of potential benefits that can be generated by economic integration and the surrender of economic sovereign rights of the member countries and is the price that all the members will have to accept if they are looking for intraregional economic development.

Notwithstanding the concerted effort to promote ASEAN as a region for investment, each member has undertaken an individual effort to liberalize its investment regime and provide competitive and attractive investment environments at its own pace (OECD 2004). Before the 1980s, most ASEAN countries employed various regulations to restrict MNEs from operating within their borders such as foreign equity ownership law and measures such as local content requirements and minimum export requirements. These measures were to put the MNEs operations under control and transfer benefits arising from the presence of foreign firms to the local economy. Singapore, Malaysia and Thailand were among the first in the region to start opening up their economies for trade and investment. They have since progressively liberalized their trade and FDI regimes as well as eliminated many restrictions.

Vietnam, Lao PDR and Cambodia have started their respective economic reform since late 1980s and attracting FDI inflow has therefore become an essential economic policy. These three Greater Mekong Sub-region (GMS) countries have gradually opened up their economies and have gone through several changes during transitions to market-oriented economies. Their FDI regimes have also become more liberal and the sectors that are open to foreign investment have been expanded over the past two decades.

Most ASEAN countries nowadays offer some forms of incentives such as tax concessions and tax holidays among other things to attract FDI as well as channel the investments to desired locations, sectors, and activities (OECD 2004). If these ASEAN countries are to be ranked on a scale based on the degree of how much their FDI regime is open for international investment and contains the least restrictions, the FDI regimes of Singapore and Vietnam are currently possibly the most liberal ones. Specifically, both countries have opened up all industries to foreign investors from other countries and a complete 100% equity is allowed in almost all industries including key industries such as telecommunication, banking, manufacturing and other service sectors[7] (Mirza and Giroud 2004). As such, in some aspects they are already doing more that they are required under AIA. It is unsurprising to see that simultaneously they are strong supporters of AIA. Other ASEAN countries have a noticeably less liberal FDI regime. For example, for Thailand, it still contains many restrictions on the foreign investors' right to establish and operate business[8]. For example, foreign equity ownership is not allowed to exceed 49%

[7] Only exception is for reasons of national security.
[8] The most important Thai laws governing businesses controlled by foreigners are the Foreign Business Act of 1997, the Investment Promotion Act of 1977 and the Industrial Estate Authority of Thailand Act.

in numerous sectors the state deems crucial and wants to reserve only for Thai entities or sectors that the government believes is not yet "competitive" and are vulnerable to foreign competition such as mass media and resource-based businesses including but not limited to agriculture, fisheries, livestock, mining and services (Nikomborirak 2004).

Taking into consideration of the great variation in the policies and the potential benefits of the ASEAN constituents, there bounds to be frictions in the efforts on the cooperation. The wide divergence of the economic development level of the ten ASEAN countries makes the tasks of integrating the Southeast Asia nations relatively more arduous than the challenges facing other regional groupings that are either more homogenous or consisting of fewer parties. Specifically, Singapore has been extremely proactive in signing new agreements concerning trade, service, and investment with other countries outside of the region. Positioned as a hub of trade, finance, and transportation for Southeast Asia, Singapore, a small nation with very limited natural resources, has all to gain from other ASEAN members implementing a region-wide, accelerated FDI promotion and liberalization. However, there are much smaller benefits to be gained from the standpoint of countries like Myanmar for participating and being subject to the same timeline for opening up countries for investment by foreign investors. Evidently, the potential benefits to the parties from AIA are asymmetrical. A solution that has been used rather effectively by ASEAN to tackle with this issue is through a use of different timeframes and/or different provisions for ASEAN six member states and for ASEAN newer member states (Vietnam, Lao PDR, Myanmar, and Cambodia), which generally

would need more for time for adjustment before being subject to the same conditions as applied to the other ASEAN six states.

As ASEAN countries are inherently not as politically stable as developed countries, unfavorable political developments that sometimes unfold in ASEAN nations are important obstacles to successful economic cooperation. For instance, a violent crackdown on protestors by Myanmar military government and its string of human rights violations that stir condemnation by international community put remaining ASEAN nations in a very difficult position. On the one hand, other ASEAN countries are morally obligated to show strong disapproval of such actions and also are expected by the international community to make greater effort in influencing Myanmar from undertaking wrong steps. On the other hand, they would not want to further strain the relationship with an ASEAN member. These constraints have stampeded efforts of ASEAN on other areas and caused an economic cooperation to stall.

Considering the considerable variation in policies, developmental gaps, and experiences with respect to FDI across the ASEAN member countries and unique situation of each country, the task of creating a single investment area is extremely difficult. In general, one can expect there to be two overall positions: one for the older ASEAN member states and the other for the newer member states. An analysis for the precise position of each country has to be done on a case by case basis where country is expected to support the continued liberalization of investment under AIA in the manner and pace that matches with its own current economic, social and political conditions.

3.7 Summary

FDI has played a rather important role in the economic development of ASEAN countries and the policies on FDI have become an integral part of the economic policies. To stimulate FDI flows from sources both outside and within the region, ASEAN countries have created AIA, which is governed by the 1998 Framework Agreement on ASEAN Investment Area and the 2001 Protocol to Amend the Framework on the ASEAN Investment Area. AIA is an investment agreement that seeks to promote the region as a single, attractive investment area that immediately opens up all the industries (with exceptions) for investments by ASEAN investors and later to outside investors and confers NT and MFN to entities that qualify as ASEAN investors and later confers NT to outside investors.

Under AIA, investors from inside and outside ASEAN would be free to invest in manufacturing, agriculture, forestry, fisheries and mining sectors and their investments extended national treatment, with each ASEAN member country allowed to make certain exceptions. To date, some extent of the liberalization has been realized since 1998 and expanded in 2003. Full AIA realization is expected to be realized by 2010 for the first six ASEAN members and by 2015 for the newer members. This means that the exceptions to free entry and national treatment would be fully eliminated by these deadlines.

CHAPTER 4

METHODOLOGY

4.1 Introduction

The goal of the proposed dissertation is to examine the impacts of BITs and AIA on the FDI inflows into ASEAN countries. The central goal is to assess whether or not these IIAs actually promote investment. Based on the existing literature, here is a list of hypotheses to be tested in this dissertation.

Hypothesis 1: BITs have a positive effect on total FDI inflows into ASEAN countries.

Hypothesis 2: North-South BITs have a positive effect on FDI inflows from developed countries.

Hypothesis 3: South-South BITs have a positive effect on FDI inflows from developing countries.

Hypothesis 4: AIA has a positive effect on total FDI inflows into ASEAN countries.

Hypothesis 5: AIA has a positive effect on intra-FDI inflows into ASEAN countries.

4.2 The Panel Data Analysis

This dissertation primarily relies on a quantitative approach to investigate the topic in question. To be able to determine the determinative effects of IIAs on FDI

inflows, a panel data methodology is recommended for use here. The reason we adopt the panel data analysis as opposed to a cross-section analysis is because a cross-section analysis is a look at the samples at one point of time so there are possibly other time series properties of the data that would be left out if the cross-section analysis is employed. By contrast, panel data are data where multiple cases (countries) were observed at two or more time periods. Panel data regression techniques allow the researcher to examine the cross-section information reflected in the differences between countries as well as the time-series information reflected in the changes within countries over time (Baltagi and Raj 1992). The advantage of this methodology is that it allows idiosyncrasies (heterogeneity) existing among groups (countries) to be considered and reduce multicollinearity problems (Nonnemberg and Cardoso de Mendonca 2004).

While it is possible to use ordinary multiple regression techniques on panel data, a problem may arise due to omissions of some unknown variables that could influence the outcome. In such instance, there is a need to control for those unknown variables even without directly observing them by detecting changes in the dependent variables over time. Fixed-effects model controls for omitted variables that differ between cases but are constant over time while random-effects model controls for omitted variables that vary over time but are constant between cases (Hsiao 2003). More specific description on which model is proper for use in our case is offered after the model has been specified in the next section.

4.3 Model Specification

The empirical analysis in this study adopts Dunning's electic paradigm that emphasizes the locational advantages of the host countries relative to other countries as determinants of cross-country pattern of FDI[9]. The model is constructed to include a set of location-specific factors considered by the existing literature to influence decisions of foreign direct investors.

There are many ways to categorize these potential determinants of FDI into groups. Different authors have different ways to classify these determinants into categories. UNCTAD categorize these determinants into three sets of factors: national FDI framework, business facilitation measures, and economic factors (UNCTAD 1998). Banga (2003) categorizes the variables into three sets consisting of overall economic policy, national FDI policy and international FDI policy. Her national FDI policy category includes rules and regulations that govern the entry and exit of FDI, fiscal incentives and financial incentives, as well as restrictions on operations of foreign firms while the international FDI policy incorporates IIAs. Although Banga's categorization

[9] The gravity model, which argues that the geographic distance between host and source countries do matter in explaining FDI phenomenon was considered for possible use but was not selected because of several reasons as follows:

1. The objective of the dissertation is to study the locational factors of the host country so factors of the source country such as distance, the GDP (or GDP per capita, population) of the source country are irrelevant.
2. The gravity model requires that we use bilateral flows between the home (typically OECD countries) and the host country. However, we do not want to use bilateral flows because theories of BITs argue that not only BITs have a commitment effect on the signatory country, but BITs also have a signaling effect on other third countries as well. The use of bilateral flows will not let us easily study the combined benefits of commitment and signaling effects at the same time.
3. The gravity model is quite a standard specification in the empirical models of bilateral trade but is more ad-hoc for the case of FDI. Other studies on the subject of BITs are also based on the Dunning's OLI framework as well. Using different model from them will render it harder to assess the qualitative and quantitative differences in the findings of this dissertation versus the existing literature on the effects of BITs

has merits from a theoretical standpoint in that national FDI policies represent a host country's most overt effort to influence FDI flows, which therefore should be controlled, there are a number of practical limitations prevent us from doing that. The main difficulty in examining the impact of these national FDI policies lies in how to quantify them. Banga (2003) approaches this problem by assigning different scores to different countries based on the incentives and restrictions on FDI that each country provides to investors. For example, on tax holidays and tax concessions that represent the level of fiscal incentives that are provided to investors, a host country is assigned a zero score if it offers no tax holidays; a score of one if it offers up to five years of tax holidays; and a score of two if it offers more than five years of tax holidays. A host country receives a zero score if it does not offer tax incentives to any industry; a score of one if it offers tax incentives to some industries; and a score of two if it offers tax incentives to all industries. The hypothesis was that a country with higher score will draw in more FDI. On the surface, this practice seems to work but it becomes problematic because this technique is not able to capture various, subtle yet significant qualitative differences inherent in a FDI policy regime. For example, most tax holidays that are often offered by a developing country, most of the times are not granted across the board, but are often targeted toward a certain geographical region in a host country that the government wants to promote. Additionally, these fiscal incentives often come with various conditions and requirements placed on the investors in return. Using a sum of scores arbitrarily assigned is not able to capture these essential qualitative details. Additionally, the data availability of new ASEAN members such as Lao PDR, Cambodia and Myanmar complicates this

further because we cannot account for over-time changes in domestic legislation, or have a clear picture of the investment rules and regulations of these countries back in the 1980s. As such, the national FDI variable cannot be included in our model and has to be dropped.

The choice of the explanatory variables is also dictated by the objectives of this study and data availability. In particular, there are some social variables such as education that we wish to control for their effect and examine their relationship with the FDI flows but due to the very limited data availability of the ASEAN countries, which have not properly collected comparable data over a long period of time, a proper education indicator could not be created; hence this variable is dropped from our model.

As for this dissertation, we can classify the determinants examined in our model into three main groups: economic fundamentals, other variables known as potential determinants of FDI flows, and investment treaties.

FDI = *f [(Economic Fundamentals), (Other Variables), (Investment Treaties)]*

Economic fundamentals are traditional FDI determinants such as market size, economic growth rate, trade openness, and macroeconomic stability that need to be in place first before most MNEs would consider investing in a certain country. The first set of variables includes traditional determinants frequently covered by the literature. Other potential determinants of FDI include factors such as the quality of institutions that are

controlled in some careful empirical studies while investment treaties refer to BITs and the AIA, which is the focus of this research.

Specifically, the logged amount of FDI inflows is a function of these various factors:

FDI = *f* (market size, economic growth, labor cost, natural resources, infrastructure, exchange rate, inflation, institutional quality, trade openness, bilateral investment treaties, and regional investment agreement)

There are several types of panel data analytic models depending on the assumptions we make about the intercept, the slope coefficients, and the error term. For example, the constant coefficients model assumes that the intercept and slope coefficients are constant across time and space and the error term captures differences over time and countries. Though highly unlikely, this model can be used when there is neither significant country nor significant temporal effects. Secondly, we can assume that the slope coefficients are constant but the intercept varies over countries. Another alternative is that the slope coefficients are constant but the intercept varies over countries and time. Our model will take into account the "individuality" of each country by letting the intercept vary for each country but assuming the slope coefficients are constant across countries.

