Executive Summary

FOREIGN DIRECT INVESTMENT IN THE PHILIPPINES AMIDST CRISIS AND A NEW GLOBAL ENVIRONMENT

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(Part 1)

More than a year after the outbreak of the Asian financial crisis, there still does not seem to be a consensus as to its proximate causes and therefore what measures ought to be attended to avert its recurrence. There have been many attempts at quantitatively measuring the degree of importance of the different factors in the evolution of the Asian crisis but events are still unfolding and until there is a definite “bottoming out” and a return to the growth experiences of the past these attempts remain incomplete. What seems evident however is a finding that weaknesses in the financial systems in Asia were stronger explanations of the crisis than of basic fundamental flaws in the economy (McKinnon and Pill, 1998). The unusually large flows of short-term capital in these countries exposed them to reversals eventually draining reserves and squeezing liquidity. Moreover one particular reason for the quick transmission of the crisis from Thailand in July of 1997 into the other Southeast and East Asian countries was the high degree of financial and trade integration among them (Glick and Rose, 1998).

The more immediate concern amidst the crisis, which is the subject matter of this paper, is its effects on the flows of foreign direct investment (FDI). There was a sharp drop in the magnitude of net capital flows into the five affected Asian countries (Indonesia, South Korea, Malaysia, Philippines, Thailand) at the onset of the crisis as net private flows suffered an outflow of $11.9B in 1997 from a net inflow of $97.1B in 1996 (Alburo, 1998a). A decomposition of these net inflows would reveal that direct equity flows hardly suffered even as portfolio equity, commercial banks and non-bank private creditors showed large declines. This is in fact the global picture of FDI during the period of the crisis.

World FDI flows in 1997, despite the Asian crisis, grew by 19 percent compared to a low growth rate of 1.9 percent in 1996 (UNCTAD, 1998). While this growth rate was not a record it still was comparable to the annual growth rates of 24 percent in the period 1986-1990 and 20 percent in the period 1991-1995. An inkling of the crisis can only be discerned from the regional breakdowns of FDI inflows, which show a decline in the share of South, East, and Southeast Asia to total flows.

FDI IN ASIA: CRISIS EFFECTS

FDI flows did decline during the immediate collapse of the currencies of the affected Asian economies though at different times for different countries. Except for Korea and Thailand, the other three countries experienced a fall in the flow of FDI beginning the third quarter of 1997. However, though all five countries have been affected by the Asian crisis
through large outflows of capital, their FDI flows have differed in characteristics in terms of apparent reaction to the short term movements, its timing by country, and the magnitudes involved. Indeed for the severely affected countries of Korea and Thailand, FDI flows have been surprisingly stable if not increasing throughout the period except in the immediate quarters following the crisis. On the other hand for countries not directly affected by the crisis (but part of the contagion area) reductions in the inflows of FDI if not outright negative inflows took place.

What might be the factors or reasons for the differences in the behavior of FDI flows into the five affected countries? First of all the five countries have had comparable figures on the importance of FDI in its overall economies measured either by the its share to gross domestic capital formation or in terms of the FDI's share to total capital flows before and during the crisis period. Except for Malaysia, which had an average of 21.3 percent share of FDI to gross fixed capital formation in the period 1991-1995, these affected countries had FDI shares at less than 10 percent (Komine, 1998). Secondly, for these five countries the share of FDI to total capital flows in the period prior to the outbreak of the crisis in mid-1997 declined relative to the past and to the average for the developing countries. The rapid decline in the share of equity investments to net private capital flows is fairly evident. If one looks at the flows of capital to all developing countries their composition is significantly different. In short there does not seem to be any variation among these countries according to currency adjustments to explain why their FDI flows differed in behavior.

The prices of domestic investment assets collapsed across these countries. All the five Asian countries had “fire sales” going on. To foreign investors, the crisis per se did not create new individual country parameters for their consideration.

The choices for new FDI however were clearly beyond these five countries at least from among the options within the Asian region. In turn this environment would have influenced the behavior of FDI flows more uniformly across all the five countries. The fact is that for the two most affected countries FDI flows increased during the period after the crisis while for the three other countries FDI flows decreased during the same period. Neither the collapse of the exchange rates or the importance of FDI flows to total investments or to capital flows appear to have been crucial to these differential movements in the flows of FDI. What then could possibly explain the way FDI flows have behaved in the five Asian countries in the aftermath of the crisis?

