ASIA'S JOURNEY TO PROSPERITY

Policy, Market, and Technology over 50 Years

Chapter 9: Trade, Foreign Direct Investment, and Openness

Outline

ADB

1. Openness and development

- Asia has a long history in international trade, spanning thousands of years. Over the past 50 years, Asia's economic reemergence was driven by a system that gradually embraced open trade and investment.

Conventional trade theories by Ricardo and Heckscher-Ohlin argue that an economy benefits from trade through comparative advantage and efficiency gains from reallocating resources, especially using interindustry international trade (trade among different industries between countries).

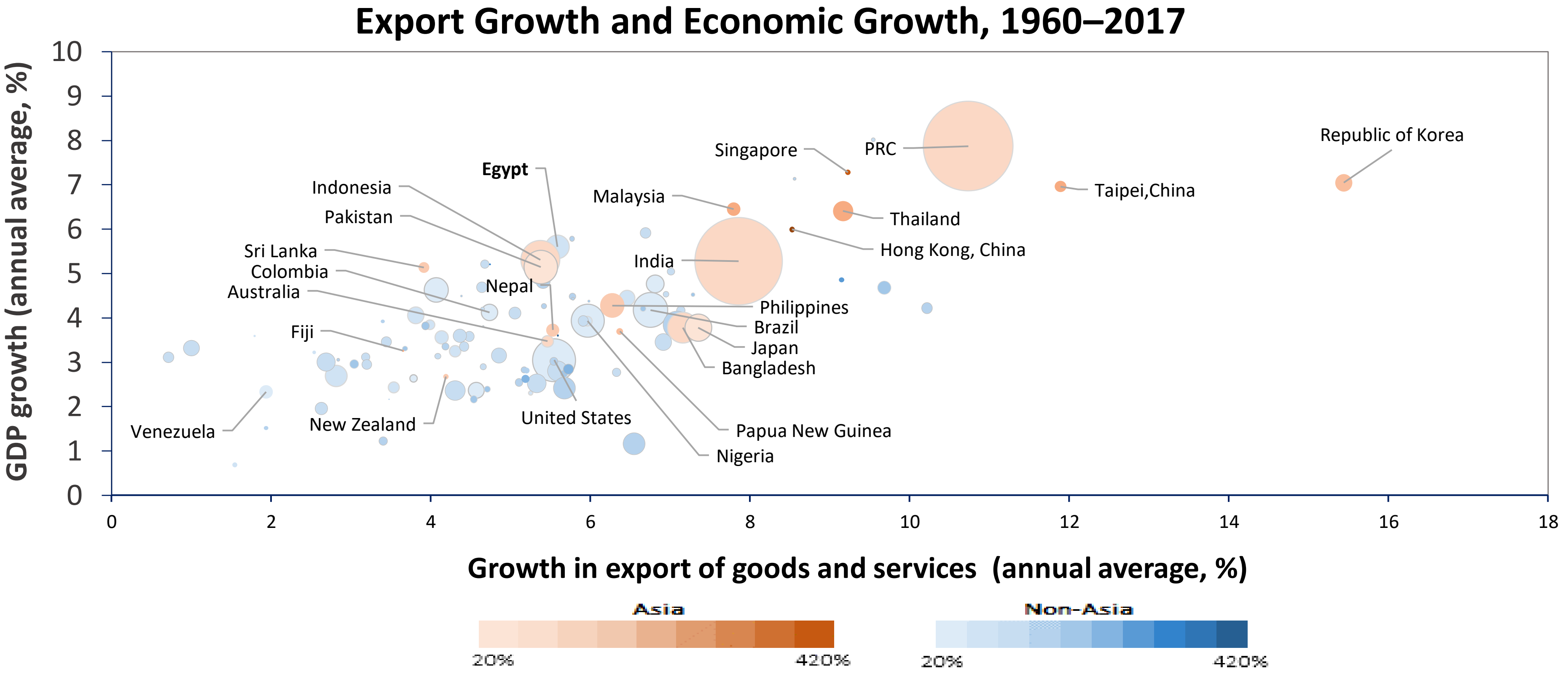
More recently, intra-industry trade—trade in the same industry between countries, such as a horizontal trade of cars exported and imported and the vertical trade of cars and their parts—deepened in many parts of the world, especially in Asia. This can be explained by trade theory that emphasizes gains from scale economies, the first-mover advantage, knowledge spillovers, and greater consumer welfare from the wider variety of goods and services available.

The trade model of firm heterogeneity shows that trade liberalization enhances overall economic productivity, because only sufficiently productive firms can survive market competition after liberalization. Asian economies captured these benefits initially through interindustry trade and later through intra-industry trade.

Foreign direct investment (FDI) inflows can bring significant benefits: access to capital, new technologies, and management know-how. This trend also helped trigger broad and deep domestic structural reforms in the region, including greater market competition and product innovation.

1. Openness and development (cont.)

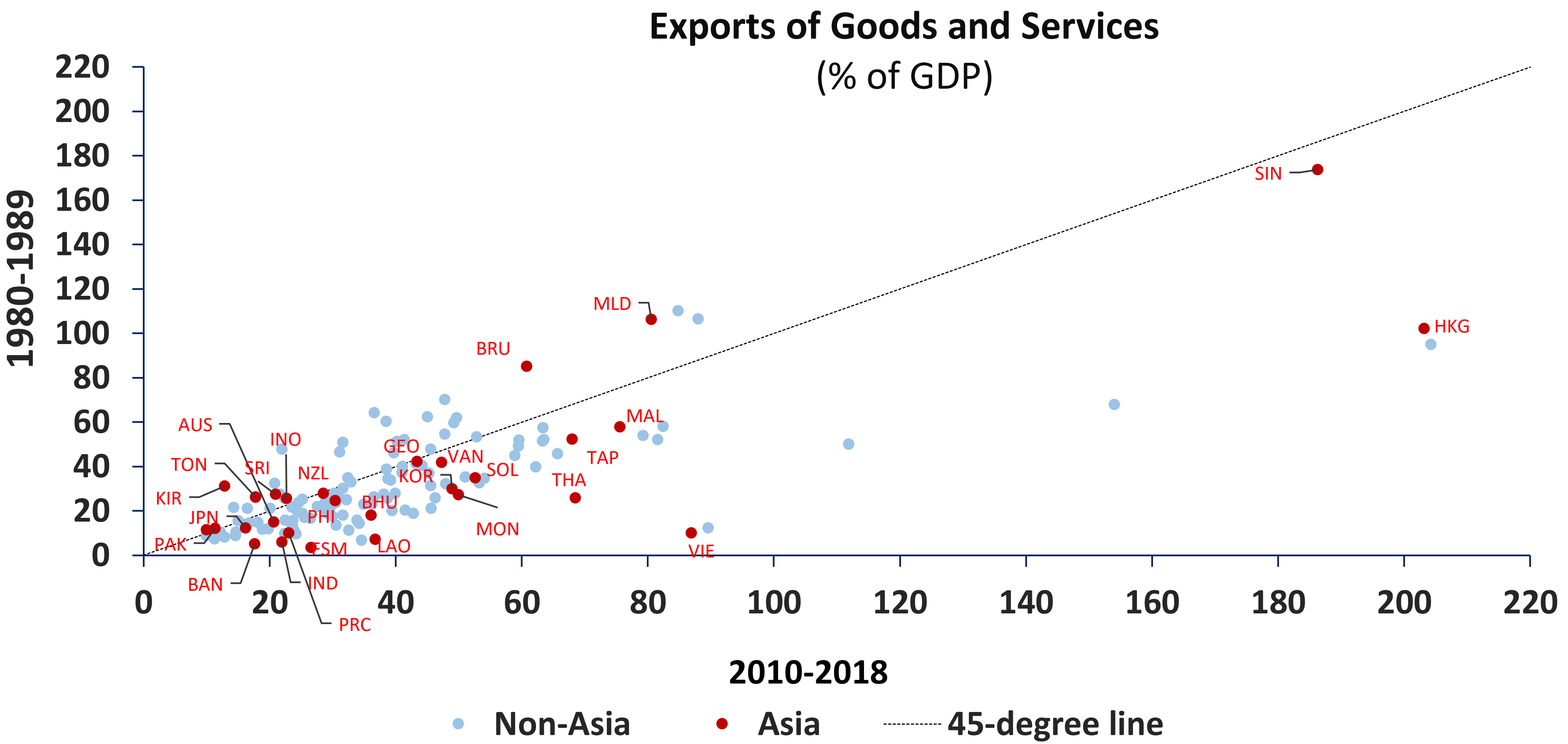
- Empirical data show a general positive relationship between export growth and economic growth in the world.
  - ❖ This relationship is salient among the newly industrialized economies (NIEs) as well as other Asian economies, which have cultivated a broader manufacturing industrial base.
  - ❖ NIEs, the People's Republic of China (PRC), and India, which have a high degree of economic openness, had faster economic growth.