Alternatively, the model can be expressed as the following:

$$FDI_{it} = \alpha + \beta_1 GDPPC_{it} + \beta_2 POP_{it} + \beta_3 GROWTH_{it} + \beta_4 OPEN_{it} + \beta_5 INFLTN_{it} + \beta_6 EXCHANGE_{it} + \beta_7 RESOURCE_{it} + \beta_8 WAGE_{it} + \beta_9 INFRA_{it} + \beta_{10} INSTN_{it} + \beta_{11} BIT_{it} + \beta_{12} AIA_{it} + \mu_i + \varepsilon_{it}$$

where FDI_{it} denotes the natural log of FDI inflows into country *i* for year *t*;

μ_i indicates country fixed effects implemented via a set of n-1 country dummies.

μ_i is an intercept term. The subscript *i* on the intercept term suggests that each country may have different intercept terms. The FEM given here assumes that the (slope) coefficients of the regressors do not vary across countries over time.

ε_{it} is the error term, which represents the effects of the omitted variables. It has two dimensions: one for the country and the other for the time period.

GDPPC is the natural log GDP per capita.

POP is the natural log of population.

GROWTH is the average rate of GDP growth over the previous 5 years.

OPEN is the share of trade to GDP.

INFLTN is average annual inflation rate.

EXCHANGE is the change in real effective exchange rates.

RESOURCE is percentage of merchandise exports that are ores and metals, fuel, and agricultural raw materials.

WAGE is real wage rate from the International Labor Organization.

INFRA is the natural of number of telephone lines and mobile phone subscribers per 1,000 inhabitants.

INSTN is the composite score of the investment profile component and the law and order component from International Country Risk Guide (ICRG).

BIT is the cumulative number of bilateral investment treaties that have been signed and ratified.

AIA is a dummy variable for the AIA Agreement. The period 1980-1998 are coded as 0 while the period 1999-2005 are coded as 1.

4.4 Testing and Estimation

To assess the significance of these IIAs as a determinant of FDI, we employ an econometric analysis to test the null hypothesis – that, ceteris paribus, the ratification of an IIA has no effect on FDI inflows.

Three different methods (namely common constant, fixed and random effects) can be used to test the data sample under different estimations. Even though the sample consists of a rather homogeneous group of countries (except for Singapore), we suspect there are unmeasured characteristics of each country making it attractive to MNEs that are not captured by our explanatory variables. Those characteristics are such as different culture, language, geography, and weather conditions.

The Fixed Effects Model (FEM) and the Random Effects Model (REM) can produce markedly different results. The core difference between the FEM and the REM

lies in the role of dummies, namely the fact that an FEM considers dummies as part of the intercept while in an REM, the dummies act as an error term. The FEM examines group differences in intercepts, assuming the same slopes and constant variance across groups. The intercept is allowed to differ among countries in recognition of the fact each individual may have some special characteristics of its own. To take into account the differing intercepts one can use dummy variables. The FEM using dummy variables is known as the least-squares dummy variable (LSDV) model. A disadvantage of LSDV is that it consumes a lot of degrees of freedom when the number of cross-sectional units, N, is large, in which case researchers have to introduce N-1 dummies. As for the REM, it assumes the same intercept and slopes and the difference among groups will lie in the variance of the error term. The model can be estimated using what is called a generalized least squares (GLS) regression.

The question facing investigators is which model is more proper for use in the situation at hand. The answer hinges around the assumption one makes about the likely correlation between the country, error component, and the regressors. The FEM is viewed as one in which investigators make inferences conditional on the effects that are in the sample. The REM is viewed as one in which investigators make unconditional or marginal inferences with respect to the population of all effects. It is up to the investigator to decide whether to make inference with respect to the population characteristics or only with respect to the effects that are in the sample. The effects of countries can be assumed random if the countries are all randomly drawn from all countries in the world. For our case, however, the ten Southeast Asian countries are not

random samples from a larger population, but are handpicked by us. As such, from a theoretical standpoint, the fixed-effects model seems more appropriate. Additionally, the situation to which a model is applied and the inferences based on it are the deciding factors whether we should treat effects as random or fixed. When inferences are going to be confined to the effects in the model, the effects are more appropriately considered fixed. When inferences will be made about a population of effects from which those in the data are considered to be a random sample, then the effects should be considered random. By this notion, the FEM is favored for the inferences produced by our study, if there is any, will focus on the effects of the investment agreements on the FDI inflows to ASEAN countries.

For analyzing the empirical results, the study will perform the regression on the equation that incorporates the hypothesized variables. If the regression results point to the effect of the IIA as hypothesized, we will reject the null hypothesis and report its statistical significance. Finally, we will report how much effect the IIA has vis-à-vis other variables on the FDI inflows into the ASEAN countries.

In summary, the model formulated here will estimate the impact of investment treaties on FDI inflows while controlling for the other two sets of variables (economic fundamentals and other potential determinants) believed to affect FDI.

Our model specification differs from that of Banga (2003) in at least two principal ways. First, Banga's model specification has no concern for the role of institutions. In fact, there is no regard for institutions anywhere throughout her research. As such, her model does not include any explanatory variable to capture this effect. Although political

variables such as institutional quality are less studied and more difficult to measure than economic ones, that does not automatically mean the political variables are any less significant. We do think this is an important omission that should be corrected. We address this problem by including an institutional quality variable in our model specification.

Second, as already noted in the earlier section, her model that includes the AIA as one explanatory variable uses the data of total FDI inflows as the dependent variable. We think it is incorrect because when looking at the details of the AIA, it has already been demonstrated that AIA assigns principal importance to the promotion of FDI from within ASEAN first and FDI from outside ASEAN second. Specifically, AIA gives preference to ASEAN investors over non-ASEAN investors. As such, to accurately estimate the impact of the AIA as an investment agreement on the FDI outcome, it is important to account only for the FDI inflows originating within ASEAN.

Throughout the next chapter, we will perform a number of estimations, which can be categorized and explained as follows:

<u>First set of estimations: Total FDI inflows as a dependent variable</u>

1. Total BITs and AIA → Total FDI inflows
2. North-South BITs, South-South BITs, and AIA → Total FDI inflows

<u>Second set of estimations: Intra-ASEAN FDI as a dependent variable</u>

3. AIA → Intra-ASEAN FDI

The first set of estimations has total FDI inflows as a dependent variable. We will first examine the separate effects of the total number of BITs entered into force and the

AIA Agreement on the total FDI inflows. Next, we will differentiate between the North-South BITs and South-South BITs and observe their differential impacts on the total FDI inflows to see the relative importance of North-South BITs vis-à-vis South-South BITs.

The second set of estimations concerns the regional nature of the FDI. An analysis will be made to analyze the impact of BITs and the AIA on intra-regional FDI for the period 1995-2004. For this estimation, intra-ASEAN FDI will be used as a dependent variable. There will be a slight change to the original model specification, namely the BIT variable will be dropped from the model since there is no need for ASEAN countries to create a separate BIT between each other for there are already pre-existing regional investment agreements among ASEAN member states to protect the investment originating from another member state. As such, BIT or BITNS/BITSS will be dropped from the model specification used in this set of estimations.

Endogeneity issue

As it is the case in other studies, endogeneity or reverse causality can be an issue. For example, for the context being examined in this dissertation, it is expected that countries sign IIAs in order to attract more FDI. At the same time, it is plausible that MNEs with substantial investments in host countries would make a demand or influence their home country government to sign a BIT with the host country, resulting in a reverse causality of FDI causing a BIT to occur. If we believe that MNEs could advocate for BITs and is a potential factor in the number of BITs, then we have to try to deal with the endogeneity issue. Theoretically, the best way to tackle the issue would be through the

use of an instrumental variable regression. However, a use of instrumental variable regression would suffer from the problem of weak instruments since valid instruments for signing IIAs besides the use of time lags have not yet been developed in the literature, making it difficult to reason what the determinants of the IIAs should be. As such, we will mitigate the issue of reverse causality by lagging economic variables by one year to avoid simultaneity with the dependent variable. Although this may not entirely solve the problem of possible endogeneity, it is the most practical solution that should be sufficiently effective. Specifically, even if the issues of causation have not been fully resolved by the use of lags, if the results that come out from the fixed effects model are quite consistent, it will reliably indicate a strong association between the variables of our interest.

CHAPTER 5

VARIABLES AND DATA SOURCES

The panel consists of 10 countries, and runs for a time span of 25 years (missing one observation due to the lags introduced in the equation). The total number of observations for the main estimation that is going to be performed is 250, which should be sufficient to produce robust estimates for most cases.

5.1 Dependent Variables

There are many forms of dependent variables that have been used on existing literature on the determinants of FDI. Examples are such as real FDI as percentage of the country's GDP, natural log of FDI per capita, FDI inflows relative to world FDI. Other studies use bilateral inflows which are based on the operating assumption that BITs have an effect only on the signatory country to that BIT. The main measure of FDI attractiveness in this study will be the amount of FDI going to ASEAN countries. FDI flows are adopted instead of FDI stocks because FDI flows are expected to be less path dependent than FDI stocks. FDI flows should be a better variable to capture the effect of the changes from year to year than FDI stocks. Any changes in the relevance of determinants will likely affect FDI flows more strongly than FDI stocks. The study will use the natural log of FDI flowing into ten countries to reduce the skewness of its

distribution and for the purpose of transforming those data to make it a linear relationship with the independent variables. This increases the model fit considerably.

UNCTAD directly provides gross inflows data, which are used here. The figures include capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise or capital received from an FDI enterprise by a foreign direct investor. There are three components in FDI: equity capital, reinvested earnings, and intra-company loans. If one of these three components is negative and is not offset by the other remaining components, the resulting amount can be negative, indicating disinvestment (UNCTAD 1996). There are some cases of negative FDI flows, which represent about four percent of all the cases. For those cases, we recoded them as one US$.

The data were originally expressed in the current US dollars and to assure their inter-temporal comparability had to be converted to constant 2000 prices using the US GDP deflator. The sample period runs from 1980 to 2005 making it possible to view factors behinds recent movements of FDI into those ASEAN member countries. The reason we select the period between 1980 and 2004 because for the developing economies, FDI data is generally not available before 1980. The database can be built by using various sources. Our data source for the equation estimating the effects of those variables on the overall FDI inflows into ASEAN is the UNCTAD's database and the data source for the equation estimating the effects of those variables including AIA on the intra-regional FDI to ASEAN countries is the ASEAN FDI Database from the ASEAN Secretariat.

5.2 Explanatory Variables

In total, the study deals with 13 explanatory variables. The explanatory variables of interest are **BIT and AIA –** controlling for the effects of other explanatory variables consistent with most literature on FDI flows, according to the model specified in the previous section. The overall economic policy group includes market-related variables, factors of production, exchange rates, macroeconomic stability, inflation rate and quality of domestic institutions of the host countries. Our three main data sources are the ASEAN FDI database, the World Development Indicators (WDI) database and the Global Development Finance (GDF) database. The following section lists the explanatory variables that will be used in the dissertation along with the description in more details.

Market size

Market size is the most important determinant consistently recognized in the literature. It consists of current market size and potential market size. Larger countries should receive more flows than smaller countries. For the market size, most empirical works use GDP per capita as a proxy but there are some studies that have used absolute GDP as a measure for market size. However, absolute GDP has been argued by Chakrabarti (2001) that it is a poor indicator for use here because it emphasizes the size of the population rather than the income level. Therefore, we will follow what most empirical studies do and use GDP per capita as an indicator for our case. Specifically, the dissertation will use the natural log GDP per capita (**GDPPC**) and the natural log of population (**POP**) as proxies to gauge the current market size. Together, they provide the

value of a market's size. Next is the potential market size, which relates to the rate of growth of the economy. Theoretically, a country with fast growing economy should be able to attract more FDI than a country with slower growing economy because a faster rate of growth means a potentially bigger market size, which would result in better return on investment. Although market size and growth should positively affect investment, an opposite direction of causation could operate here. That is, more FDI leads to higher economic growth and larger market size. To prevent this possible endogeneity issue, we will use their lagged values in the estimation. For the potential market size, we will use the average rate of GDP growth over the previous 5 years (**GROWTH**) to proxy market growth. All of these variables should have a positive sign on the regressions. The data sources are the World Development Indicators (WDI) database.

Macroeconomic Stability

Another factor to represent overall economic policy is macroeconomic stability. Macroeconomic stability can be proxied by average annual inflation rate (**INFLTN**) for low inflation rate is often associated with economic stability in the host country and high inflation points to government and its central bank's incompetence in balancing the budget and conducting appropriate monetary policy. It is hypothesized that countries with lower inflation rates will be able to attract more FDI flows ceteris paribus (Kinoshita and Campos 2004).