The three Asian countries, which have experienced declines in their FDI inflows, either had weak fundamentals or had other intervening factors, which fostered a more uncertain environment for foreign investors. Both the political and economic problems of Indonesia have deterred FDI after apparent continued confidence early in the crisis. The equally political and economic problems of Malaysia have neither been conducive to further FDI into the country. In the case of the Philippines both fundamentals and others may explain declines in FDI.
FDI IN THE PHILIPPINES: TRENDS AND DETERMINANTS

The Asian economic crisis triggered by the events in Thailand in the second quarter of 1997 occasions another look into FDI in the Philippines, this time within the context of the divergence in the movement of FDI flows into the five Asian countries. This new inquiry relies on the notion that factors associated with the eruption of the crisis may have also affected variations in the movements of FDI flows. When compared with the yearly movements of portfolio investments, it would appear that the FDI flows have been quite stable. Similarly, the non-tradable sectors of public utilities and construction received a large share of FDI in 1997.

Also, while internal markets have contributed to the variations in FDI for the decade of the seventies and eighties, FDI has not been positively associated with exports. FDI and exports are in effect substitutes reinforcing the positive contribution of internal markets to the inflows of FDI into the country.

A technical analysis on FDI inflows using log-linear multiple regression techniques for the period 1985-1997 revealed some interesting insights into the behavior of FDI into the Philippines. The policy environment relating to trade and investment, among others, is especially crucial for the flows of FDI to be smooth over a long horizon. First, movements of the country's stock prices have exerted a positive effect on FDI. Increased rates of returns among industries in the sample data lead to increases in FDI inflows. Third, FDI decisions will also rely on the cost structure of the country relative to other FDI destinations. As costs in the Philippines fall relative to the rest of the alternative destination, the more likely will FDI flow into the country. However calculated, it is expected that as this exchange rate depreciates, more FDI flows into the country other things being equal. In the fourth place, and related to the exchange rate, an important element that usually distinguishes whether FDI is export promoting or import substituting is the effect of the country's protection structure on foreign investment flows.

Aside from analyzing the behavior of aggregate FDI into the Philippines, seven sectors were examined. Based on the pooled data for all sectors, the strongest determinant of FDI flows during the period is effective protection rate. In the individual sector results, the effective protection rate appears to be the dominant determinant of FDI flows into these sectors. The second factor driving FDI flows is the movement of stock prices in the country. However the responsiveness of FDI to this variable is not as strong as the protection system in the country. But needless to say this actually reinforces the importance of domestic market in the flow of FDI. In terms of sectors, stock prices have a secondary strong effect on FDI in manufacturing.

Further, the amount of commercial credits leads to a reduction in the amount of FDI inflows - a one percent increase in commercial credit reduces FDI by about 0.6 percent. On the other hand an increase of one percent in rates of returns increase FDI by about 0.25 percent. For the tradable sectors, stock price indices and commercial credits are pacing the movement of FDI in specific sectors with rates of returns having the least inducement for capital flows. The FDI flows into the non-tradable sectors tell a different
story. The factors that seem to smoothly explain FDI into the tradable goods sector do not matter to the FDI flows into the non-tradable sectors. The former depicts the magnitude of the domestic markets in FDI inflows.

**BILATERAL INVESTMENT TREATIES AND IMPACT ON FDI**

In recent years there has been a growing interest in, and in fact an expansion in the number of bilateral investment treaties (BITs) entered into between any two countries. The experience in the Philippines with respect to the formulation of BITs appears to follow the worldwide increase in these BITs.

In the case of the Philippines, the BITs entered into appear to have similar provisions across different countries. Thus the value of these may have been the signaling effects of policies with respect to FDI coming from a specific country. But the BIT did not really influence the flows of FDI into the country signing the treaties. BITs provide certain parts of an investment environment important parameters (as incorporated in the BIT) but they do not change the fundamental factors that are crucial to investment decisions. In other words, the signaling effect is what the BITs influence.

**RESPONSES TO THE CRISIS**

The Asian crisis had a profound effect on the five Asian countries and a contagious impact on the remaining other East and Southeast Asian countries. With respect to the flows of FDI however it appears that the impulse reaction of flow reduction was simply short-lived. Foreign investment interests regained in the aftermath of the crisis. Indeed these flows even exceeded their usual behavior prior to the crisis. However there were clearly significant variations to these flows among the five affected countries. Conversely, the two countries experiencing surges of FDI had had strong “fundamentals” to begin with, which exerted a dominant force in drawing in these flows. For sure each of these five countries instituted adjustment policies in reaction to the crisis and avoid reductions in FDI inflows. In other words these may not have been enough to make a difference in the FDI inflows among the five Asian countries.