GDP = gross domestic product, PRC = People's Republic of China.
Bubble size: Population (2017); Color gradient: Trade/GDP (2017)
Notes: GDP and exports of goods and services are in constant national 2011 prices. Trade-to-GDP ratio is based on nominal values. Trade refers to exports plus imports of goods and services.
Source: Feenstra, R. C., R. Inklaar, and M. P. Timmer. 2015. The Next Generation of the Penn World Table. *American Economic Review*. 105 (10). pp. 3150–3182. http://www.ggdc.net/pwt.

2. Trends in Asia's trade and foreign direct investment

- Asia's trade has grown substantially over the past 50 years, driven by the region's proactive outward-oriented development policies.



❖ As a result, most Asian economies have seen a higher export-to-gross-domestic-product (GDP) share in the 2010s compared to the 1980s

Note: Observations below (above) the 45-degree line indicate an increase (decrease) in exports as a percentage of GDP.

Sources: CEIC Data. Global Databases. https://www.ceicdata.com/en (accessed 31 July 2019); and World Bank. World Development Indicators. https://data.worldbank.org/indicator (accessed 31 July 2019).

GDP = gross domestic product; AUS = Australia; BAN = Bangladesh; BHU = Bhutan; BRU = Brunei Darussalam; FSM = Federated States of Micronesia; GEO = Georgia; HKG = Hong Kong, China; IND = India; INO = Indonesia; JPN = Japan; KIR = Kiribati; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; MLD = Maldives; MON = Mongolia; NEP = Nepal; NZL = New Zealand; PAK = Pakistan; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; SOL = Solomon Islands; SRI = Sri Lanka; TAP = Taipei,China; THA = Thailand; TON = Tonga; VAN = Vanuatu; VIE = Viet Nam.

2. Trends in Asia's trade and foreign direct investment (cont.)

- The share of exports as % of GDP increased dramatically in Asia, for both large and small economies.

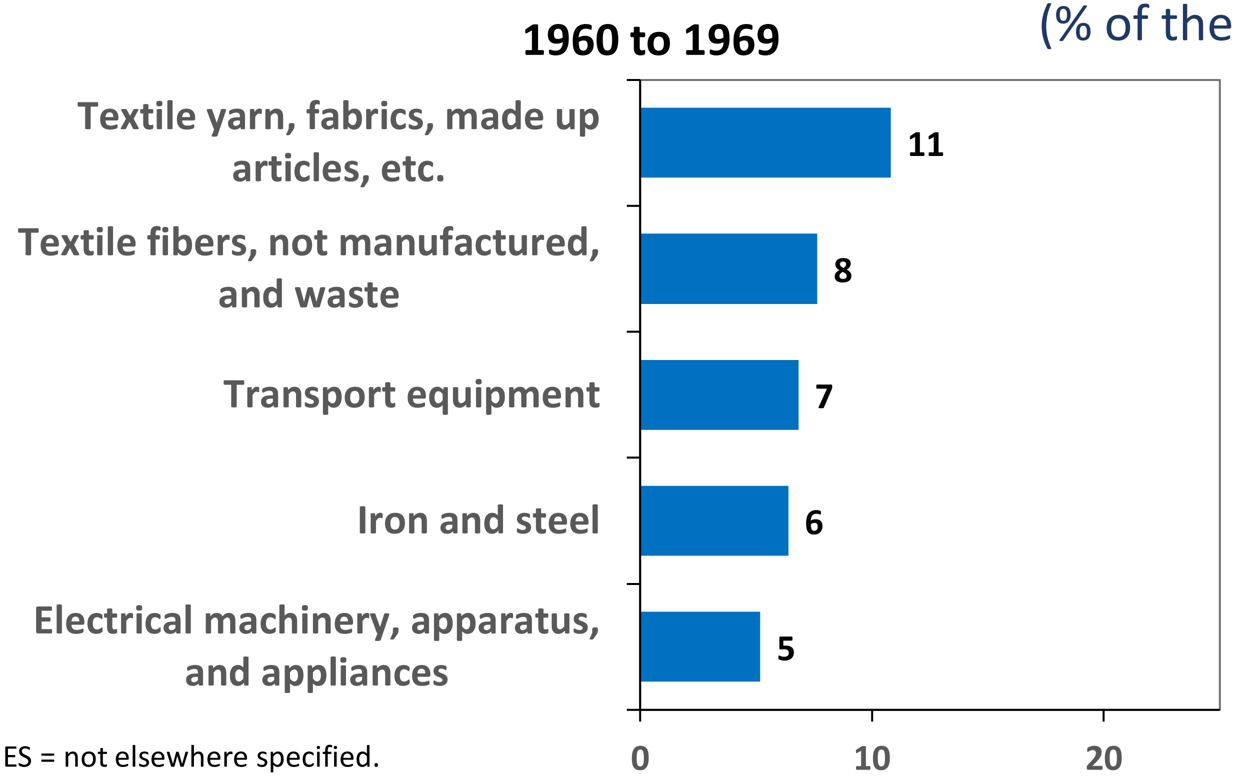
❖ The PRC's accession to the World Trade Organization in 2001 and India's economic liberalization reform beginning in 1991 provided further impetus to their outstanding export growth.