The Degree of Openness

For policies on tariff, countries with lower tariff and non-tariff barriers attract more FDI inflows. This assumption is in line with the one stating that open economies attract higher FDI inflows than close economies, which is well supported by the empirical literature. On openness, economists have constructed various indicators as an indicator of openness to trade (Sachs and Warner 1995). The one that is used most often to proxy for openness is the ratio of total trade (exports plus imports) to GDP (Ancharaz 2003; Amaya G. and Rowland 2004). Various scholars have pointed out that this openness variable is not perfect based on a couple of grounds. Some suggest that average tariffs be used instead because they are a more direct way to gauge for openness and the variable would be exogenous. It is important to note that using average tariffs can also create some other issues too. Edward (1998) reviews various trade openness measures and average tariffs appears to be one of the worst performing measures of openness. Based on the fact that the share of trade to GDP has been used by almost all studies on the determinants of FDI, we adopt this indicator for use in our model (Nunnenkamp 2002; Hallward-Driemeier 2003; Busse and Hefeker 2005; Botrić and Škuflić 2006). The sign of this variable is expected to be positive. However, it can become opposite in the case of tariff-jumping investment whereby investors decide to invest in a host as a way to sidestep tariff and non-tariff barriers present in that economy. In that case, the high level of barriers can induce more investment in the host country.

Labor Cost

Next determinant also in the same overall economic policy category is factors of production. These factors such as the availability of low cost labor will be an important factor drawing in foreign firms whose investments can be described as resource-seeking or efficiency-seeking in nature. The real wages (**WAGE**) in the host country can be used as a proxy for labor cost. The data source for WAGE is the International Labor Organization (ILO). It is expected that lower real wages attract more FDI. On the labor issue but from a quality perspective, a more educated work force can be trained and taught on new technologies faster and at less cost, which should be appealing to investing firms. Thus, the quality of work force is supposed to be another important determinant, which arguably could be proxied by a variable such as a secondary enrollment rate. However, there are insufficient observations whether from data sources such as the World Bank, UN, UNESCO, Asian Development Bank or even ASEAN Secretary. As such, there will not be an education variable in this model.

Natural Resource Abundance

The measure that we will use to control for the effect of natural resource endowments (**RESOURCE**) is the country's natural resource-based exports, measured as a per cent of GDP (Sachs and Warner 1997). Resource-based exports in this case are defined as agriculture, minerals and fuels. The share of exports of natural resource goods in GDP indicates a country's dependence on its natural resource. The data on each type of

natural resource good can be obtained from the WDI database to calculate for the composite one.

The majority of FDI to the least developed countries is through natural resource investment. The presence of natural resources in a country is expected to attract foreign investment regardless of other factors that would usually attract or discourage investors.

Infrastructure

Good infrastructure is an essential condition for foreign firms to operate successfully. Infrastructure of a given country is made up by many elements such as roads, ports, electricity, water distribution systems, phones, internet connectivity, and etc. Different studies have employed various kinds of indicators to proxy for the availability and cost of infrastructure. Many studies on FDI determinants have chosen the number of main telephone lines per 1,000 inhabitants (**INFRA**) as their infrastructure variable to capture the availability of infrastructure due to its simplicity and data availability (UNCTAD 1998; Calhoun, Yearwood et al. 2002; Kinoshita and Campos 2004; Botrić and Škuflić 2006). This measure has also been widely used in other fields to proxy for the availability of infrastructure. Another relatively similar indicator that is becoming increasingly adopted and will be used in this study is the number of fixed telephone lines and mobile phone subscribers per thousand inhabitants. While imperfect as an indicator of the infrastructure for it only proxies the telecommunication aspect but does not encompass other aspects of the infrastructure, it is an indicator that is kept fairly complete by all ASEAN countries; hence our study will use the natural log of the number of fixed

telephone lines and mobile phone subscribers per population as an indicator for infrastructure. Yet, we recognize the validity of alternative measures of infrastructure. Some alternatives that we consider using are consumption of electricity per capita (electricity consumption), road length per capita (road density). We include these measures in separate estimations and explore the sensitivity of results to these alternative indicators of infrastructure. The figures can be obtained from the WDI database. In general, it is expected that the more available the infrastructure of the host country, the greater its ability to attract FDI. The expected sign on the regression is positive.

Exchange Rate

The effect of changes in real exchange rates on FDI flows is ambiguous because investors could gain or lose from devaluation depending on the time that they have invested and the currency that they have relied on. Devaluation of currency could work as an incentive or a disincentive depending on the motives and pre-existing positions of the investing firms. Based on the fact that their investment in dollars would be converted to more money in local currency, this characteristic could attract resource-seeking and efficiency-seeking FDI. On the other hand, currency depreciation can also increase the costs of imported inputs and reduces the value of profit remittances in foreign currency (Ancharaz 2003). Overall, it is assumed that everything being the same, devalued exchange rate would likely bring more FDI in the host countries. The data can be obtained from the World Bank's GDF database. The variable used here is the change in

real exchange rate, of which the data are taken from the WDI database and computed as follows.

$$EXCHANGE_{it} = \frac{REX_{it} - REX_{it-1}}{REX_{it-1}} \times 100$$

$$REX_{it} = EX_{it} \times \frac{USCPI_t}{CPI_{it}}$$

where REX_{it} is the real exchange rate, EX_{it} is the nominal exchange rate, and $USCPI_t$ and CPI_{it} are the consumer price index (CPI) of the U.S. and country *i*, respectively.

A negative value of this variable indicates currency appreciation while a positive value indicates currency depreciation. As country's currency depreciates, it is hypothesized that FDI inflows will increase; hence the expected sign of the relationship between **EXCHANGE** and **FDI** is positive.

Institution

As to the quality of domestic institutions, it is difficult to find a single measure that best represents the quality of institutions relevant to FDI location decisions. There are a variety of measures that have been used by different authors. Some authors use measures that primarily focus on specific dimension of institutions such as rule of law and political stability, while others use broader measures that also include dimensions

such as the efficiency of bureaucracy, the level of corruption in a host country among others things. They are all related but differ from one another in subtle details.

The selection of a good indicator for institutional quality is limited by various constraints. The main data source for our study relies on the International Country Risk Guide (ICRG) index published by the Political Risk Services (PRS) Group due to the fact that the index has great country and time coverage (135 countries starting from 1984). This index comprises 22 variables in three main categories of risk: political, financial, and economic. While the full composite index is commonly used in other studies investigating the determinants of FDI or the relationship of IIAs and FDI due to convenience, our study will not use the full composite index and instead elect to use a composite score of only the selected components identified as relevant. This is because the ICRG index is designed for use by investors or MNEs as a guide to determine how much financial, economic and political risk facing their investment, which is not the same thing as institutional quality. In particular, the ICRG index contains many items that do not fit with the general description of institutions as 'formal and informal constraints that shape human interaction' as discussed in the literature review chapter. For those studies that use the full composite ICRG index, it means that they also unintentionally, incorrectly included the socioeconomic conditions such as unemployment, consumer confidence and poverty that are subcomponents of ICRG in their models. More importantly, there clearly would be multicollinearity between such indicators such as poverty and GDP per capita as an example. To proxy for the security of property and contract rights which would provide a better explanation of institutional quality and is

consistent with the context of this study, our study will use a composite score of the two components that are most relevant to IIA provisions, namely the investment profile component and the law and order component. The investment profile index runs from 0 (highest risk) to 12 (lowest risk). It is comprised of contract viability/expropriation, profit repatriation and payment delays subcomponents (PRS Group 2007). The law and order component runs from (0 highest risk) to 6 (lowest risk). This component includes the Law subcomponent that measures the strength and impartiality of the legal system and the Order subcomponent that measures the observance of the law by public (PRS Group 2007). For this variable **INSTN**, higher values indicate stronger institutions. It is expected that countries with the higher index score will attract more FDI inflows.

Investment Treaties

There are two main explanatory variables of interest: BITs and the regional investment agreement of the ASEAN countries. Based on international law principles, a signing of a treaty indicates a state's intention to become a party to the treaty but it does not establish the binding effect of the treaty on the signatory country. The only duty the signatory country has before ratification is to refrain from actions that would defeat the purposes of the treaty, but the signatory country is not bound by any specific articles in the treaty, and is not bound to ratify the treaty it has signed. The standard procedure in most countries by which the signatory country obtains the ratification is by seeking the approval from the parliament or its legislative body in accordance with its national constitutional requirements. Once the treaty has been ratified and the ratification has been

officially notified, the treaty will enter into force and have a binding effect on the signatory countries. Egger and Pfaffermayr (2004) point out the differences between BITs that have been ratified and those that have not and find that ratified BITs have a significant effect on the OECD outward FDI stocks in developing and OECD countries while the only signed BITs do not have. This finding is corroborated by Sullivan and Salacuse's study(2005). Thus, what we will use in the regression is the total number of BITs entered into force. The data source for BITs is the UNCTAD's work program on international investment agreements, which keeps records of all BITs along with the dates and parties.

Although BITs vary across countries, they generally share similar principles (Neumayer and Spess 2005). Almost invariably, they contain provisions that define foreign investment, specify the kind of protection against expropriation, and dispute settlement mechanism among others. The first test is to examine the impact of total number of BITs signed by each ASEAN country in each year on total FDI inflows. The data used is the cumulative number of BITs derived from a listing published by UNCTAD, which documents the parties to every bilateral investment treaty of public record, the date of signature, and the date of entry into force. The reason we use the cumulative number of BITs because treaties are assumed to have continuous, long-term effect on the FDI flows, not on just the following year after the treaty goes into effect. Table 6 and figure 7 describe the nature of growth of the BITs that have been signed and ratified by ASEAN from 1980 to 2005.

Table 6. Cumulative Number of BITs Signed and Ratified by Countries, 1980-2005

Countries	1980		1985		1990		1995		2000		2005	
	Signed	Ratified	Signed	Ratified	Signed	Ratified	Signed	Ratified	Signed	Ratified	Signed	Ratified
Brunei	0	0	0	0	0	0	0	0	5	0	5	2
Cambodia	0	0	0	0	0	0	2	0	10	4	10	6
Indonesia	4	4	4	4	5	5	25	20	52	36	59	41
Lao PDR	0	0	0	0	2	1	8	7	18	15	21	17
Malaysia	6	4	11	6	15	13	42	27	63	40	66	43
Myanmar	0	0	0	0	0	0	0	0	2	1	4	2
Philippines	0	0	2	1	3	2	17	8	32	22	35	26
Singapore	7	7	8	7	10	10	15	14	24	20	28	22
Thailand	2	2	3	3	5	5	15	11	28	20	39	32
Vietnam	0	0	0	0	1	0	28	20	40	33	48	39
Total	19	17	28	21	41	36	152	107	274	191	315	230

Source: UNCTAD database on BITs

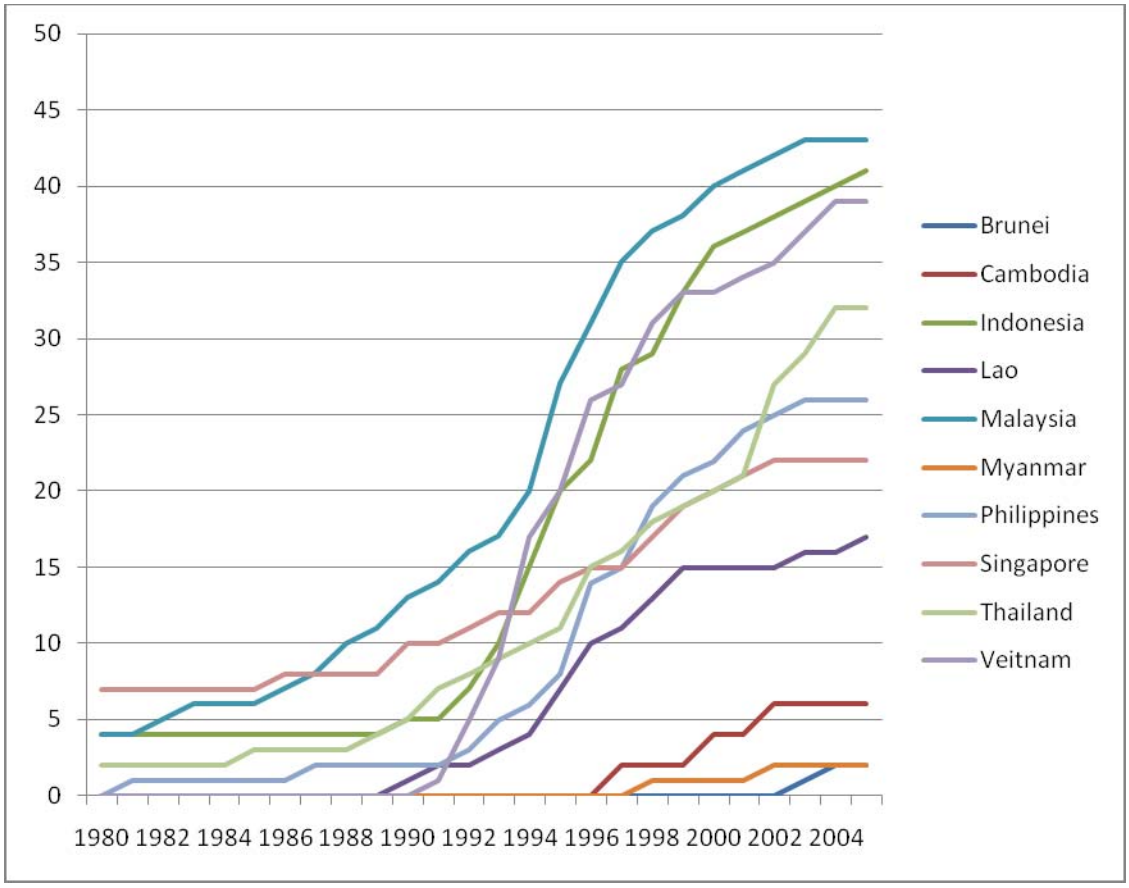

Figure 7. Cumulative BITs signed by 10 ASEAN countries

Source: UNCTAD database on BITs

As the study proceeds to examine the impact of BITs signed with developed countries and BITs signed with developing countries on the FDI inflows, the main BIT variable will be decomposed into 2 separate variables: North-South BITs (BITNS) and South-South BITs (BITSS). Table 7 and figure 8 provide the comparison of the number of North-South BITs versus South-South BITs entered into force by ASEAN countries from 1980 to 2005.