The technical analysis of FDI inflows into the Philippines does not constitute a validation of these observations. The results, extended into the short period of the crisis, simply affirm previous findings about the long-term behavior of FDI. It supports the observed view on FDI inflows after the crisis among the five affected countries. Moreover given the similarity of responses and the concomitant inflows, the FDI behavior into the Philippines seems stable.

It may however turn out that normal FDI flows would be coming back into these countries including the Philippines. This means that individual countries become more constrained in instituting unilateral measures meant to attract foreign investments. There will be a review of its FDI policies, its past behavior, and the record arising from the recent Asian crisis. It is likely that the country’s decisions on internal FDI policies and external positions to global FDI issues will hinge on these actions.
CONCLUSIONS AND DIRECTIONS

The Asian crisis had a profound effect on the five Asian countries and a contagious impact on the remaining other East and Southeast Asian countries. With respect to the flows of FDI however it appears that the impulse reaction of flow reduction was simply short-lived. Foreign investment interests regained in the aftermath of the crisis However there were clearly significant variations to these flows among the five affected countries. One possible explanation is that the three countries which had seen reductions in FDI inflows after the crisis had extraneous forces that discouraged investments - the political climate in Indonesia, the uncertainty of policy pronouncements in Malaysia, and the vestiges of protection in the Philippines which do not jibe with the contemporary rationale for FDI.

The point is that the underlying factors (e.g., long-term prospects, policy stability, infrastructure, overall environment, etc.) that drive FDI inflows have remained important and are apparently independent of the underlying causes of the crisis in the first place. Put differently, the country fundamentals have been influencing FDI inflows more than any other factor. In still other words, the transient nature of the crisis did not deter the relative attractiveness of the Asian countries to foreign direct investments as reflected by their inflows subsequent to the outbreak of the crisis.

The options exercised by the five countries in attracting FDI inflows amidst loss of confidence occasioned by the crisis have been varied but comprehensive, as shown in the previous section. These options however are becoming more limited in view of many regional and global developments related to the movement of foreign direct investments across countries.

In the ASEAN region, the conclusion of the ASEAN Investment Agreement (AIA) would lead towards more harmonization of investment regimes, incentives, regulatory environments, and promotional schemes among the ASEAN member countries. This means that individual countries become more constrained in instituting unilateral measures meant to attract foreign investments. On the other hand, this means that simplification of procedures, consistency in rules and incentives, and harmonization of sectoral policies will induce larger FDI in more integrated and homogenized markets. Though the AIA still has a long way to go, the Agreement provides a new parameter for FDI flows into the ASEAN region including those affected by the Asian crisis.

In the APEC region, the previous adoption of a non-binding Investments Code, the pursuit of Individual Action Plans, and the likely adoption of a Competition Principles will also see a more harmonized environment for FDI into the wider Asia and Pacific region which includes all the affected Asian countries. While the Investments Code and the Competition Principles are not binding on the APEC members, they are not end in themselves. There is likely going to be expectations that the APEC region will transform them into specific policy directions that will again alter the environment for FDI flows into the area.
Globally, part of the built-in agenda of the World Trade Organization (WTO) Uruguay Round is the possibility of a global set of rules and disciplines defining the flow of capital including FDI. The failed Multilateral Agreement on Investment (MAI) does not mean that the contracting parties to the WTO will not agree upon a new search. Indeed some of the agenda are already a precursor of FDI-related initiatives such as the review of the Trade Related Investment Measures (TRIMS).