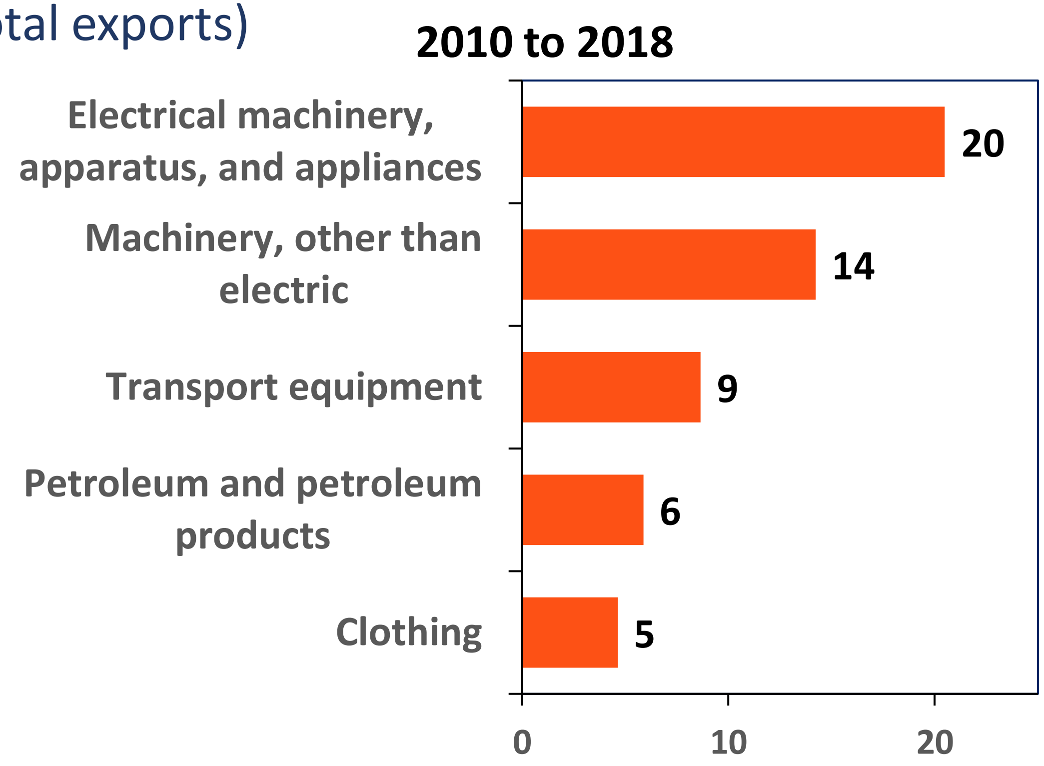
Sources: Asian Development Bank. Key Indicators Database. http://kidb.adb.org (accessed 16 September 2019); World Bank. World Development Indicators Database. http://data.worldbank.org (accessed 2 August 2019); and ADB estimates. For Taipei,China: Directorate General of Budget, Accounting, and Statistics .

2. Trends in Asia's trade and foreign direct investment (cont.)

- Initial inter-industry trade based on comparative advantage switched to intra-industry global value chain (GVC) trade spurred by scale economies as well as product differentiation and sophistication.

Asia's Top Merchandise Exports
(% of the total exports)

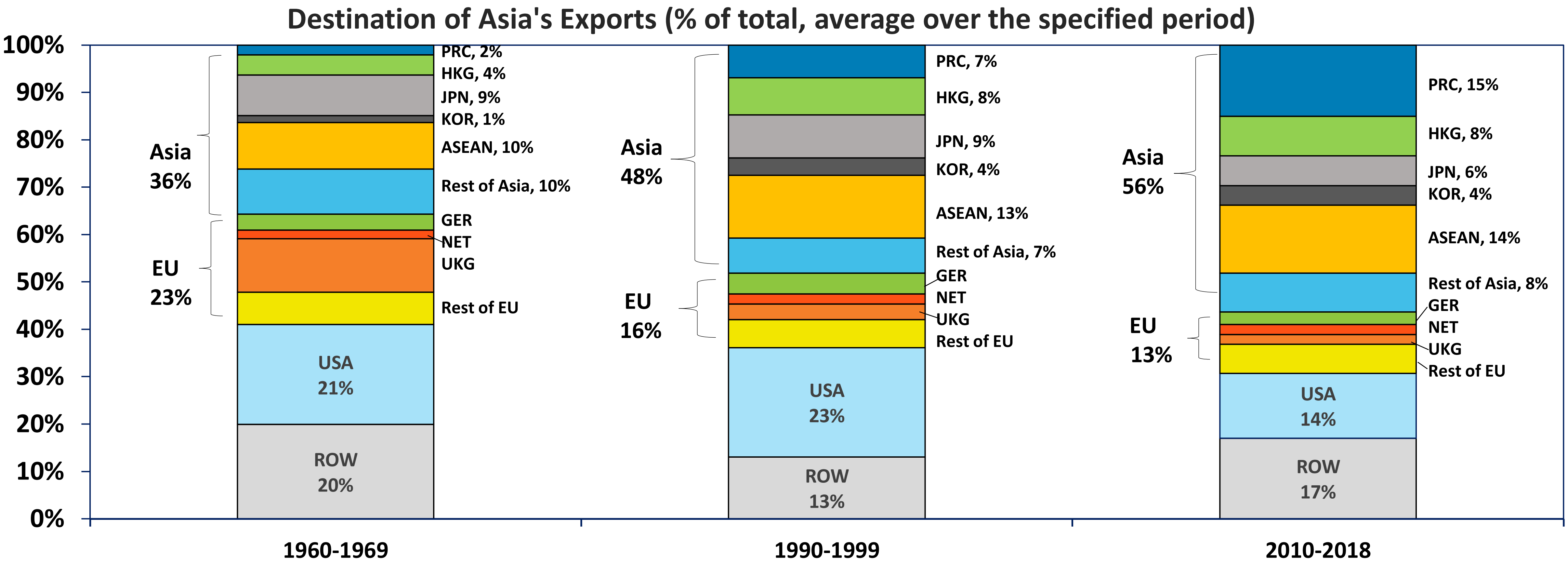




NES = not elsewhere specified.
Notes: Commodity classification is based on SITC Rev 1 (2-digit commodity codes). The category "miscellaneous manufactured articles, NES" includes the following: musical instruments, sound recorders and parts; printed matter; articles of artificial plastic materials, NES; perambulators, toys, games, and sporting goods; office and stationery supplies, NES; works of art, collectors' pieces, and antiques; and manufactured articles, NES.
Source: World Bank. World Integrated Trade Solution. https://wits.worldbank.org/(accessed 4 November 2019).

2. Trends in Asia's trade and foreign direct investment (cont.)

- Intraregional exports have expanded over time across Asia. The region's annual average share of intraregional exports to total exports increased to more than half in 2010s.



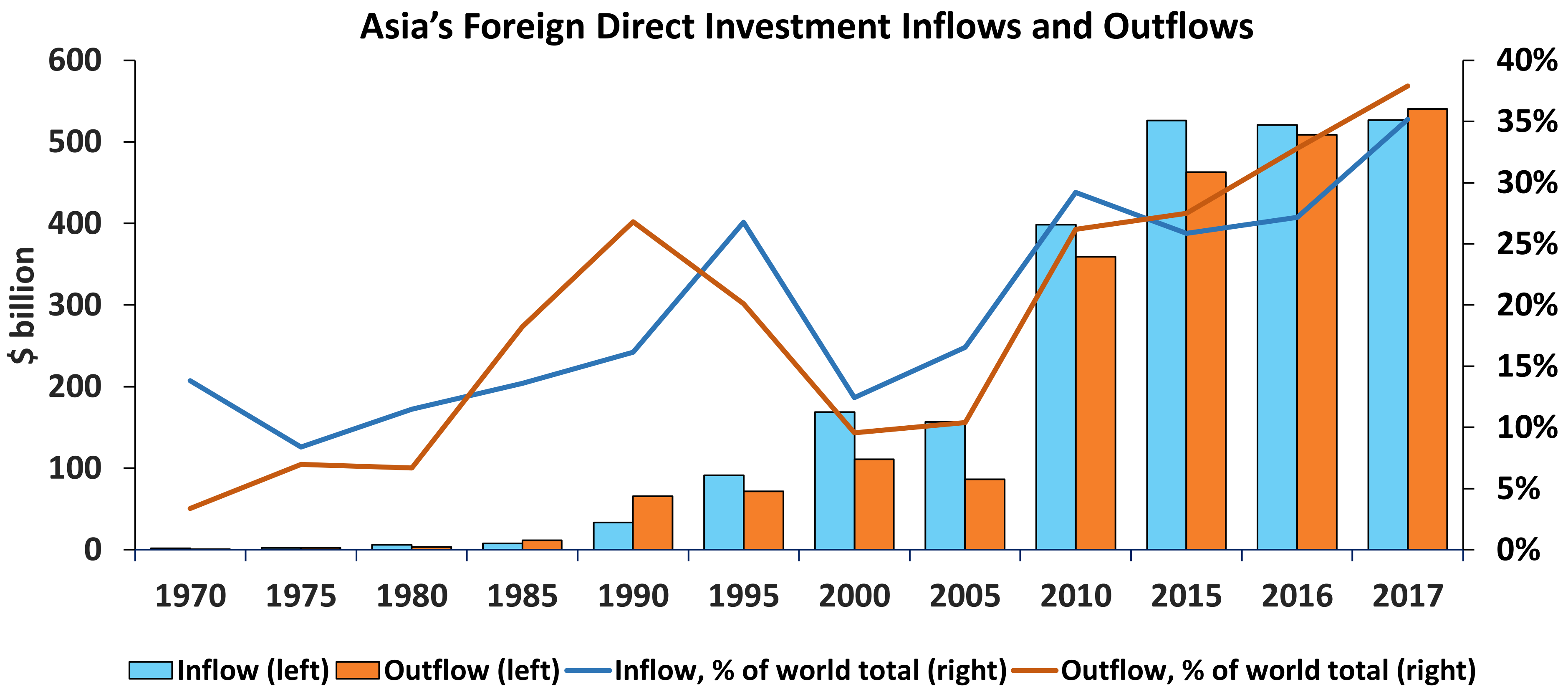
ASEAN = Association of Southeast Asian Nations; EU = European Union (28 members); GER = Germany; HKG = Hong Kong, China; JPN = Japan; KOR = Republic of Korea; NET = Netherlands; PRC = People's Republic of China; ROW = rest of the world; UKG = United Kingdom; USA = United States.