Table 7. Cumulative Number of effective North-South BITs vs. South-South BITs, 1980-2005

Countries	1980		1985		1990		1995		2000		2005	
	DC	DPC	DC	DPC	DC	DPC	DC	DPC	DC	DPC	DC	DPC
Brunei	0	0	0	0	0	0	0	0	0	0	2	0
Cambodia	0	0	0	0	0	0	0	0	2	2	3	3
Indonesia	4	0	4	0	5	0	13	7	15	21	15	26
Lao PDR	0	0	0	0	0	1	3	4	9	6	10	7
Malaysia	4	0	6	0	12	1	16	11	17	23	17	26
Myanmar	0	0	0	0	0	0	0	0	0	1	0	2
Philippines	0	0	1	0	2	0	6	2	13	9	14	12
Singapore	6	1	6	1	7	3	8	6	8	12	9	13
Thailand	2	0	2	1	3	2	4	7	9	11	13	19
Vietnam	0	0	0	0	0	0	10	10	14	19	17	22
Total	16	1	19	2	29	7	60	47	87	104	100	130

Source: the Author's estimation based on BITs Database, UNCTAD

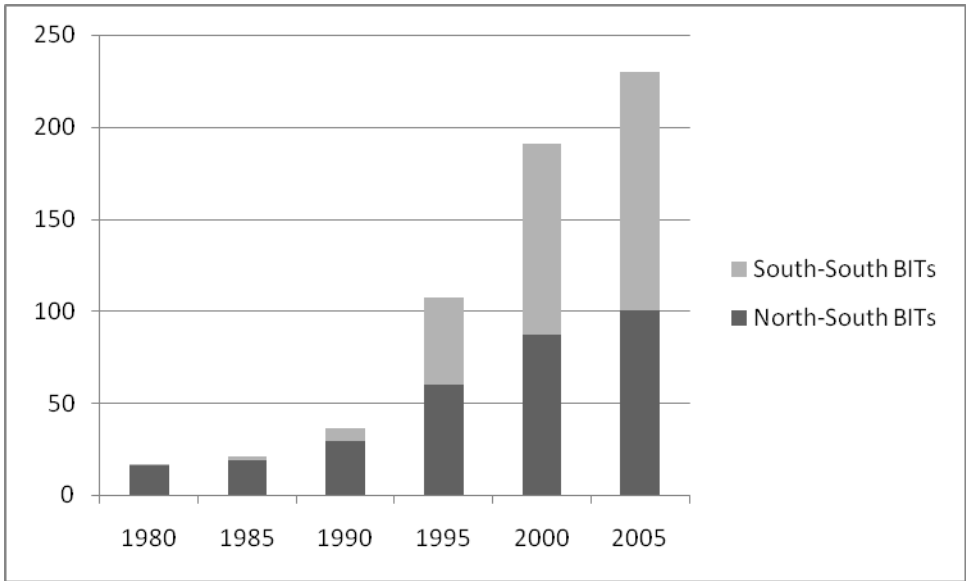

Figure 8. Cumulative Number of North-South BITs and South-South BITs in ASEAN, 1980-2005

Source: the Author's estimation based on BITs Database, UNCTAD

As for the regional investment area, we create a dummy variable AIA to capture the effect of AIA agreement, which was signed in October 1998. Thus, the period 1980-1998 are coded as 0 while the period 1999-2005 are coded as 1. The AIA variable is an explanatory variable included in our main model specification to estimate the effect of IIAs on the overall FDI inflows to the region.

As we proceed to the later set of estimations that investigate the effects of IIAs on the intra-ASEAN FDI, It is hypothesized that AIA has a positive impact on intra-ASEAN FDI.

Table 8. Variables, Description, and Expected Signs

#	Variables	Abbreviation	Description	Expected Signs
1	FDI Inflows	FDI	Natural log of FDI inflows	Dependent Variable
2	Market size	GDPPC	Natural log of GDP per capita	+
3	Population	POP	Natural log of population	+
4	Economic Growth	GROWTH	Average rate of GDP growth over 5 years	+
5	Inflation Rate	INFLTN	Inflation rate	-
6	Openness	OPEN	Trade/GDP	+
7	Labor Cost	WAGE	Real wage rate	-
8	Natural Resources	RESOURCE	Exports of ores and metals, fuel, and agricultural raw materials (% of merchandise exports)	+
9	Infrastructure	INFRA	a) Number of telephone lines and mobile phone subscribers per 1,000 inhabitants, natural log	+
10	Exchange Rate	EXCHANGE	Change in real exchange rate	-
12	Institutions	INSTN	Composite score of the investment profile component and the law and order component from ICRG	+
13	Ratified BITs	BIT	Cumulative number of bilateral investment treaties that have been signed and ratified	+
		BITNS	Cumulative number of BITs signed with developed countries	+
		BITSS	Cumulative number of BITs signed with developing countries	+
14	AIA	AIA	ASEAN Investment Area	+

Table 9. Summary descriptive statistics of the study variables.

Variable	Obs	Mean	Std. Dev.	Min	Max
FDI	238	5.591079	2.755794	-3.21888	9.907616
GDPPC	179	7.028436	1.347023	5.284684	10.10821
POP	260	16.61491	1.840655	12.17059	19.21167
GROWTH	223	5.308755	3.089458	-4.35308	11.57871
INFLTN	208	9.041801	14.56628	-2.31497	128.4191
OPEN	180	75.6904	49.42198	1.530677	228.8752
WAGE	107	5.214491	2.505661	-3.62258	12.11907
RESOURCE	155	33.17173	30.56863	1.774347	99.27284
INFRA	229	3.124096	2.120904	-1.25088	7.207894
EXCHANGE	214	0.8144	12.98945	-36.3969	120.6788
INSTN	175	10.69784	3.409816	2	18
BIT	260	9.669231	12.09703	0	43
AIA	260	0.269231	0.4444156	0	1

Table 10. the correlation matrix

	FDI	GDPPC	POP	GROWTH	INFLTN	OPEN	WAGE	RESOURCE	INFRA	EXCHANGE	INSTN	BIT	AIA
FDI	1												
GDPPC	0.4786	1											
POP	-0.4841	-0.8115	1										
GROWTH	0.4881	0.414	-0.3561	1									
INFLTN	-0.5155	-0.4599	0.4729	-0.245	1								
OPEN	0.3166	0.852	-0.7094	0.1967	-0.3786	1							
WAGE	0.6282	0.5418	-0.7692	0.2183	-0.4836	0.4425	1						
RESOURCE	-0.3082	0.0466	-0.1571	-0.0077	0.0796	0.0001	-0.4291	1					
INFRA	0.1991	0.7407	-0.4232	0.0587	-0.348	0.7992	0.2807	-0.0954	1				
EXCHANGE	-0.2812	-0.0769	0.2129	-0.1456	-0.2643	0.0313	-0.3044	0.0694	0.0143	1			
INSTN	0.583	0.4913	-0.2828	0.3467	-0.436	0.4364	0.2928	-0.1628	0.6102	-0.0328	1		
BIT	-0.2962	0.2181	0.2075	-0.1761	0.1199	0.4755	-0.4351	0.0764	0.6509	0.2071	0.2313	1	
AIA	-0.3678	-0.0411	0.2761	-0.5559	0.188	0.1591	-0.2094	-0.143	0.485	-0.1294	0.0799	0.6237	1

Table 10 reports the correlation coefficients among the study variables to check for multicollinearity issue. Multicollinearity in regression is a condition that occurs when some explanatory variables in the model are correlated with other explanatory variables. The presence of high degree of multicollinearity increases the standard error and causes a decrease in statistical power, making it hard to precisely estimate the impact of each explanatory variable on the dependent variable. However, multicollinearity does not violate any assumptions of ordinary least-squared regression (OLS), and the OLS estimators under such circumstances are still B.L.U.E. (Best Linear Unbiased Estimator). Theoretically, multicollinearity is essentially causing the same problems as caused by not having enough observations or the lack of variability in the explanatory variables (Gujarati 2003).

Based on the result shown in Table 10, population has a strong, negative correlation with GDP per capita, and a moderate, negative correlation with trade openness and wage. Trade openness and GDP per capita are strongly correlated. This is somewhat to be expected as countries that trade more would tend to have higher income, resulting in greater GDP per capita. Infrastructure has a moderate, positive correlation with GDP per capita, trade openness, institution, and BITs. BITs and AIA are moderately correlated. Because the inclusion of each variable is based on the theoretical arguments that we made based on the literature and removing them could constitute specification bias misleading the values of the parameters, we try not to drop any of those variables

except for some variables that have already been dropped due to its collinearity with other variables.[10]

5.3 Handling of missing data

The way we deal with missing data is to use a most common approach called listwise deletion that is also referred as complete case analysis. We omit those cases with missing data and run our analyses on what remains. For example, if there are 5 years that Myanmar has missing scores on one or more variables, we simply omit Myanmar in those years from the analysis. The alternative is pairwise deletion. Under the pairwise deletion approach, all the available data is used. However, this technique is undesirable and will produce biased estimated unless the missing data are MCAR (missing completely at random), which is not the case here. We know for a fact that our data is not completely missing at random because less-developed countries (i.e. Myanmar, Cambodia) tend to have missing data than more developed countries (i.e. Singapore). Therefore, in this case, listwise deletion, which is what we use, is a preferred solution. More details on the analysis and comparison of the potential maximum number of observations versus the effective number of observations available in all estimation results can be found in the appendix.

[10] For example, we considered examining INFRA3 that is natural log of electric power consumption per capita (kWh per capita), but it was dropped from the analysis due to its being strongly correlated with GDPPC having the correlation coefficient above 0.90.

5.4 Summary

Table 8 summarizes the variables that will be used in this study. In sum, for the main model specification, the dependent variable will be the natural log of total FDI inflows into ASEAN and there are 13 explanatory variables. For the second set of estimations, the dependent variable will be the natural log of intra-ASEAN FDI, and the natural log of inter-ASEAN FDI respectively. Most of our attention will be devoted to the first set of estimations.

CHAPTER 6

EMPIRICAL RESULTS

6.1 RESULTS AND INTERPRETATIONS

This chapter presents the empirical results regarding the effect of IIAs on FDI inflows after controlling for other FDI determinants. There are two main sets of estimations to be carried out. The first has to do with finding the effects of BITs on overall FDI inflows to ASEAN. The second set focuses on examining the intra-ASEAN FDI.

In the first set, the estimations are to be carried out using four model variants. First will be a baseline model that includes only the economic fundamentals that are universally accepted in the literature as determinants of FDI flows. They are natural log of GDP per capita (GDPPC), log of population (POP), economic growth (GROWTH), trade openness (OPEN) and inflation rate (INFLTN). We will progressively add more variables into the baseline model and discuss the results.

The second variant is specifically aimed at dealing with the 1997 Asian financial crisis. The third variant incorporates other explanatory variables that should be treated as important potential determinants of FDI such as infrastructure and institutions while BITs and AIA are still left out. Finally, the BIT and AIA variables will be added to the model. We will compare and report the results from all these four model variants and evaluate

whether our model specification fits well with the empirical data or not. Throughout this chapter, we will also report the estimation results that we could obtain when replacing a certain explanatory variable with its alternative measure that is of relevance to readers.

6.2 Empirical Results: Determinants of Aggregate FDI

Effects of BIT and AIA on overall FDI inflows

Baseline model

First, to avoid the complication of the Asian financial crisis 1997 that could interfere with the results, we use data of aggregate FDI inflows into ten ASEAN economies for the period 1980 to 1995[11].

[11] More details on the analysis of the potential maximum number of observations versus the effective number of observations available are provided in Appendix C.

Table 11. Baseline Model, Fixed-effects estimation results (logged FDI flows in constant (2000) dollars).