The Philippines, being a member of ASEAN, APEC, and the WTO is going to be confronted with these global arrangements and initiatives. There will be a review of its FDI policies, its past behavior, and the record arising from the recent Asian crisis. It is likely that the country's decisions on internal FDI policies and external positions to global FDI issues will hinge on these actions. That will be the subject of another study.
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1. INTRODUCTION

More than a year after the outbreak of the Asian financial crisis, there still does not seem to be a consensus as to its proximate causes and therefore what measures ought to be attended to avert its recurrence. Despite the numerous papers (scholarly as well as popular), conferences, publications, and official meetings that have proliferated, there is no convergence on its explanation - its unpredicted occurrence, its severity, and its widespread across Asia and the rest of the world. At one extreme is a school of thought that the crisis was caused by fundamental weaknesses in the economies of the affected countries manifested by macroeconomic imbalances, excessive borrowings, overvalued currencies, and poor investments, among others (Moreno, Pasadilla, and Remolona, 1998; Glick, 1998). At the other extreme is an argument that the crisis was triggered by speculators and their panic behavior of fleeing emerging markets in fear of losses (Moreno, 1998; Montes, 1997). Between these two extremes are various shades of explanation. There is the notion of lack of governance in both public and private transactions especially in terms of close relationships between financial institutions and regulators. There is the notion that corruption weakens the system of investment decision making in emerging markets. There is the notion that “Asian values” had dictated the manner of financial exchanges. There is the notion that the crisis is essentially a bubble crisis (Nomura, 1998). While the truth may lie somewhere between these two extremes, these have different policy implications. If the crisis was caused by fundamental weaknesses of the economy, the crisis-hit countries should carry out reforms to improve the foundation for sustainable development. On the other hand, if the crisis was caused by the sudden loss of confidence among short-term investors and speculators not directly related to country fundamentals, then the essential task is not really reforms nor would they be necessary. Restoring confidence where the basic fundamentals are “correct” may require other measures that would bring back investors. Without a clear specification which of these explanations jibe with the actual experience among the Asian affected countries it would be difficult to prescribe policy options.

There have been many attempts at quantitatively measuring the degree of importance of these factors in the evolution of the Asian crisis but events are still unfolding and until there is a definite “bottoming out” and a return to the growth experiences of the past these attempts remain incomplete. What seems evident however is a finding that weaknesses in the financial systems in Asia were stronger explanations of the crisis than of basic fundamental flaws in the economy (McKinnon and Pill, 1998). The unusually large flows of short-term capital in these countries exposed them to reversals eventually draining reserves and squeezing liquidity. Moreover one particular reason for the quick transmission of the crisis from Thailand in July of 1997 into the other Southeast and East Asian countries was the high degree of financial and trade integration among them (Glick and Rose, 1998).
The vulnerability of the financial sector to external shocks was not a product of the economic fundamentals but of more micro aspects of the sector such as less-than-arms-length transactions and poor risk management, which led to unusual credit booms. Indeed there is an argument that none of these explanations suffice since the Asian crisis is a bubble crisis, had its beginnings much earlier than the explosion in Thailand, and runs across most of Southeast and East Asia (Ichimura, James, and others, 1997).

In the more formal theoretical models of foreign exchange crisis, second-generation and third-generation models emphasize the importance of government conflicting objectives and interaction between banking and balance of payments crises, respectively. In this sense there is no necessity for domestic policy failures to precede a crisis for governments to decide to alter its exchange rate policy in the second-generation models. Domestic banking crisis however often precedes payments crisis among the third-generation models. The Asian crisis itself has spawned some theoretical exploration explaining the behavior of agents and institutions to over-borrow that rely on the implicit government guarantees under fixed exchange rates (Krugman, 1997; Montes, 1997).

Both the empirical works and the extensions of the theoretical foundation have clearly enriched the competing alternative ways of describing the onset of an exchange rate crisis. While this may make it more difficult to ascertain the more likely channels and mechanisms that approximate the actual experiences, they provide a new set of issues and concerns which otherwise were overlooked in the past.

The more immediate concern amidst the crisis, which is the subject matter of this paper, is its effects on the flows of foreign direct investment (FDI). While it is true that determinants to the flows of FDI may be different from those that determine the flows of short-term capital, the common interaction seems to be country “fundamentals” since these in turn define its long-term horizon.

There was a sharp drop in the magnitude of net capital flows into the five affected Asian countries (Indonesia, South Korea, Malaysia, Philippines, Thailand) at the onset of the crisis as net private flows suffered an outflow of $11.9B in 1997 from a net inflow of $97.1B in 1996 (Alburo, 1998a). A decomposition of these net inflows would reveal that direct equity flows hardly suffered even as portfolio equity, commercial banks and non-bank private creditors showed large declines. This is in fact the global picture of FDI during the period of the crisis.