Note: In 2010–2018, out of the PRC's 15% share in Asia's exports, 4% came from Hong Kong,China; and out of Hong Kong, China's 8% share, 5% is from the PRC.

Source: International Monetary Fund. Direction of Trade Statistics. http://data.imf.org (accessed 26 July 2019).

2. Trends in Asia's trade and foreign direct investment (cont.)

- FDI inflows (in United States dollars) to the region increased steadily, especially after the 1985 Plaza Accord.



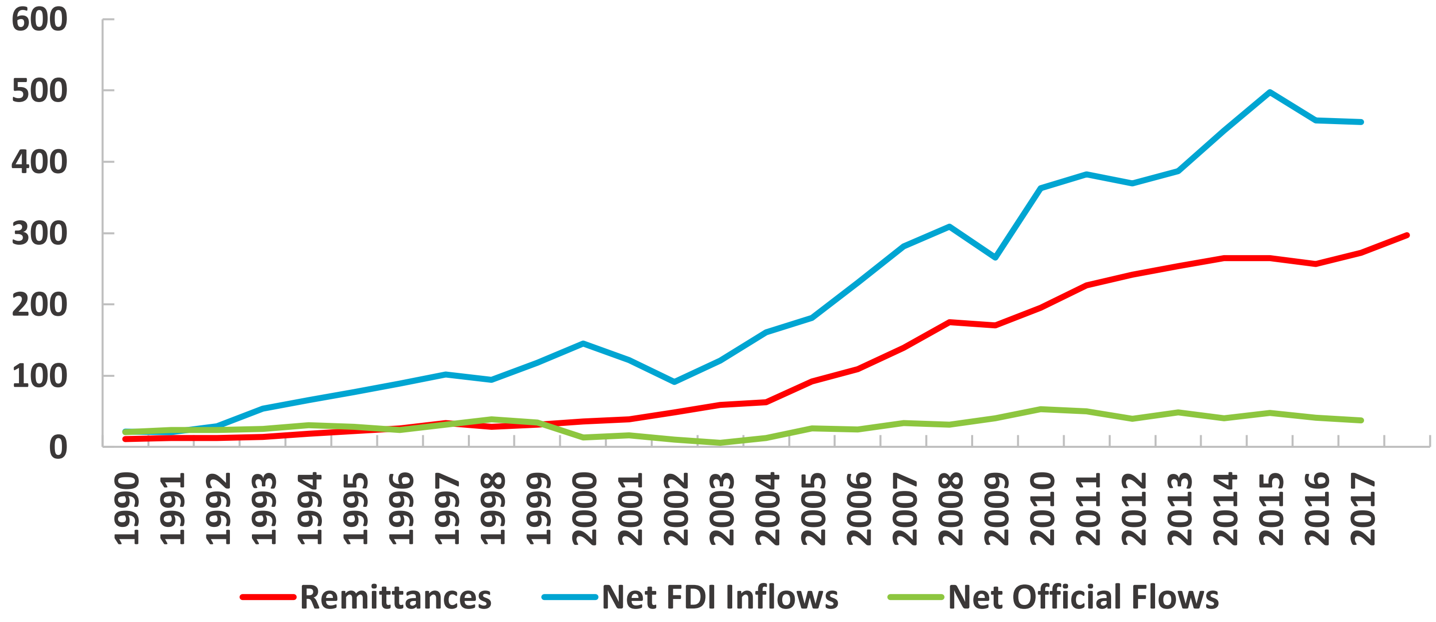
Note: Asia refers to the 49 Asian Development Bank regional members for which data are available.
Sources: Asian Development Bank estimates; and United Nations Conference on Trade and Development. UNCTAD Statistics. https://unctadstat.unctad.org (accessed 30 August 2019).

❖ Hong Kong, China and the ASEAN4 (four members of the Association of Southeast Asian Nations)—Indonesia, Malaysia, the Philippines, and Thailand—were the first Asian economies to begin liberalizing FDI; it was the 1985 Plaza Accord that played a huge role in accelerating the process.

2. Trends in Asia's trade and foreign direct investment (cont.)

- FDI inflows, along with remittances, are now the major source of financial inflows to developing economies in the region.

Financial Flows to Developing Asia by Type
($ billion)



Developing Asia became a natural destination for FDI because of:

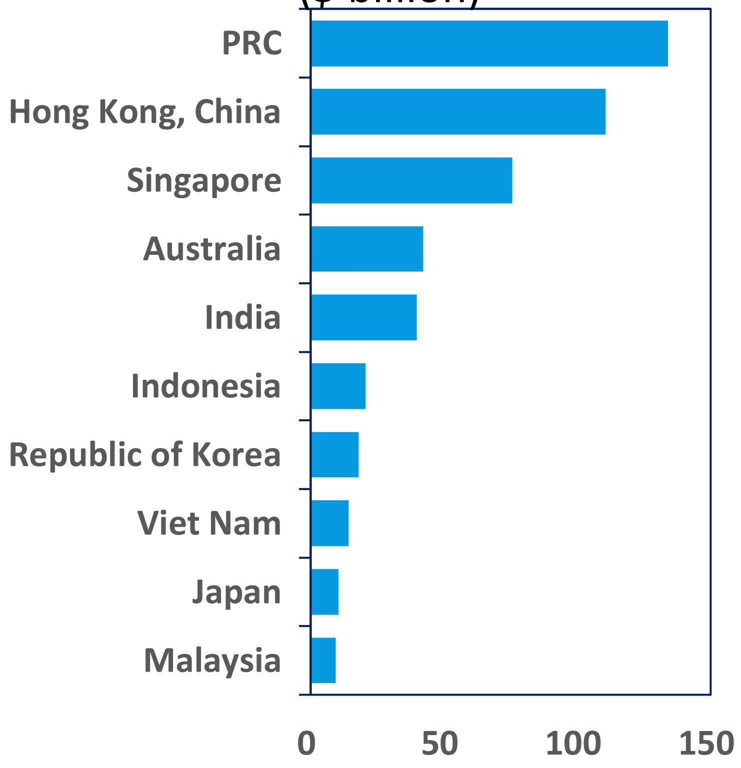
- Relatively low labor costs (particularly during initial phases of development)
- Improving business climate and large market size
- Policies on export promotion, current and capital account liberalization, special economic zones, and tax incentives
- Development of GVCs and regional production networks

FDI = foreign direct investment.
Sources: Asian Development Bank estimates; Knomad Database. https://www.knomad.org (accessed 26 November 2019); World Bank. World Development Indicators. https://data.worldbank.org (accessed 15 October 2019); United Nations Conference on Trade and Development (UNCTAD). UNCTADStat. https://unctadstat.unctad.org (accessed 28 August 2019); and Organisation for Economic Co-operation and Development (OECD). OECD Statistics. https://stats.oecd.org (accessed 26 August 2019).