Independent Variables	Base-line Model
GDPPC	.6209
	(0.202)
POP	7.022***
	(0.000)
GROWTH	.1927***
	(0.000)
INFLTN	-.0167**
	(0.021)
OPEN	-.0066
	(0.340)
constant	-121.934***
	(0.000)
Observations	66
R^2	0.1702

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Table 11 reports the results of the baseline model using a fixed effects estimator to control for time invariant host country effects, where the dependent variable is the logged amount of net FDI inflows to a host country, reported by UNCTAD. The result is consistent with our assumptions. Most of the variables reported in column 1 of Table 11 have the expected signs and are consistent with the literature. FDI is found to be attracted to countries with larger market size as proxied by GDP per capita, and population. Note

that both POP is positive and significant at the one percent level while GDPPC shows the correct sign but is insignificant. Similarly, the host country's economic growth is found to positively influence FDI inflows, and is significant at the one percent level. As for inflation, the findings show that high inflation, which indicates macroeconomic instability, discourages FDI flows. It is significant at the five percent level. As for openness, its effect is not significant. This finding can be understood by the fact that a host's trade openness's effect could be ambiguous if MNEs are looking to jump tariffs.

However, at this point, the model specification is still biased as it misses some important determinants considered essential for determination of FDI flows. What can be concluded from the finding at this point is that from the period of 1980 to 1995, FDI that went into Southeast Asia appears to be influenced by strong economic fundamentals in the host countries, namely market size, and inflation (Dunning 1993, Globerman and Shapiro 1999, Shapiro and Globerman 2001).

As we move to use the data set of the period from 1980-2005, Table 12 reports the results as follows:

Table 12. Comparison of results, 1980-1995 vs. 1980-2005, using baseline model. (logged FDI flows in constant (2000) dollars).

	Baseline Model 1980-1995	Baseline Model 1980-2005
GDPPC	.6209	.9312
	(0.202)	(0.257)
POP	7.0216***	-.3270
	(0.000)	(0.861)
GROWTH	.1927***	.3117***
	(0.000)	(0.000)
INFLTN	-.0167**	-.0148*
	(0.021)	(0.099)
OPEN	-.0066	.0102
	(0.340)	(0.220)
constant	-121.934***	3.083
	(0.000)	(0.919)
Observations	66	130
R^2	0.1702	0.3229

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

After adding data from 1995 thereafter, one of the variables that originally appeared significant when data were only limited to 1980-1995 now become insignificant. This means that those 5 variables have less relevance in explaining the FDI flows into ASEAN over a longer period of time. This may have to do with the 1997

Asian financial crisis, which could add complexity to the phenomenon making the original model no longer able to accurately describe the situations. For example, the 1997 Asian financial crisis involves abrupt shock to the banking system and sudden changes in the currency exchange rates of the ASEAN countries. This fact well suggests that more variables such as exchange rate should be added to the model to better predict the outcome.

Table 13. Comparison of Baseline Model vs. Model 2 that controls for exchange rate (logged FDI flows in constant (2000) dollars).

	Baseline Model 1980-2005	Model 2 1980-2005
GDPPC	.9312	2.469**
	(0.257)	(0.022)
POP	-.3270	-4.905*
	(0.861)	(0.066)
GROWTH	.3117***	.3240***
	(0.000)	(0.000)
INFLTN	-.0148*	-.0159*
	(0.099)	(0.085)
OPEN	.0102	.0164*
	(0.220)	(0.060)
EXCHANGE		-0.0196**
		(0.032)
constant	3.083	72.150*
	(0.919)	(0.083)
Observations	130	120
R^2	0.3229	0.0074

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

After adding the EXCHANGE variable into the model 2 as shown in the second column of Table 13 and controlling for other effects, the model seems to improve significantly. For the EXCHANGE variable, a positive value of the variable itself indicates currency depreciation. The fact that the coefficient of EXCHANGE appears to

be negative means that for every one point currency depreciation while other effects are being controlled, there is a reduction of FDI inflows. This means that as the currency depreciates, the FDI inflows reduce. The effect is significant at the five percent level

Other variables that were not significant in the preceding estimation suddenly all become significant. Adding EXCHANGE to the model makes the most typical determinant of FDI, GPPPC, become statistically significant. Openness now appears to significantly, positively influence the FDI inflows as well, which is consistent with the literature.

All explanatory variables have expected signs except for POP that posts a negative sign. This is opposite to our expectation that controlling for other 5 factors (GDPPC, GROWTH, INFLTN, OPEN, EXCHANGE), more population suggests a larger market, and thus should attract more FDI. Even though POP appears to be negatively associated with FDI, this does not automatically mean that more POP results in decreased FDI, but it could be that there are other factors that potentially cause a decrease in FDI but they are not captured in this present model yet and they may associate with POP.

In model 3 we are adding to the model 2 some additional variables that are potential determinants of FDI, namely natural resource, wage, infrastructure and institution. The results are as reported in table 14.

Table 14. Comparison of Baseline Model, Model 2, Model 3, Fixed-effects estimation results (logged FDI flows in constant (2000) dollars).

	Baseline Model 1980-2005	Model 2 1980-2005	Model 3 1980-2005
GDPPC	.9312	2.469**	7.090**
	(0.257)	(0.022)	(0.016)
POP	-.3270	-4.905*	-3.171
	(0.861)	(0.066)	(0.820)
GROWTH	.3117***	.3240***	.0947
	(0.000)	(0.000)	(0.353)
INFLTN	-.0148*	-.0159*	-.0800**
	(0.099)	(0.085)	(0.020)
OPEN	.0102	.0164*	.0204
	(0.220)	(0.060)	(0.401)
EXCHANGE		-0.0196**	-.0369**
		(0.032)	(0.020)
RESOURCE			.0375
			(0.688)
WAGE			.0352
			(0.986)
INFRA			-1.697*
			(.068)
INSTN			.5484***
			(.001)
constant	3.083	72.150*	9.9145
	(0.919)	(0.083)	(0.968)
Observations	130	120	49
R^2	0.3229	0.0074	0.3766

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

In model 3, the coefficients of most variables display the expected signs. In brief, the variable GDPPC shows a positive impact on FDI flows to ASEAN countries at the five percent significance level. Macroeconomic stability as proxied by inflation is still important factor for investors as high inflation has a negative correlation with FDI inflows at the five percent significance level. The exchange rate variable continues to post a negative sign as shown in the previous tests. Its negative association with FDI means that as the host country's currency depreciates the FDI decreases. The direction of the sign seems to match with the event post the 1997 Asian financial crisis followed by abrupt currency depreciation, and the steep decline in FDI thereafter. Its negative sign can also be explained by the fact that the effect of change in real exchange rate is ambiguous and it can potentially discourage FDI in both directions. Specifically, the trend of depreciation reduces the expected future stream of revenues repatriated from the affiliated operation to the home country.

Notably, the variable of great interest to us is the institutional variable, which has a positive sign and is statistically significant at the one percent level. This indicates that ceteris paribus, MNEs are drawn to a host country that has better domestic institutional quality. As for the INFRA variable, in general, infrastructure availability should contribute to the attractiveness of the location for FDI by MNEs. However, our empirical result shows that in contrast to our expectation, INFRA appears to show a negative sign and is significant at the ten percent level. This means that as other factors are being held constant, the availability of infrastructure is associated with reduced FDI inflows. This part of results appear counterintuitive but it is possible considering the fact that many

large-scale investment projects in those developing countries are investments towards the upgrading or creating large scale infrastructure such as building a public transportation system so what it does is make the reverse true. Specific to this dissertation is that large telecommunication MNEs would invest in a country with pre-existing low penetration of telephones and mobile phone subscribers. If this is the case, the lack of infrastructure would help bring in FDI.

Next step we introduce the 2 investment treaty variables into the model. They are BIT and AIA. To examine the impact of BITs on FDI inflows, two equations are separately estimated. The first one uses the total number of BITs that have been ratified by the host country while the second one differentiates between the total number of effective BITs with developed countries (North-South BITs) and the one with developing countries (South-South BITs). Table 15 shows the results as follows.

Table 15. Model 4, BITs Ratified vs. BITNS, BITSS

	BITs ratified	BITNS, BITSS
GDPPC	7.098**	9.330***
	(0.012)	(0.000)
POP	12.108	24.484**
	(0.410)	(0.039)
GROWTH	.0262	.0756
	(0.801)	(0.348)
INFLTN	-.0891**	-.0701**
	(.017)	(0.015)
OPEN	.0348	.0183
	(0.157)	(0.333)
EXCHANGE	-.0618**	-.0446**
	(0.011)	(0.018)
RESOURCE	.1112	.3205***
	(0.244)	(0.001)
WAGE	-1.978	-.2146
	(0.444)	(0.914)
INFRA	-1.420	-4.424***
	(0.143)	(0.000)
INSTN	.5098***	.2390*
	(0.002)	(0.071)
BIT	-.0767	
	(0.338)	
BITNS		.7853***
		(0.000)
BITSS		-.0962
		(0.179)
AIA	-2.100	-1.434
	(0.126)	(0.173)
constant	-253.767	-410.304**
	(0.331)	(0.030)
Observations	49	49
R^2	0.2121	0.2699

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

The result of this complete model specification goes in accordance with the previous ones. In terms of how good the model on the first column is, we find that these 13 variables together explain about 21 percent of the variance in net FDI inflows to the ASEAN countries. Specifically, GDP has a significantly positive relationship with FDI at .05 level. Inflation has a negative sign on FDI and is significant at .05 level. As with exchange rate that has a negative sign and is significant at .05 level. MNEs are attracted to countries with greater natural resource abundance as RESOURCE is positive and significant at .01 level.

As for the BIT and AIA, their coefficients appear to have signs opposite to our expectations, but their t-values are insignificant. For infrastructure, it also has a negative sign contrary to our expectation. This is possible for the context of ASEAN countries where a lion's share of investment goes into exploitation of natural resources as investors are willing to locate the operations in locations that do not have good infrastructure[12].

We still obtain the negative sign on the coefficient of the BITs variable when various explanatory variables are dropped from the model or when the original explanatory variables such as infrastructure or GDPPC are replaced by their alternative proxies. The natural log of GDP per capita was replaced by the natural log of GDP per capita based on purchasing power parity (PPP) base. The sign of the BITs variable

[12] Alternative estimation that uses INFRA2 (road density per capita) instead of INFRA (natural log of phone lines and mobile phone subscribers per 1,000 inhabitants) is shown in Appendix A. It appears that INFRA is a better measure of infrastructure.

remains negative even in a hypothetical test where all explanatory variables but GDPPC, POP, and GROWTH are dropped[13].

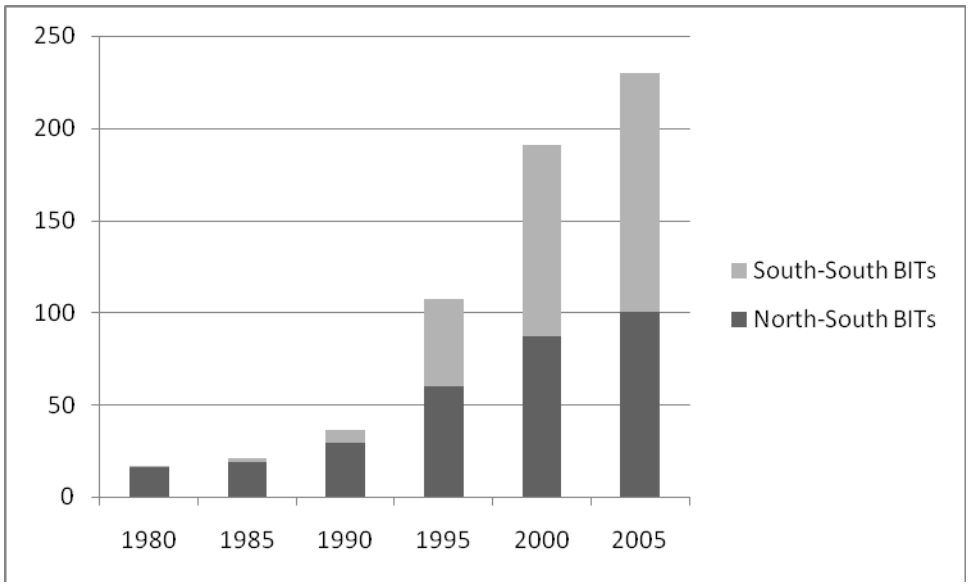

Figure 8. Cumulative Number of North-South BITs and South-South BITs in ASEAN, 1980-2005

What can explain the negative association between the aggregate BITs and the overall FDI flows? It could come from the fact that South-South BITs represent the largest portion of BITs signed in recent years. This evidence is clearly shown in figure 8. As previously noted in the earlier chapter, a South-South BIT tends to diverge from the standard BIT. Particularly, South-South BITs tend to involve other issues besides the core investment provisions typical in a standard BIT with at least one developed country as signatory. Often times, issues such as trade and labor aimed at addressing the

[13] Please find in Appendix B.

development concerns of the parties can be included in a South-South BIT (UNCTAD 2005m). In the cases that some of those South-South treaties put onerous obligations on the investors, it is reasonable that not only such treaties do not attract FDI inflows, but may even discourage FDI inflows to some extent.