World FDI flows in 1997, despite the Asian crisis, grew by 19 percent compared to a low growth rate of 1.9 percent in 1996 (UNCTAD, 1998). While this growth rate was not a record it still was comparable to the annual growth rates of 24 percent in the period 1986-1990 and 20 percent in the period 1991-1995. An inkling of the crisis can only be discerned from the regional breakdowns of FDI inflows, which show a decline in the share of South, East, and Southeast Asia to total flows.

This paper attempts to examine the flows of FDI into the Philippines during the period when the Asian crisis occurred. In particular we want to find out whether FDI flows
have been affected by the crisis apart from understanding some possible determinants of their behavior. To do this some comparisons are made of the FDI flows to the other affected Asian countries focusing on the period before and after the onset of the crisis. This means relying on information from 1997 until 1998 and in greater frequency as feasible with country data.

In the next section of the paper we examine the flows of FDI into the five affected Asian countries and the effects of the crisis. The intention here is to understand whether the crisis has taken any toll on the flows of long-term capital into these countries. This is a narrow approach and does not deal with larger questions of effects nor its broader social consequences. The limited data between 1997 and until the third quarter of 1998 indicate that the countries, which have been hardest hit by the crisis (Korea and Thailand), experienced cumulative increases in FDI flows. For the other three countries (Indonesia, Malaysia, Philippines) these have experienced a cumulative decline, fluctuations in flows, or a combination. Why these have differed among countries, which had faced similar environments, is initially explored.

The third section looks at FDI flows into the Philippines, their trends and determinants. Instead of an examination of FDI breakdown into sectors, its sources and other details, we concentrate on the more behavioral factors influencing the general movement of capital flows. This allows some comparability with FDI flows into the other affected Asian countries. The analysis appears to support the view that FDI into the country over the last ten years, including the crisis years, still retain the vestiges of the past FDI behavior i.e., domestic market orientation more than export orientation that one finds among the other Asian countries. The analysis is carried out on selected sectors, which seem to validate the aggregate analysis.

Bilateral investment treaties (BIT) and double taxation treaties (DTT) have proliferated in recent years with a view to increasing the flow of FDI across countries, which enter into these agreements. In the fourth section the record of BIT in the Philippines is described and documented to the extent that information will allow. The experience of the country is parallel to the global experience with BITs bunching in the last few years. Whether in fact these treaties have been useful in generating investment flows into the country is a question that needs to be answered. This does not seem to be the case since the major sources of FDI into the Philippines are those with which the country has no BIT while for those which agreements have been entered into, FDI flows from them have been marginal. Nevertheless one reason for the BIT is precisely to encourage more interest in and eventually induce FDI inflows.

The fifth section describes some of the measures that the governments have taken to presumably mitigate a perceived adverse impact of the crisis on FDI inflows. The larger measures intended to address the root causes of the crisis (e.g., banking practices, disclosure, etc.) are not direct responses to FDI changes. Thus the responses analyzed in this section are narrow and deal only with those that affect long-term investments. In general most of the affected Asian countries carried out policy modifications, incentive changes, and other measures. It is not clear however whether these were necessary or not. The Philippine
response was fairly limited and may not have had a perceptible positive impact as in the other countries.

The final section takes on two tasks in terms of direction for policy and study. To the extent that the flow of FDI into the affected Asian countries has been quite independent of the crisis itself the implication is continued attention to the factors that have always influenced FDI. These range from fundamentals to specific promotion schemes. The divergent streams of FDI flows into the same group of crisis countries suggest the importance of more underlying elements that drive these flows than those that have triggered the crisis.

A number of recent global developments are likely to impinge on the behavior of FDI not only into the Philippines but elsewhere. These range form the aborted Multilateral Agreement on Investment to the consideration of phasing out various incentives which are revenue losing and concentrate on investment promotion. The analysis of the various changes in the global and regional environment (ASEAN and APEC) is merely outlined in this section since that will be the subject matter of another paper. Though they may imply a potential array of studies, these are not spelled out in the section except a brief sense of the direction.

If the more formal analysis of FDI into the Philippines is plausible then it may mean that the country continuing on its present course is not likely to attract more flows. A clear sense of different direction is implied. The section outlines a number of these without indicating in concrete terms how to proceed and what actions need to be taken to move the direction forward. These will be treated in a subsequent paper. A capsule summary of the previous sections completes the paper.

2. FDI IN ASIA: CRISIS EFFECTS

One of the fears from the aftermath of the Asian crisis in 1997 was the possible drying up of FDI into the region as investors perceive inherent risks and uncertainty as the countries experience severe contraction and recession. But as pointed out in the previous section the global flows of FDI remained buoyant in 1997 in spite of the Asian crisis. In fact there was an acceleration of FDI relative to the sluggish 1996 growth.