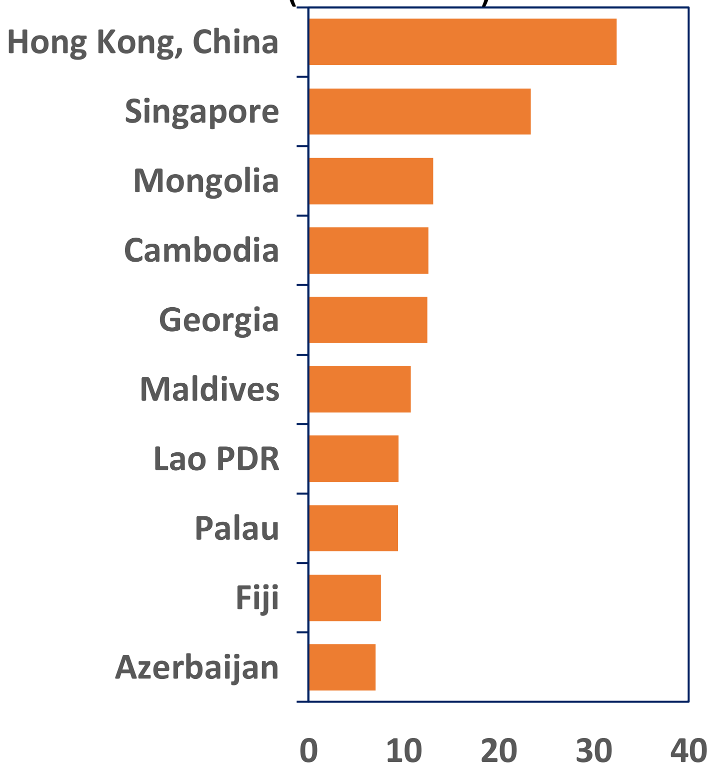
2. Trends in Asia's trade and foreign direct investment (cont.)

- In 2017, Hong Kong, China; the PRC; and Singapore remained Asia's top FDI recipients. As share of GDP, FDI was higher in open, small economies.

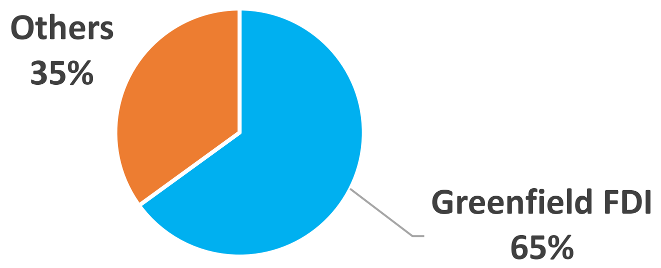
FDI Inflow in 2017
($ billion)



FDI Inflow in 2017
(% of GDP)



FDI in Asia, 2003-2017

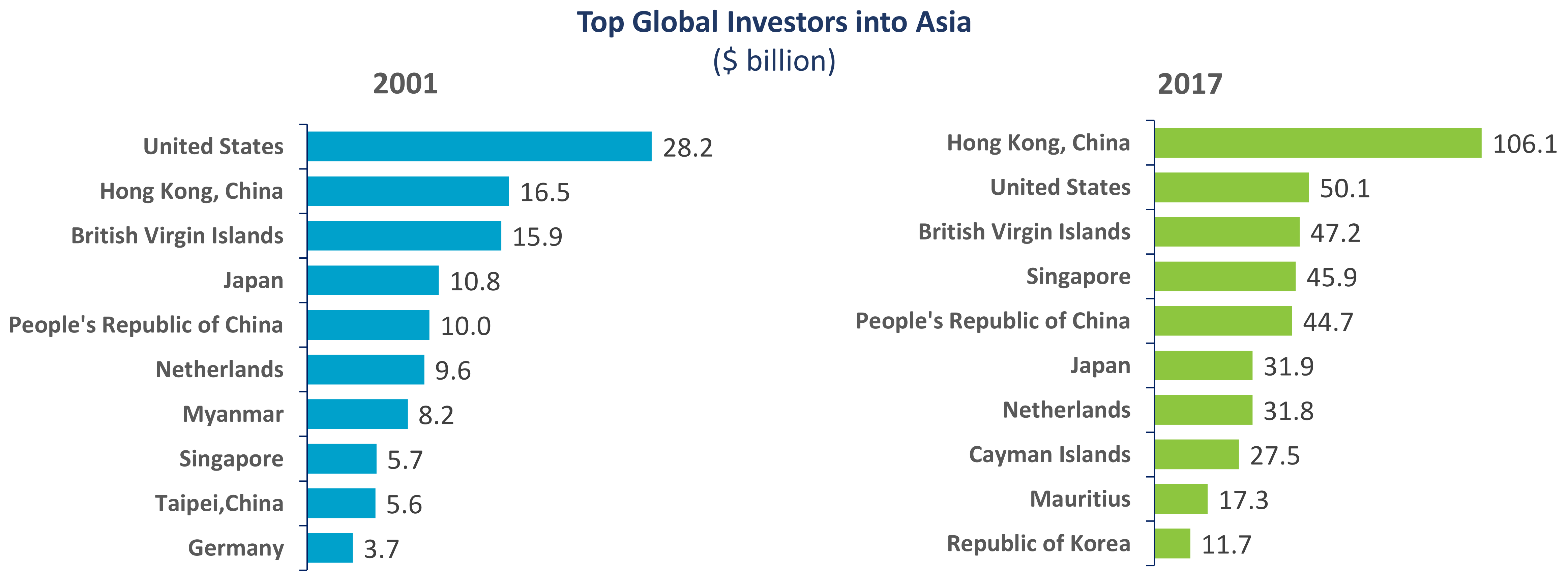


- ❖ Greenfield FDI has been the more common mode of entry in manufacturing and primary sectors since the early 2000s, while mergers and acquisitions gradually became prominent in business and financial services as well as transportation and communications.

FDI = foreign direct investment, GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Sources: Asian Development Bank estimates; and United Nations Conference on Trade and Development. UNCTAD Statistics (UNCTADSTAT). https://unctadstat.unctad.org (accessed 30 August 2019).

2. Trends in Asia's trade and foreign direct investment (cont.)

- Traditionally, most FDI to Asia came from Japan and other advanced countries. Recently, intraregional FDI accounted for almost half of developing Asia's FDI inflows.



Source: Asian Development Bank, Asia Regional Integration Center. Integration Indicators. https://aric.adb.org/integrationindicators (accessed 30 August 2019).

2. Trends in Asia's trade and foreign direct investment (cont.)

- More recently, Asia strengthened its presence as a major global outward FDI investor.