However, as the aggregate number of ratified BITs (BIT) is decomposed into North-South BITs (BITNS) and South-South BITs (BITSS), an interesting result emerges. In this estimation, the regression result (column 2) shows that the North-South BITs emerge as another important determinant of FDI as BITNS shows a positive influence on aggregate FDI flows at 99% significance level. However, the South-South BITs is still negative and non-significant. This concurs with our suspicion mentioned earlier that South-South BITs were probably the factor causing the aggregate BIT variable to come out as having negative effect on FDI flows.

These findings lay support to one of our hypotheses that predicts a positive relationship between North-South BITs and FDI while disproves the other one that also predicts a positive relationship between South-South BITs and FDI. A possible explanation as to why the North-South BITs and South-South BITs appear to contribute differently to FDI may have to do with the operating assumption of BIT as either a signal or a commitment device, which arguably would be credible only when it is done with a developed country.

Another explanation that has just been addressed briefly is that a BIT in which at least one of the party is a developed country seems to be rather identical in provisions while a south-south BIT tend to vary more in the extent to which it contains provisions

related to the development dimension. For instance, a number of South-South IIAs do not contain strong substantive obligations, but rather establish frameworks for general principles in promoting investment and mandates for future cooperation. As such, it is not unusual for South-South BITs to have a negative influence on the FDI inflows. As for the South-South BIT's insignificant effect on with FDI flows, this suggests that South-South BITs do not serve to attract additional FDI as those developing countries that are signatory to those BITs have hoped for.

Against the backdrop of these results, it is possible there are other factors affecting FDI that occur at the same timeframe. Such factors could include decreasing trade barriers and increasing familiarity of conducting business in a foreign country among others. However, those factors would likely work to increase the likelihood of investing in a foreign country, so if the BIT variable is taking some of these effects, one would expect omitting these factors to bias up the coefficient of the BIT and the BIT should show a positive sign. Some other unobserved factors that could work in the other direction include the ratification of a tax treaty or more specifically double tax treaties (DTTs). The growing wave of South-South has also been accompanied by an increase number of South-South DTTs (cite South-South IIAs). Dagan (2000) argues that DTT is mainly intended to share tax information across countries in order to deter tax evasion and to reduce administrative costs and, thus, should have little, or even negative, effects on FDI flows. Blonigen and Davis (2002) find that the signing of DTT could reduce FDI and if a DTT is entered into at the same time as BIT, this could weaken the observed effect of the BIT.

Interaction between institution and BITs

In order to test a general theoretical expectation of IIAs as to whether they IIAs work as a more credible signal in a riskier country, the interaction term between IIAs and institutional quality is created and included in the equation. The interaction effect between the IIAs and other traditional variables such as institutional quality tells us if IIAs function as substitutes or complements to a country's institution. A positive interaction term would suggest that BIT functions as a complement for a strong domestic protection of property rights while a negative interaction term would suggest that BIT functions as a substitute. In particular, the negative sign of the interaction term would be consistent with the hypothesis that BITs are one of the efficient tools to strengthen the credibility of a developing country's commitment to protect foreign investors.

The interaction of BIT and institution suggests that institution may be important in determining the effectiveness of a BIT in attracting FDI. If BIT functions as a substitute, as a country's institutional quality improves, a ratification of BIT would have a diminished impact on FDI. In this case, a policymaker can look to sign and ratify a new BIT right away before long to substitute for a strong domestic protection of property rights that the country is still lacking and it would help on the FDI situation. If BIT however functions as a complement, a certain level of institutional capacity has to be first in place before the BIT is seen as credible.

Table 16. Model 4, No interaction term vs. Interaction term

	No interaction term	With interaction term
GDPPC	9.330***	1.794
	(0.000)	(0.573)
POP	24.484**	29.471***
	(0.039)	(0.008)
GROWTH	.0756	.0138
	(0.348)	(0.854)
INFLTN	-.0701**	-.00188
	(0.015)	(0.956)
OPEN	.0183	.0358*
	(0.333)	(0.052)
EXCHANGE	-.0446**	-.0068
	(0.018)	(0.742)
RESOURCE	.3205***	.3063***
	(0.001)	(0.000)
WAGE	-.2146	3.150
	(0.914)	(0.145)
INFRA	-4.424***	-2.862***
	(0.000)	(0.007)
INSTN	.2390*	-.4584*
	(0.071)	(0.089)
BITNS	.7853***	-.1028
	(0.000)	(0.767)
BITSS	-.0962	-.1770**
	(0.179)	(0..015)
BITNS INSTN		.0664***
		(0.006)
AIA	-1.434	-1.184
	(0.173)	(0.211)
constant	-410.304**	-539.561***
	(0.030)	(0.006)
Observations	49	49
R^2	0.2699	0.1562

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Table 16 shows the comparison of results from the model without the interaction term and the model with the interaction term (the interactive model)[14]. The beta coefficients in these two models differ considerably because the two models are describing different relationship. The original model describes a constant effect of the explanatory variable (INSTN or BITNS) on the FDI inflows while the interactive model describes a conditional relationship or the effects of each explanatory variable (INSTN or BITNS) on the FDI inflows varying according to the level of the other explanatory variable (BITNS and INSTN respectively).

Results in column 2 shows that the interaction term between institutional quality and BIT is statistically significant at 1% level. The positive sign of the interaction term means that the positive effect of cumulative BIT signature is higher when the ICRG composite index is low, that is, in high-risk environments. Contrary to theoretical expectations of the role of BITs as substitute in terms of commitment device in the absence of good domestic institutional quality, the result demonstrates the complementary role of BIT to the institutional quality of a country. Such finding weakens a rationale often cited by developing countries when entering into investment treaties hoping to bypass the need to have well functioning domestic institutions in place first. It

[14] The correlations of the constituent variables (BITNS and INSTN) with the product term (BITNS_INSTN) are usually high because the product term (BITNS*INSTN) is an exact nonlinear function of the constituent variables.

seems that BITs could not be used as a short-cut to FDI paradise as economic fundamentals and institutions are still among the factors that matter to investors the most.

The fact that some of the constituent variables are non-significant does not imply that they are dispensable. The constituent variables of the interaction model should always be included regardless of whether they are significant. As the product term is significant this means that the effect of INSTN at some other value of BITNS has a significant effect on the FDI flows variable or the effect of BITNS at some other value of INSTN has a significant effect on the FDI flows. The significance of INSTN can vary at differing values of BITNS and in some instances this can involve the constituent variables. As for the sign switch on BITNS in the interactive model, this is not surprising given that BITNS_INSTN is a product of BITNS, which would result in both variables exhibiting some degree of collinearity. The fact that both BITNS_INSTN and BITNS are in the same model would probably result in BITNS_INSTN biasing downward the effect of BITNS and causing its sign switch, but even if BITNS now appears to be negative, its effect is not significant. The coefficient of BITSS stills appears negative but the effect is now significant in this interactive model now that BITNS_INSTN is introduced into the model. As argued earlier, there are several reasons as to why BITSS could lead to reduced FDI inflows. When the interaction of BITNS and INSTN or what we may hereby roughly refer as “the credibility of a host country” is controlled, BITSS is associated with a reduction of inward FDI.

Alternate model specifications

As to the relationship between IIAs and FDI flows, it is difficult to establish a clear cause and effect relationship between them. Although we have lagged the FDI by one year, it does not solve the possible endogeneity issue completely. On one hand, the fact that we have obtained the positive correlation between North-South BITs and FDI could come from the parallel growth trends of IIAs and FDI flows during the time frame in question.

How do we control for the strong upward and downward trend in FDI over time? We have estimated the logged country share of global FDI in a separate estimation. The results are rather similar to the one where the logged FDI amount is used. The consistency of the findings from these two estimations allows us to have confidence in our findings that we do not compound time trends with the impact of BITs.

Table 17. Logged country share of global FDI

	1.BIT	2.BITNS, BITSS	3.BITNS_INSTN
GDPPC	7.337** (0.006)	9.146*** (0.000)	1.4816 (0.655)
POP	9.866 (0.477)	19.898* (0.100)	24.970** (0.027)
GROWTH	.0965 (0.330)	.1366 (0.107)	.0737 (0.348)
INFLTN	-.0994*** (.006)	-.0840*** (0.006)	-.0146 (0.679)
OPEN	.0264 (0.253)	.0130 (0.504)	.0308 (0.105)
EXCHANGE	-.0683*** (0.004)	-.0543*** (0.006)	-.0159 (0.461)
RESOURCE	.1153 (0.201)	.2850*** (0.002)	.2706*** (0.001)
WAGE	-2.362 (0..335)	-.9324 (0.653)	2.490 (0.265)
INFRA	-1.410 (0.124)	-3.845*** (0.000)	-2.256** (0.037)
INSTN	.5012*** (0.001)	.2817** (0.041)	-.4276 (0.126)
BIT	-.1006 (0.255)		
BITNS		.6085*** (0.004)	-.2948 (0.417)
BITSS		-.1061 (0.154)	-.1882** (0.013)
BITSNS_INSTN			.0674*** (0.007)
AIA	-2.381* (0.068)	-1.840* (0.094)	1.586 (0.110)
Constant	-212.1897 (0.389)	-405.9691 (0.061)*	-453.4947** (0.023)
Observations	49	49	49
R^2	0.2326	0.3032	0.1802

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

In general, even after the measure of FDI is changed from the logged amount of FDI inflows to the logged country share of world FDI, we still obtain the results that go in line with the results of the previous estimations. The results in this alternate model specification well mirror the results obtained in the previous model specification shown in Table 15 and Table 16 in both the direction of the sign and the significance of the coefficients in both the standard model without the interaction and the interactive model in which BITNS_INSTN is added.

Comparing the column 1 in Table 17 (aggregate BIT, logged country share of global FDI) to the column 1 in Table 15 (aggregate BIT, logged amount of FDI inflows), the directions of the signs of all the 12 explanatory variables are identical. The significance level of the explanatory variables between these 2 compared results are generally similar insofar as those that were significant under the original model specification still appear significant under new alternate model specification and those that were insignificant previously still appear insignificant here except for AIA that showed negative but insignificant effect on FDI now shows negative and significant effect on FDI.

Comparing the column 2 in Table 17 (BITNS and BITSS, logged country share of global FDI) to the column 1 in Table 16 (BITNS and BITSS, logged amount of FDI inflows), the directions of the signs of all the 13 explanatory variables remain identical. Those that were significant factors in Table 16 are still significant factors in Table 17 where the dependent variable is changed to the logged country share of global FDI. The

only exception is that AIA appears to have a negative and significant effect on the FDI inflows as well.

Still, comparing the column 3 in Table 17 (interactive model, BITNS_INSTN, logged country share of global FDI) to the column 2 in Table 16 (interactive model, BITNS_INSTN, logged amount of FDI inflows) shows no material change that alters our findings. The signs and the significance of the explanatory variables between the two model specifications are nearly identical. The only difference is on the OPEN variable, which was previously having significant, positive effects on FDI inflows now lacks the significance.

Some key observations worth highlighting here are as follows. First, most explanatory variables included in the second variant (column 2) have a statistically significant influence on the outcome of FDI measured by the logged country share of world FDI. The finding corroborates the important role played by economic fundamentals. It also confirms that institutions are still important and that North-South BITs are effective. In the interactive model where the interaction of BITNS and INSTN is controlled, as in original model specification, North-South BITs still function as complement to institutions.

6.3 Additional Empirical Results: Determinants of Intra-ASEAN FDI

Effects of AIA on intra-ASEAN FDI

The second set of estimations concerns the regional nature of the FDI. An analysis is made to analyze the impact of BITs and the AIA on intra-regional FDI and inter-regional FDI for the period 1996-2005[15]. Before proceeding, it should be noted that in contrast to the earlier estimations, which rely on the FDI data from the UNCTAD World Investment Report database, the following estimations will have to rely on the FDI data from the ASEAN Secretariat because the UNCTAD World Investment Report database does not have FDI data broken down by sources. They are only available from the ASEAN Secretariat. However, the ASEAN Secretariat FDI database only offers data between 1995 and 2005. There are at least two concerns here. First, there are cases in which ASEAN Secretariat record different amounts from the UNCTAD database so there could be an issue of comparability between estimations using these 2 different datasets.

Second, the period 1996-2005 of which the data is only available will likely create some problems. First and foremost, 1996 was when FDI in ASEAN was rising before it hit the peak the in 1997 and had a sharp drop after most ASEAN economies were severely affected by the 1997 Asian financial crisis. This inopportune timeframe complicates an analysis we are to conduct. Second, the data limitation allows us to have a mere 94 observations in the case of intra-ASEAN FDI compared to 260 observations in the case when the total FDI inflows data were used.

Table 18 reports and compares the results as follows:

[15] The length of the period is dictated by the availability of the data.