FDI flows did decline during the immediate collapse of the currencies of the affected Asian economies though at different times for different countries. For Thailand the flows of FDI did not decrease until well into the fourth quarter of 1997 while inflows into Korea declined in the first quarter of 1998 (and also in the third quarter of 1997). Thus while for other capital flows the withdrawals were immediate the reduction in FDI into the two countries were delayed. In the case of Indonesia, Malaysia and the Philippines, the decreases came in the last quarter of 1997, the first quarter of 1998 and the last quarter of 1997, respectively. Table 1 shows the average value of FDI for the five countries between 1985 and the third quarter of 1998. Except for Korea and Thailand, the other three countries experienced a fall in the flow of FDI beginning the third quarter of 1997. Even if these averages hide variations between periods the pattern is instructive.
Figures 1 (a and b) and 2 (a, b, and c) give a quarterly trace of FDI flows based on balance of payments information. Figure 1a is the quarterly FDI into Korea. By the third quarter of 1997 there was a reduction in the flows of FDI but then a recovery in the next quarter and another fall in the beginning of 1998 before a somewhat sustained climb into the third quarter of 1998. A parallel behavior can be found in the FDI flows into Thailand as shown in Figure 1b. What is surprising is that even with the sudden withdrawal of short-term funds from the country FDI expanded 45 percent between the second and third quarter of 1997. Indeed as the figure shows there was sustained increase in FDI into Thailand except for a drop in the flows between the second and third quarter of 1998.

Contrast Figure 1 (a and b) from Figure 2 (a, b, and c). In Indonesia (Figure 2a) the decline in the flows of FDI started as early as the second quarter of 1997 from the first quarter’s flow if US $ 2.3B to the second quarter’s flow of US $ 1.4B and subsequently into negative flows (disinvestment) into the last quarter of 1997 and up to the second quarter of 1998. The same pattern can be said of Malaysia (Figure 2b) whereby beginning in the third quarter of 1997 FDI flows into the country started a decline from a peak during the last quarter of 1996 but only in the first quarter of 1998 that a sharp fall takes place. For the Philippines (Figure 2c) one can see some fluctuations in the quarterly flows of FDI but the trend decline appears to have started by the last quarter of 1997 after a last peak of US $ 572 M in the first quarter of 1997.

What the two figures say is that though all five countries have been affected by the Asian crisis through large outflows of capital, their FDI flows have differed in characteristics in terms of apparent reaction to the short term movements, its timing by country, and the magnitudes involved. Indeed for the severely affected countries of Korea and Thailand, FDI flows have been surprisingly stable if not increasing throughout the period except in the immediate quarters following the crisis. On the other hand for countries not directly affected by the crisis (but part of the contagion area) reductions in the inflows of FDI if not outright negative inflows took place.

What might be the factors or reasons for the differences in the behavior of FDI flows into the five affected countries? First of all the five countries have had comparable figures on the importance of FDI in its overall economies measured either by the its share to gross domestic capital formation or in terms of the FDI’s share to total capital flows before and during the crisis period. Except for Malaysia, which had an average of 21.3 percent share of FDI to gross fixed capital formation in the period 1991-1995, these affected countries had FDI shares at less than 10 percent (Komine, 1998). In fact both Korea and Thailand had their FDI shares much lower than the others did in 1995. Put differently, the two countries directly in the heart of the Asian crisis (Korea and Thailand) had quite low ratios of FDI to gross domestic capital formation (average of 2.25 percent in 1991-1995) than the other three countries (average of 11.0 percent in 1991-1995). And even if we remove the Malaysian value the average of the two countries would still be more than twice the share of Korea and Thailand. Thus while on average there seems to be comparability in the importance of FDI to capital formation in these Asian countries they can in fact be classified along the lines used to distinguish them by the pattern of FDI flows before and during the crisis.
Secondly, for these five countries the share of FDI to total capital flows in the period prior to the outbreak of the crisis in mid-1997 declined relative to the past and to the average for the developing countries. The share of equity investment (direct equity plus portfolio equity) was 31.9 percent in 1994, which fell to 19.2 percent by 1996 prior to the start of the crisis. Table 2 shows the external financing table for the five Asian countries between 1994 and 1998 (forecast). The rapid decline in the share of equity investments to net private capital flows is fairly evident. Moreover the distribution between direct and portfolio equity remained stable throughout the period. If one looks at the flows of capital to all developing countries their composition is significantly different. Between 1990 and 1997 the average share of both equity and portfolio investments has been at least 88 percent (the share of FDI being half and portfolio equity being a third). In short the five Asian economies patterns were not typical of all developing countries during the period of the nineties (UNCTAD, 1998).