Top global investors
($ billion)

Economy	1970
United States	7.6
United Kingdom	1.7
Netherlands	1.3
Germany	1.1
Canada	0.9
France	0.4
Japan	**0.4**
Sweden	0.2
Belgium	0.2
Italy	0.1

Economy	2017
United States	300.4
Japan	**160.4**
PRC	**158.3**
United Kingdom	117.5
Germany	91.8
Hong Kong, China	**86.7**
Canada	79.8
British Virgin Islands	54.7
Singapore	**43.7**
France	41.3

➢ Asian countries are accumulating more domestic savings, augmenting supply-chain networks, and becoming important producers of new business models and technologies.

PRC = People's Republic of China.
Source: United Nations Conference on Trade and Development. UNCTAD Statistics. https://unctadstat.unctad.org (accessed 30 August 2019).

2. Trends in Asia's trade and foreign direct investment (cont.)

- Asia's impressive growth in trade and FDI inflows had a significant impact on development in the region.

Greater openness helps spur economic and productivity growth through gains from trade, learning effects, and the exploitation of economies of scale. FDI inflows helped the region's countries grow by helping firms overcome growth constraints such as lack of management skills and of access to finance.

Trade and FDI helped reduce poverty directly by generating employment and indirectly by enhancing overall economic development.

Asia's experience shows that expanding trade and FDI requires countries to put in place basic conditions—such as the quality of human capital and infrastructure, financial and institutional development, the quality of governance, and macroeconomic stability.

3. Evolution of trade and foreign direct investment policies in Asia

- What allowed Asia to grow fast was in part the gradual evolution of trade and FDI policies towards openness in the region. Over the past 50 years, Asia's economies passed through three stages of external economic policy regimes.

In the 1950s and 1960s, many Asian economies adopted post-independence import substitution strategies to build self-reliance.

From the 1960s and 1970s, more and more Asian economies became outward-oriented.

From the 1990s, Asian economies deepened trade liberalization and integration into GVCs and embraced regional trade agreements.

3. Evolution of trade and foreign direct investment policies in Asia (cont.)

- Import substitution strategies and policies were marked by high and complicated tariffs and taxes on imports. Protection for infant industries was a key tool used in developing domestic industry in the 1950s-1970s.

Timing: After gaining independence in the late 1940s and 1950s, several Asian economies adopted a strategy of import substitution to create a domestic industrial base. These policies were used in the 1950s and 1960s, and they persisted in some form until the 1980s.

Form: Widespread and discretionary use of prohibitions and quantitative restrictions on imports; overvalued exchanged rates; several monopolies on imports and exports were created—mostly state-owned. In tandem, there were restrictions on FDI (e.g. on commodity extraction, agricultural processing, or manufacturing, and on foreign exchange transactions).

Consequence: Made the economies inefficient and triggered balance of payments crises.

3. Evolution of trade and foreign direct investment policies in Asia (cont.)

- Asian economies moved away from import substitution to more outward-oriented policies over time. Country experience has been diverse.

  - **Timing:** Japan adopted restrictive import policies due to severe foreign exchange constraints immediately after the war, but achieved a high level of integration with the global economy by the 1960s. NIEs also moved toward outward-oriented policies in the 1960s. Other developing economies in Asia followed in the 1970s and 1980s.

  - **Instruments:** Foreign exchange allocations for necessary inputs; subsidies; tax incentives; favorable access to credit; establishment of export-promotion agencies; and competitive exchange rates.

  - **Goals of these policies**: Access to large external markets, and earning sufficient foreign exchange to increase import of natural resources, capital goods, and intermediate inputs.

Country experiences vary based on:

1. Length of import substitution phase
   - India and Philippines (1950s to 1980s) versus Taipei,China (1950s)
2. Different starting points and speed
   - Japan, then NIEs, then some Southeast Asian economies
3. Policy mix and instruments adopted during transition
   - Special economic zones in Southeast Asia and the PRC

3. Evolution of trade and foreign direct investment policies in Asia (cont.)

- Outward-oriented trade reforms paved the way for the easing of FDI restriction in Asia.

❖ Hong Kong, China and the ASEAN4 were the first Asian economies to begin liberalizing FDI to attract FDI from Japan. But it was the 1985 Plaza Accord that played a large role in accelerating the process.

❖ Restrictions on FDI continued to decline as competition for investments increased and regional production networks began to blossom.

❖ Investment incentives eventually became standard in most Asian economies, coming in four types: fiscal, financial, regulatory, and technical/business support.

❖ Over time, more developing countries began pursuing a much broader reform agenda aimed at reforming the overall investment climate.

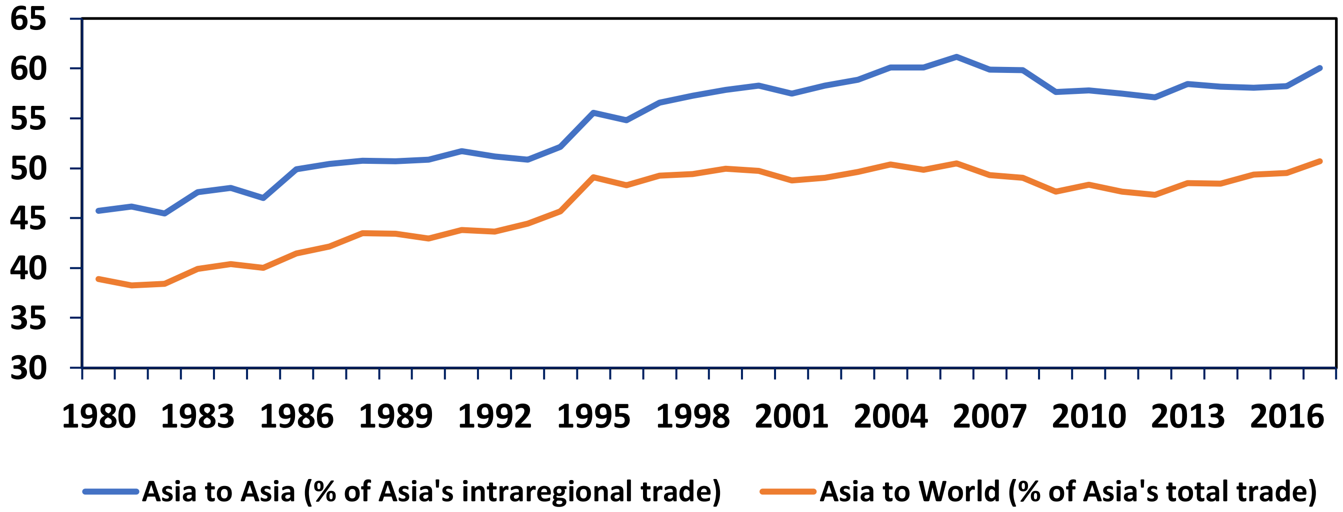
Note: Asia refers to the 49 Asian Development Bank regional members for which data are available.
Sources: Asian Development Bank estimates; and United Nations Conference on Trade and Development. UNCTAD Statistics. https://unctadstat.unctad.org (accessed 30 August 2019).

4. Emergence of global value chains

- In the third stage of Asia's international economic policy regime, most Asian economies joined GVCs due to several drivers.

  - The surge of FDI inflows in Asia enabled Asian trade to transform from inter-industry trade to intra-industry trade. Accordingly, many Asian economies entered GVCs.
  - GVCs were driven by a steady decline in cross-border transportation costs due to liberalized trade, and advances in transport and logistics.
  - Other drivers of GVCs are: enhanced infrastructure connectivity, expanding economies of scale and scope in mass production, rapid progress in standardized processes, and homogenization of consumer tastes (due to an ever-expanding middle class).