Table 18. Impact of IIAs on Aggregate FDI inflows and Intra-regional FDI, 1996-2005

	Aggregate FDI	Intra-ASEAN FDI (I)	Intra-ASEAN FDI (II)
GDPPC	17.290 (0.363)	21.559 (0.160)	17.911 (0.196)
POP	6.972 (0.837)	-22.571 (0.405)	-.7710 (0.971)
GROWTH	-.0630 (0.810)	.0808 (0.670)	.0050 (0.981)
INFLTN	-.0868 (0.533)	-.1697* (0.098)	-.2524*** (0.006)
OPEN	.0497 (0.298)	-.0049 (0.891)	
EXCHANGE	-.0690 (0.463)	-.11445 (0.110)	-.1705*** (0.005)
RESOURCE	-.0639 (0.885)	.01800 (0.961)	-.3474 (0.265)
WAGE	2.465 (0.795)	-9.761 (0.119)	-12.584** (0.031)
INFRA	-2.962 (0.331)	-1.697 (0.342)	-2.584 (0.170)
INSTN	.1478 (0.635)	.5693*** (0.009)	.5635*** (0.012)
BITNS	.8149* (0.069)		
BITSS	-.2855 (0.233)		
AIA	-1.310 (0.604)	-1.255 (0.535)	-3.894*** (0.025)
constant	-250.084 (0.646)	292.546 (0.497)	-55.485 (0.863)
Observations	49	27	37
R^2	0.4970	0.0444	0.2381

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Table 18 displays the issues that we just described. As the estimation is performed using only the data from the problematic period 1996-2005, we obtained a result that lacks significance in almost all the explanatory variables included in the model, except for one variable (BITNS), even if the model specification and all the variables being used here are exactly the same as the one used in the earlier estimation. However, the model specification that we created appears to work fairly well when covering data over a longer period of time but is struggling when covering the problematic period 1996-2005. Nevertheless, BITNS still shows its statistically significant, positive impact on the aggregate FDI inflows during 1996-2005.

As we proceed to investigate the effects of AIA on the intra-ASEAN FDI relying on the original model specification, the results are as shown on column 2 of table 18. The most obvious problem is that the number of observations available is only 27, which are too low for generating any credible conclusions. There are only two explanatory variables that are significant in this instance, namely inflation and institution. This indicates that other things being equal, ASEAN investors are attracted to a neighbor ASEAN country that has macroeconomic stability and that has strong institutions.

The possible reasons to explain the overall lack of significance in most explanatory variables are just as we mentioned. First, it has to do with the problematic period 1996-2005 and the data limitation. It could also indicate a misspecification of a model in the sense that the original model specification is not proper for use to predict the intra-regional investment, which still represents a small part of the overall inward FDI to ASEAN. Intra-ASEAN FDI during 1996-2005 could arguably be driven by a set of

factors that are different from what influence the aggregate FDI flows over a longer period of time.

We have made modifications to the original model specification based on the fact that OPEN should be dropped from the model. The rationale is that this measure is intended to capture how much a country is open to trade. As ASEAN countries do have ASEAN Free Trade Area among themselves, it can be argued that ASEAN countries are open to trade with another ASEAN country and the trade openness indicator proxied by a measure of trade over GDP may be less relevant in this case. The results are shown in column 3. The number of observations is now increased to 37, which is more acceptable. Overall, the model appears to improve significantly and these 10 explanatory variables can now explain nearly 24% of the variability in intra-ASEAN FDI. Based on these results, high inflation discourages intra-ASEAN FDI. INFLTN is negative and significant at .01 level. Currency depreciation is associated with reduced FDI and its correlation is significant at .01 level. Higher wage discourages FDI. In other words, ASEAN MNEs are attracted to another ASEAN neighboring country that has cheap labor. The quality of institutions still matter for intra-regional flows and is statistically significant at .5 level. Furthermore, it is important to note that, in contrast to our expectation, AIA appears to have a statistically significant, negative impact on the intra-ASEAN FDI. We do not find evidence that AIA has stimulated intra-ASEAN FDI as believed by its proponents.

As far as the complication by the 1997 Asian financial crisis interferes with the results, it may be that the event interfered with those variables that are economic in nature, while the intrinsically social variables such as BITNS (in column 1) or institutions

(in column 2) remain unaffected and still show its expected influence on the FDI flows regardless of changes in model specification.

Robustness Check

Additional tests were performed to check for robustness of the findings. For instances, we use GDP per capita in purchasing power parity terms and alternative measure of infrastructure using road density per capita instead of the logged amount of telephone lines and mobile phone subscribers per 1,000 inhabitants. Some of these measures exhibit higher levels of multicollinearity with other variables in our models but overall they do not alter our main findings, which are generally robust to changes in the model specification.

6.4 Summary of the Findings

In summary, the effects of the explanatory variables are mostly of the expected sign. Our empirical results confirm the necessary roles played by traditional economic factors such as market size and macroeconomic stability. It also confirms the essential role played by domestic institutions. As for BITs, the findings demonstrate the positive impact of North-South BITs on investment, which is consistent with theoretical expectations.

Our statistical analyses demonstrate that ratifying a BIT has helped ASEAN developing countries attract more FDI inflows. In other words, these BITs have fulfilled their objectives. However, South-South BITs do not serve to attract more FDI to ASEAN.

It is only the BITs signed with a developed country that matter. This is likely because the international commitments made with developed countries are more credible than domestic policy choices and are more credible than commitment made between developing countries themselves.

Both BITs and institution contribute to credibility of the protection of property rights. These two factors seem to be complements to each other. The interplay of these two factors will have important meaning for the assurance of investors of their contemplated investment. The findings from our study should have some applicability to those developing countries that have weak institutions and are looking to sign a BIT either with a developed country or a developing country. Specifically, the virtue of a contemplated BIT should not be judged by the merits of its content and the signatory country alone, but has to be weighed with the context of the economic and political characteristics of the host country as well.

As to why this research has reached different conclusions from the other relevant studies, it can be explained as follows. Hallward-Driemeier (2003) concluded that BITs were not helpful for promoting investment, but the author only analyzed the dyadic relationships while completely disregarding the signaling effect that a BIT could likely have on the flows originating from other third party countries. As a result, it is not surprising to see the author find BITs having no influence on FDI.

By contrast, we argue that ratifying a BIT allows a developing country government to make a more credible commitment to providing a favorable environment for foreign investment, not just for foreign investors from the signatory country.

Both Neumayer and Spess (2005) and Tobin and Rose-Ackerman (2006) seem to find that BITs have a significant and positive effect on FDI to developing countries but in these studies, the BITs signed between a developing country are ignored. Unlike those two studies, we estimate both the combined and separate effects of the North-South BITs and the South-South BITs. Separating the BITs into those made with a developed country and those made between developing countries allowed us to disentangle the differing effects of the two types of BITs. It allows us to reach more precise findings on BITs. We find that when the North-South BITs and South-South BITs are combined together and estimated, the aggregate number lost a significant impact on FDI. However, after breaking the aggregate number into two separate variables and estimating them, interestingly, we find evidence that the North-South BITs have stimulated FDI while the South-South BITs have not and may have even discouraged FDI in some cases. This distinction is crucial and it is something that developing country governments should pay heed to. We conclude that ratifying a BIT has a significant, positive effect on FDI in subsequent periods, but it is only BITs with developed countries. On this point, our findings seem to go in accordance with those reached by the Banga (2003)'s study. However, the fact that the institution variable is controlled only in our study allows us to better understand the interaction of institution and BITs. Their interaction is positive, suggesting a complementary role of BIT to institution. In other words, it suggests that BITs are more credible and have a greater effect on FDI in countries that have strong institutions than in countries that have weak institutions. Countries most likely to gain from ratifying a BIT are those that are already reforming and have reasonably well-functioning institutions rather than

countries with weak institutions, which should not rely on BITs as a bypass for the need to reform. Ironically, those who will benefit the most from a BIT are those who need a BIT to signal their strong protection of property rights the least.

With regard to the ASEAN Investment Area Agreement, we do not find evidence of its positive impact on intra-ASEAN FDI due to various issues such as data limitation issues among others. Currently, intra-ASEAN FDI still makes up a relatively small share of total flows to the region when compared to other regions such as the EU and NAFTA. However, our finding of the lack of significant impact of AIA on the intra-regional FDI flows do not affect other regional investment agreements such as MERCOSUR, which is also a South-South arrangement found to increase investment flows into its respective region.

The AIA Agreement is a regional instrument that formally binds ASEAN countries together in promoting FDI from outside and within the region. It may be a very long-term endeavor that has yet to fully bear its fruits. As more harmonization and cooperation have been carried out, and more linkages have been created, it could yield positive results in the long term.

CHAPTER 7

CONCLUSIONS AND POLICY IMPLICATIONS

7.1 Conclusions

Developing countries are increasingly aware of the role of foreign direct investment (FDI) as an engine of growth in their economies. From a foreign investor standpoint, one wants a predictable investment climate and assurance that his/her investment will be treated in a fair and equitable way. This involves a host economy providing a credible and proper protection of property rights through strong domestic institutions. Host country governments have attempted various policies to attract FDI with the hope that it will positively affect its economy and promote economic development. One of the tools that have been used with increasing popularity is through reliance of international treaties as an international FDI policy tool to promote investment. The growing number of BITs signed yearly around the world has led to a variety of differing conclusions as to the impact of these treaties on developing countries. This study takes a step towards resolving some of these differing opinions.

IIAs had traditionally been signed primarily between developed and developing countries. This corresponds with their main objectives of protecting investment originating from home countries, which are often developed countries and attracting more

investment to host countries consisting of both developed and developing countries. Recently, the treaties between South-South countries have emerged to become an important part of the universe of IIAs and even a greater part for some developing countries rushing to sign additional South-South BITs. They are heralded by proponents as another mechanism to stimulate investment.

There is strong evidence that suggest BITs can be used as a mechanism to ensure the investors of their investment, and thus promote FDI by creating a stable and transparent policy environment for FDI. Investors need some assurance that their direct investment will be protected and treated in a non-discriminating way and will be fairly compensated in an event of expropriation and the predictability of the investment climate is enhanced when domestic policies are enshrined or locked into international investment treaties. The likely explanation for the fact that the North-South BITs have a significantly positive effect on the FDI is that these international commitments the signatory developing countries made with other developed countries are credible to foreign investors for reneging on these commitments is more difficult than changing policies at home and would have a severe impact to the developing host country.

Our conclusion with regard to the effects of BITs should be strictly applied to the agreements that have rather similar terms. Policymakers and analysts have to look closely at the terms of agreements. It shall not be construed to the effect that investment treaties to be crafted in the future by legal professionals and economists in the future will have the same effects for one should not underestimate the innovation that can be put into new

legal instruments, which could create a combination of incentives and disincentives that alters the consequence.

7.2 Policy Implications

Our research contributes to current debates and provides some useful important policy implications. The implications developed from this dissertation may be useful not only for the developing Southeast Asian countries but for developing countries in other regions as well. We demonstrate that a significant amount of the variation in FDI can be explained by political variables such as institution and international FDI policy such as BITs even after controlling for important economic variables.

This dissertation makes a case that concerns should be given to the quality of their domestic institutions and questions should be asked with regard to the credibility of the substantive provisions centered on providing legal protection for foreign investment whether these would be credible enough for foreign investors or not. The effort may prove more worthwhile if they focus on signing with a developed country.

However, our findings on the positive effects of BITs cannot be interpreted to the effect that to boost FDI, developing countries should pursue new agreements with new partners. Certainly, policymakers cannot sign new treaties with assumption that FDI will automatically increase as a result for IIAs should not be used to promote and protect investment without the assistance of other mechanisms. BITs will be more effective only when utilized in conjunction with other mechanisms such as institutions, which will work to make the investment regime more attractive for MNEs. While a government looks to

sign a new IIA, it must not take its focus away from constantly further enhancing and strengthening the quality of domestic institutions.

Considering the full range of policies that can attract FDI, there are other factors that can outweigh any advantages conferred by IIAs. Governments should be aware that other traditional determinants of FDI such as market size, economic fundamentals such as inflation, and exchange rate stability still matter greatly and may be even more important factors in boosting foreign investment from MNEs than BITs. A number of policy tools already exist and are at a country's disposal to use to achieve its national economic objectives. FDI promotion through BITs is only one of many tools in the FDI policy toolbox.

It is also hoped that governments pay full attention to the content of each IIA itself. Developing country governments will have to identify and prioritize what substantive provisions among topics such as cooperation, facilitation programs and establishment of credibility that would be most useful to be in the agreement. What provisions would be those to which investors from developed countries pay the most attention?

They should very carefully evaluate the potential benefits and costs of a BIT as well as the party to the treaty involved before expending their already limited resources in negotiating for additional South-South BITs. There are real transaction costs involved in negotiating, signing, ratifying, complying with and enforcing the obligations stated in a treaty.

Each international treaty signed is a commitment made. Every new agreement signed limit options available to policymakers and as such sometimes signing a BIT is referred to as 'trading sovereignty for credibility' (Elkins, Guzman and Simmons 2004, p. 4). The case to ratify new treaties is harder to make if there is little apparent benefit and the terms are extremely favorable to the investor. Nevertheless, many host country governments have used South-South BITs not only as a vehicle to attract more FDI but to address other development-related goals as well. The BITs in those cases are different from typical BITs. For example, many agreements also include specific features towards strengthening their development dimension, including the establishment of an institutional framework, the granting of flexibility and special and differential treatment, the provision of technical assistance and capacity building. They do not confer as many rights to foreign investors as in other BITs. Insofar as those BITs have not been crafted only to stimulate FDI but to fulfill other developmental objectives as well, a measure of FDI inflows alone will not be the best indicator for the success of some of those South-South BITs.