Share of Asia's Intermediate Goods Trade (%)



Notes: Concordance between Standard International Trade Classification (SITC) revision 2 and Broad Economic Categories was used to define intermediate goods. Trade refers to the sum of exports and imports.
Sources: Asian Development Bank estimates; and Growth Lab at Harvard University. Atlas of Economic Complexity Database. http://atlas.cid.harvard.edu/about-data/goods-data (accessed 30 August 2019).

❖ Enhanced infrastructure connectivity allowed the seamless flow of intermediate goods trade

4. Emergence of global value chains (cont.)

- GVC progress in Asia and around the globe went hand in hand with the increased capacity of multinational corporations (MNCs).

- MNCs played a key role in transferring frontier technologies and new business models which, in turn, promoted further GVC development.
- MNCs relocated parts of the production process to their home countries or third countries. They also set up affiliates in a foreign country to serve the domestic market.
- Semiconductors attracted the most GVC-FDI as a share of affiliates.

Top Manufacturing Sectors of Foreign Affiliates Engaging in Trade in Asia, 2015

Affiliated industry	Number of Affiliates	Number of Affiliates that Export and Import	Share of Affiliates that Export and Import (%)
Semiconductor and related device manufacturing	1,275	694	54.4
Bare printed circuit board manufacturing	819	360	44.0
Other electronic component manufacturing	3,423	1,358	39.7
Motor and generator manufacturing	960	354	36.9
Ethyl alcohol manufacturing	1,302	477	36.6
Nonferrous metal (except copper and aluminum) rolling, drawing, and extruding	806	286	35.5
Motor vehicle brake system manufacturing	5,760	1,925	33.4
Motor vehicle air-conditioning manufacturing	858	270	31.5
Plastics material and resin manufacturing	1,487	465	31.3
Textile bag mills	924	275	29.8

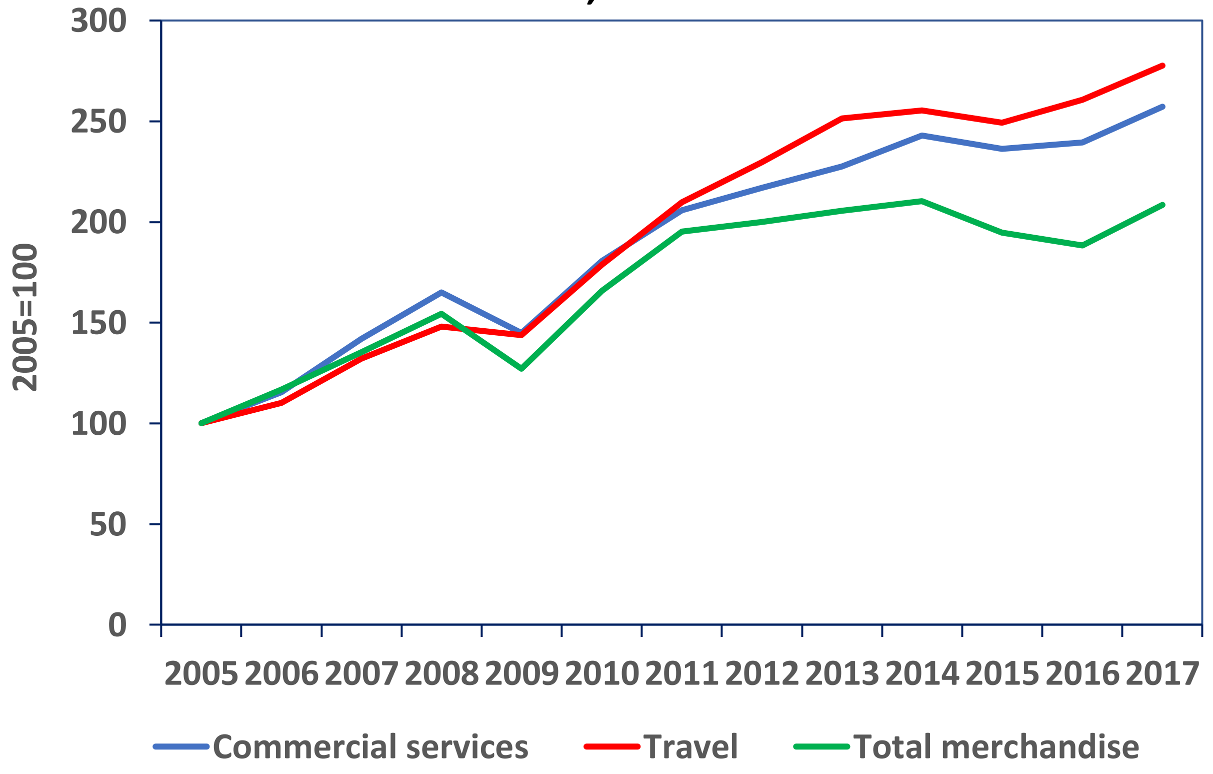
Source: Asian Development Bank (ADB) estimates based on data from ADB. 2016. *Asian Economic Integration Report 2016: What Drives Foreign Direct Investment in Asia and the Pacific?* Manila.

5. Growing importance of services trade

- More recently, services are increasingly traded as part of GVCs.

  - The share of services involved in manufacturing value added in Asia varies across countries. Regionally, it has reached 43%.
  - More services enter the manufacturing process as intermediate inputs. For example, automobile companies increasingly outsource engineering services, logistics, and back-office operations to third-party providers.
  - Services are increasingly traded. Exports of commercial services more than doubled between 2005 and 2017.
  - Continued regional integration in Asia, combined with advances in technology will further help expand trade in services within GVCs and offer new opportunities.

Growth in Asia's Exports of Goods, Services, and Travel, 2005–2017



Sources: Asian Development Bank estimates; and World Trade Organization (WTO). 2018. WTO Online Database. data.wto.org (accessed 15 May 2019).

6. Global and regional trade agreements

- The General Agreement on Tariffs and Trade (GATT) became effective in 1948. Over the next several decades, more and more Asian economies became members of GATT and, after 1995, of the WTO.

Asia's World Trade Organization Accessions

prior to 1995 (original GATT members)

Australia (1948)
India (1948)
Myanmar (1948)
New Zealand (1948)
Pakistan (1948)
Sri Lanka (1948)
Indonesia (1950)
Japan (1955)
Malaysia (1957)
Republic of Korea (1967)
Bangladesh (1972)
Singapore (1973)
Philippines (1979)
Thailand (1982)
Maldives (1983)
Hong Kong, China (1986)
Brunei Darussalam (1993)
Fiji (1993)
Papua New Guinea (1994)
Solomon Islands (1994)

1995–2000

Mongolia (1997)
Kyrgyz Republic (1998)
Georgia (2000)

2001-2010

PRC (2001)
Taipei,China (2002)
Armenia (2003)
Cambodia (2004)
Nepal (2004)
Tonga (2007)
Viet Nam (2007)

2011-present

Vanuatu (2012)
Samoa (2012)
Lao PDR (2013)
Tajikistan (2013)
Kazakhstan (2015)
Afghanistan (2016)

Under the WTO framework, the Doha Round, which started in 2001, has not yet concluded. Given the slow progress in multilateral trade liberalization, Asia has shifted its focus more on FTAs.

GATT= General Agreement on Tariffs and Trade, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Sources: World Trade Organization (WTO). *WTO Accessions*. https://www.wto.org/english/thewto_e/acc_e/acc_e.htm (accessed 9 November 2018); and World Trade Organization. *GATT Members*. https://www.wto.org/english/thewto_e/gattmem_e.htm (accessed 9 November 2018).

6. Global and regional trade agreements (cont).

- Globalization accelerated in the 1990s and Asian economies became actively involved in a variety of regional trade arrangements.

1990s: First wave of Asian free trade agreements (FTAs): emphasized trade in goods, tariffs and other border measures that affected market access directly

1992: ASEAN Free Trade Agreement was launched

1994: Uruguay Round Agreements Act

1995: WTO was established

2000s: Continued reduction of trade barriers attracted FDI in East and Southeast Asia

2001: PRC joined WTO; start of the Doha round

2003: ASEAN Free Trade Area was launched

2012: Regional Comprehensive Economic Partnership negotiations launched

2015: ASEAN Economic Community was launched

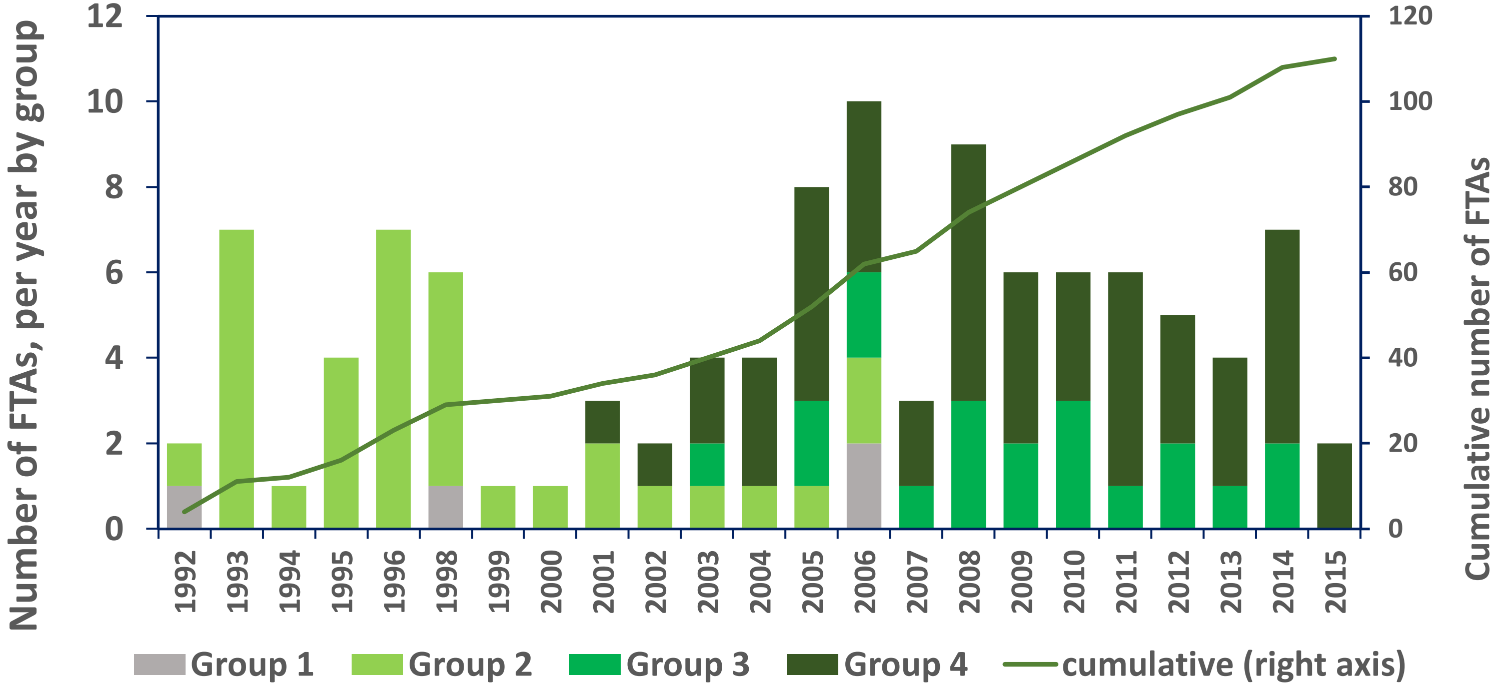
2018: Number of Asian FTAs reached 151; Comprehensive and Progressive Agreement for Trans-Pacific Partnership entered into force.

FTAs have been used to strengthen cooperation in facilitating trade and investment. FTAs cover broad areas that serve as engines of trade creation, allowing them to function as "building blocks" rather than "stumbling blocks." The multitude of FTAs has helped spur further economic liberalization as well as domestic structural reforms across the region. Sometimes, they created a proliferation of rules (such as technical standards and rules of origin) that companies must comply with, which is called the "noodle bowl" effect.

6. Global and regional trade agreements (cont.)

- The first wave of Asian FTAs that surged in the 1990s was mostly traditional. They largely emphasized trade in goods and focused on tariffs and other border measures that directly affected market access. More recent bilateral FTAs cover a broader range of liberalization.

Content of Free Trade Agreements in Asia, 1992–2015



Group 1 = Free Trade Agreements (FTAs) that only have border policies.
Group 2 = FTAs with less than five border policies and less than five behind-the-border policies.
Group 3 = FTAs with five or more border policies and less than five behind-the-border policies.
Group 4 = FTAs with five or more border policies and five or more behind-the-border policies.

Notes:

1. Border policies cover tariff reductions in manufacturing and agriculture, anti-dumping, countervailing measures, Agreement on Trade-Related Investment Measures, Agreement on Trade-Related Aspects of Intellectual Property Rights, customs, export taxes, sanitary and phytosanitary measures, technical barriers to trade, and the movement of capital.
2. Behind-the-border policies cover state enterprises, state aid, competition policy, intellectual property rights, investment, public procurement, and the General Agreement on Trade in Services.
3. The categorization of border and behind-the-border policies is based on the methodology of Hofmann, C., A. Osnago, and M. Ruta. 2017. Horizontal Depth: A New Database on the Content of Preferential Trade Agreements. *Policy Research Working Paper*. No. WPS 7981. Washington, DC: World Bank.

Source: World Bank. Content of Deep Trade Agreements. https://datacatalog.worldbank.org/dataset/content-deep-trade-agreements (accessed 4 June 2019).

7. Looking Ahead

- Looking ahead, whether Asia will continue to reap the benefits of globalization depends on several future developments.

  - ❖ First, governments should continue to promote open trade and investment. Governments should work toward lowering nontariff measures, harmonizing standards, and applying mutual recognition.
  - ❖ Second, as Asian economies increasingly rely on services, governments must think about how to incorporate them into their trade and growth strategies.
  - ❖ Third, governments need to continue helping small and medium-sized enterprises access international markets by improving regulations, easing access to finance, and supporting capacity building, among others.
  - ❖ Fourth, governments must keep abreast with rapidly changing technologies and the Fourth Industrial Revolution—which is fundamentally changing how goods and services are produced, traded, and consumed, including through e-commerce and digital trade.
  - ❖ Finally, Asia’s governments should renew efforts to support the multilateral trading system.

8. Questions and further readings

- Questions

01 How does openness contribute to economic development?

02 What are some salient trends in Asia's trade and FDI in the past 50 years? How have trade and FDI affected development in the region?

03 What have been the drivers of FDI inflows in Asia? How did FDI develop in Asia?

04 What are three stages of external economic policy regimes in Asia? How do they differ in terms of timing , instruments used, and economic outcomes? How do country experiences differ from each other?

05 How did MNCs in Asia impact the development of GVCs? Why do we say that services trade is growing in importance in Asia?

06 How did regional trade agreements in Asia evolve over time? What is the noodle bowl effect? When are FTAs "building blocks" or "stumbling blocks"?

07 Looking ahead, how will the region continue to reap the benefits of globalization?

ADB

8. Questions and further readings (cont.)

- Further readings

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8. Questions and further readings (cont.)

- Further readings

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