On the plus side, policymakers also need to factor in other intended, potential external benefits from the IIAs to the analysis. In particular, IIAs could provide the anchor for other legal institutions and agreements, such as taxation treaties, political risk insurance, Investment Guarantee Agreements (IGAs), domestic laws of the host and home countries, investment contracts between a foreign investor and the host state, and intellectual property protection agreements

Equal if not greater attention must be given to policies to benefit from inward FDI as well as mitigate costs associated with the investment and the fallout of the operations. The type of FDI and the motivation and strategies of MNEs will later shape the consequences of the investment so the host country have to make sure that they have attracted the right kind of FDI in the first place. What really matters is not the magnitude of the annual flow FDI, but rather the quality of the investment or the value-adding business activities to be conducted by MNEs and other tangible and intangible benefits that the investment potentially generates. Policy recommendations for developing countries should focus on what type of FDI is needed and how the positive and negative, long-run and short-run characteristics of the various types of FDI fit in with their national economic development plan (Te Velde 2002). By the word "quality", it refers to the high value-added activity or the kind of FDI which has potentials to create positive linkages and spillovers effects under the conditions as prescribed in the earlier section. Through its investment promotion agency, the host should target and attract those types of quality investment that supports the government's broader economic development goals and objectives.

With respect to AIA, the qualitative analysis suggests that the AIA is a promising, liberal framework agreement that has yet to create tangible, positive effects as hoped by the proponents. There is no empirical evidence to date that lends strong support to the proposition that AIA leads to increased intra- or inter-regional investment yet. It is possibly because the Framework Agreement mainly states the objectives of the AIA but provides sparse details of the implementation, which is left to each individual country's

discretion (Thanadsillapakul 2004). Even though the AIA advocates the liberalization of investment through eventual elimination of investment barriers, the agreement has allowed generous exceptions (TEL, SL, and General Exceptions). The negative list approach to investment liberalization employed by the AIA, which arguably is a more proactive way in opening up industries for investment than a positive list approach may have not occurred so in reality. In practice, some member countries have listed so many industries in the negative list that renders the scheme not significantly different than the positive list approach. Equally unhealthy to the progress, some member countries such as Thailand simply reproduced the list of restrictions under its existing laws and just re-compiled them into the SL, which requires occasional review but has no phasing-out commitments unlike the TEL. Consequently, these practices render the full implementation of the AIA in January 2003 less effective than it could have been. While having reached the AIA is a notable milestone, to see any tangible impact on investment requires more from the members. This dissertation suggests that there are more work to be done by the researchers and policymakers to analyze and develop further findings on the AIA as well as additional measures that have to be carried out to at the regional level to improve the policy outcome of AIA.

7.3 Future Research Direction

This dissertation uses a quantitative approach to investigate the relationship of IIAs and FDI inflows to ASEAN. Although the empirical results here show BITs to have an important role to play in influencing the location decisions of FDI, a further study

using a qualitative approach would greatly help us to have a more complete and deeper understanding of not just whether or not the BITs, institutions and credibility, but how they impact the decision making of those MNEs considering to invest in ASEAN. How important are those factors relative to other determinants of FDI such as market size, and etc.? A survey and interviews with the managers of those MNEs currently in operation in ASEAN would give invaluable managerial insights into what factors ultimately convince them to invest in ASEAN vis-à-vis other regions. Such research will add deeper context missing in quantitative research and together they will form an important body of knowledge that can be employed by entities such as investment promotion agencies.

In addition, the present dissertation focuses only on the FDI inflows to developing Southeast Asian countries but there are more regions and countries that rely on FDI and are active on signing new IIAs. Those regions and countries would benefit from having a similar kind of study being performed on them too. It would be interesting to see and understand how the results compare across countries and regions.

Despite efforts to make this dissertation as complete as possible, it does still contain limitations. First of all, on FDI data, we rely on what can be obtained from the World Bank and the ASEAN Secretariat. For the sets of estimations on the intra-regional, inter-regional, North-South, and South-South nature of FDI, the ASEAN Secretariat only have record between 1995 and 2004. Having a greater length of period would have helped us arrive at more confident results. We also acknowledge that there could be other factors affecting the location choice of MNEs our study may fail to capture. Some other

variables that we wished to control but have to drop due to low number of observations include education factors and other measures for infrastructure.

Additionally, our model treats every BIT equally when in fact every BIT is different. The nature of each BIT can vary greatly depending on the actual terms contained in that particular BIT. Our research design does not differentiate the content and uniqueness of each BIT and the party. Actually, each agreement is worthy of an in-depth investigation of its detailed provisions in its own right. There are also differences in signing with different countries. It is highly unlikely that they will have identical effect on FDI inflows. Currently, there is no empirical evidence that addresses the effects of individual investment provisions on FDI. In future research we would like to analyze BITs in more details. Not all BITs are the same and one would like to know whether it is certain element in BITs that matters for FDI location more than others. There are great variations in BITs. Even when BITs contain rather similar provisions, tribunals are not bound to interpret the provisions in the same way and different tribunals can have contradicting interpretation of BITs that have similar terms.

Our conclusion is based on the current architecture of the BITs. However, we can expect that there will be a continuous evolution of the legal architecture for the protection and promotion of foreign investment, which can change considerably from the current state in the future. As the content of international investment law is changed, it is to be expected that its impact on FDI will differ from now. This would require a new study to assess the impacts of new wave of innovative legal instruments that may emerge and bring changes to the field.

APPENDIX A

Table 19. INFRA (natural log of telephone lines and mobile phone subscribers per 1,000 inhabitants) vs. INFRA2 (road density per capita)

	INFRA	INFRA2
GDPPC	9.330***	3.889
	(0.000)	(0.176)
POP	24.484**	-37.617***
	(0.039)	(0.009)
GROWTH	.0756	-.1466
	(0.348)	(0.189)
INFLTN	-.0701**	-.0416
	(0.015)	(0.258)
OPEN	.0183	-.0315
	(0.333)	(0.255)
EXCHANGE	-.0446**	-.0219
	(0.018)	(0.393)
RESOURCE	.3205***	.1697
	(0.001)	(0.111)
WAGE	-.2146	-.2493
	(0.914)	(0.920)
INFRA	-4.424***	
	(0.000)	
INFRA2		-8.94e+07***
		(0.001)
INSTN	.2390	.5148**
	(0.071)*	(0.016)
BITNS	.7853***	.6939***
	(0.000)	(0.006)
BITSS	-.0962	-.2283**
	(0.179)	(0.021)
AIA	-1.434	-1.450
	(0.173)	(0.264)
constant	-410.304**	667.642***
	(0.030)	(0.009)
Obs.	49	39
R^2	0.2699	0.4931

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

APPENDIX B

Table 20. The effects of BITNS, BITSS and AIA on the overall FDI inflows, 1980-2005

GDPPC (Current 2000 US$) vs. GDPPC (PPP)

	1	2
GDPPC	9.330***	
	(0.000)	
GDPPC_PPP		8.573***
		(0.000)
POP	24.484**	25.222**
	(0.039)	(0.039)
GROWTH	.0756	.0932
	(0.348)	(0.267)
INFLTN	-.0701**	-.0662**
	(0.015)	(0.024)
OPEN	.0183	.0200
	(0.333)	(0.300)
EXCHANGE	-.0446**	-.0420**
	(0.018)	(0.028)
RESOURCE	.3205***	.3217***
	(0.001)	(0.001)
WAGE	-.2146	-..0565
	(0.914)	(0.978)
INFRA	-4.424***	-4.256***
	(0.000)	(0.000)
INSTN	.2390*	.2577*
	(0.071)	(0.062)
BITNS	.7853***	.7907***
	(0.000)	(0.000)
BITSS	-.0962	-.1110
	(0.179)	(0.131)
AIA	-1.434	-1.536
	(0.173)	(0.155)
constant	-410.304**	-511.943**
	(0.030)	(0.020)
R^2	0.2699	0.2659

t-value in parentheses. * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

APPENDIX C

Table 21. The effective number of observations available in the estimation result shown in Table 11 (Baseline Model, Determinants of Aggregate FDI, 1980-1995).

Variable	Observations
FDI	138
GDPPC	99
POP	160
GROWTH	126
INFLTN	110
OPEN	110
Potential Maximum Obs.	160
Complete Case	**66**

Table 22. The effective number of observations available in the estimation result shown in Table 12 (Baseline Model, Determinants of Aggregate FDI, 1980-2005).

Variable	Observations
FDI	238
GDPPC	179
POP	260
GROWTH	223
INFLTN	208
OPEN	180
Potential Maximum Obs.	260
Complete Case	**130**

Table 23. The effective number of observations available in the estimation result shown in Table 13 (Model 2, Determinants of Aggregate FDI, 1980-2005).

Variable	Observations
FDI	238
GDPPC	179
POP	260
GROWTH	223
INFLTN	208
OPEN	180
EXCHANGE	214
Potential Maximum Obs.	260
Complete Case	**120**

Table 24. The effective number of observations available in the estimation result shown in Table 14 (Model 3, Determinants of Aggregate FDI, 1980-2005).

Variable	Observations
FDI	238
GDPPC	179
POP	260
GROWTH	223
INFLTN	208
OPEN	180
EXCHANGE	214
RESOURCE	155
WAGE	107
INFRA	229
INSTN	175
Potential Maximum Obs.	260
Complete Case	**49**

Table 25. The effective number of observations available in the estimation result shown in Table 15 (Model 4, BITs Ratified vs. BITNS, BITSS, 1980-2005).

Variable	BITs Ratified	BITNS, BITSS
	Obs.	Obs.
FDI	238	238
GDPPC	179	179
POP	260	260
GROWTH	223	223
INFLTN	208	208
OPEN	180	180
EXCHANGE	214	214
RESOURCE	155	155
WAGE	107	107
INFRA	229	229
INSTN	175	175
BIT	260	
BITNS		260
BITSS		260
AIA	260	260
Potential Maximum Obs.	260	260
Complete Case	**49**	**49**

Table 26. The effective number of observations available in the estimation result shown in Table 16 (No interaction term vs. Interaction term, 1980-2005).

Variable	No interaction term	With interaction term
	Obs.	Obs.
FDI	238	238
GDPPC	179	179
POP	260	260
GROWTH	223	223
INFLTN	208	208
OPEN	180	180
EXCHANGE	214	214
RESOURCE	155	155
WAGE	107	107
INFRA	229	229
INSTN	175	175
BITNS	260	260
BITSS	260	260
BITNS INSTN		260
AIA	260	260
Potential Maximum Obs.	260	260
Complete Case	**49**	**49**

Table 27. The effective number of observations available in the estimation result shown in Table 17 (Logged country share of global FDI, 1980-2005).

Variable	1.BIT	2.BITNS, BITSS	3.BITNS_INSTN
	Obs.	Obs.	Obs.
FDI	238	238	238
GDPPC	179	179	179
POP	260	260	260
GROWTH	223	223	223
INFLTN	208	208	208
OPEN	180	180	180
EXCHANGE	214	214	214
RESOURCE	155	155	155
WAGE	107	107	107
INFRA	229	229	229
INSTN	175	175	175
BIT	260		
BITNS		260	260
BITSS		260	260
BITNS INSTN			260
AIA	260	260	260
Potential Maximum Obs.	260	260	260
Complete Case	**49**	**49**	**49**

Table 28. The effective number of observations available in the estimation result shown in Table 18 (Determinants of Intra-ASEAN FDI, 1996-2005).

Variable	Aggregate FDI	Intra-ASEAN FDI (I)	Intra-ASEAN FDI (II)
	Obs.	Obs.	Obs.
FDI	100	85	85
GDPPC	80	80	80
POP	100	100	100
GROWTH	97	97	97
INFLTN	98	98	98
OPEN	70	70	
EXCHANGE	95	95	95
RESOURCE	60	60	60
WAGE	39	39	39
INFRA	86	86	86
INSTN	80	80	80
BITNS	100		
BITSS	100		
AIA	100	100	100
Potential Maximum Obs.	100	100	100
Complete Case	**49**	**27**	**37**

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List of References

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"The behaviour of multinational corporations and their affiliates, and the impact of foreign direct investment on host economies, vary between countries and industries in a systematic way. Multinational corporations (MNCs) select their strategies depending on the characteristics of their technologies and products, as well as the characteristics and policies of the host countries. Some host country governments try simultaneously to influence the behaviour of the foreign MNCs operating in their territory, either directly through regulations, or indirectly by affecting the environment in which the MNCs operate. The effects of foreign direct investment (FDI) on the host economy are determined by this intricate interplay of firm and host country strategies. This book summarizes more than a decade of research aiming to understand this interplay." "The analyses of MNC behaviour and the effects of FDI presented in this book are of interest to students of international business, economics and development, as well as to policy-makers in countries hosting foreign MNCs."--BOOK JACKET.

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