Thirdly, the increasing use by the five Asian economies of private credit implied that the countries themselves were highly leveraged, shown by the rapid increase in the debt (credit) equity ratios. For instance in 1994 the share of private creditors (commercial banks, non-bank private creditors) to total equity capital (direct and portfolio) was 2.1. By 1996 this ratio had risen to 4.2. This doubling of debt equity ratio in two years was clearly troublesome since much of the debt flows were short-term capital. The rapid deterioration of the capital structure in the five economies meant that as the crisis became full-blown, the reduction in net private capital flows combined with the maturing capital stocks and their non-renewal led to actual outflows as shown in Table 2. Indeed the subsequent increases in the net official flows (mostly from multilateral financial institutions) just covered the loss of capital stocks from the private financial sources. While these official resources helped shore up the net financing requirements in the balance of payments of the affected countries, this did not compensate for the actual deterioration of the banking systems in these countries. In short the balance sheets of the banking systems in these countries suffered despite the continued flows of capital resources in the external financing sense. Thus the rest of the private sectors of these economies were acutely affected by shortages of capital.

Fourth, all the five countries' currencies depreciated substantially but comparable again in the magnitudes involved. Moreover these countries exchange rates moved in the same direction and almost the same amounts. Thus there were no undue advantages enjoyed by any one country on the basis of competitive devaluations. There may have been some initial advantage by the country that had devalued first but in the experience of the 1997 crisis comparable devaluations took place within a quarter. In short there does not seem to be any variation among these countries according to currency adjustments to explain why their FDI flows differed in behavior.

As a result of a comparable magnitude of currency depreciation among the five Asian countries, no one seems to have had an undue advantage in attracting incremental FDI that arose from the crisis. The prices of domestic investment assets collapsed across these countries. Though there were countries that adjusted domestic rules to increase the attractiveness of foreign investments these were not immediately apparent as pivotal and had to take time in implementation (see Section 6 below). All the five Asian countries had "fire
sales” going on. To foreign investors, the crisis per se did not create new individual country parameters for their consideration.

The choices for new FDI however were clearly beyond these five countries at least from among the options within the Asian region. In terms of asset prices the rest of the region's countries had also a modicum of currency depreciation ranging from Singapore in Southeast Asia to Taiwan in East Asia. But if prices were a critical factor the depth of currency depreciation among the five Asian countries would have given them an edge in attracting new FDI relative to other countries in the region.

What these four points imply is that the crisis and its consequent effects had a more neutral impact on the environment for FDI than is often argued. In turn this environment would have influenced the behavior of FDI flows more uniformly across all the five countries. The fact is that FDI flows to the five have not been the same after the crisis as shown in Figure 1 and Figure 2. More importantly, the fact is that for the two most affected countries FDI flows increased during the period after the crisis while for the other three countries FDI flows decreased during the same period. Neither the collapse of the exchange rates or the importance of FDI flows to total investments or to capital flows appear to have been crucial to these differential movements in the flows of FDI. What then could possibly explain the way FDI flows have behaved in the five Asian countries in the aftermath of the crisis?

There are two related points to consider in understanding these movements. The first is the notion that FDI reflects a long-term relationship between a host country and a source country. What enters into the calculus of foreign investors is the perspective of profit streams over a long run. The other is that strong economic foundation or “fundamentals” are often seen as driving the behavior of foreign investors. This being the case, most of the Southeast Asian countries, which were directly hit by the crisis, or part of the contagion have strong economic fundamentals (in the sense of traditional macroeconomic variables). This therefore does not provide an explanation for the divergence of FDI flows among the five Asian countries.

Yet there were other factors that may have been in the way of sustaining these foundations after the crisis. For Korea and Thailand the commitment to correct the inherent flaws of the macroeconomic foundations was addressed (e.g., banking reforms, prudential regulations, transparency, etc.). In the case of Indonesia, the economic crisis was just a manifestation of more serious political problems, which were glossed over. The Malaysian immediate response shook these foundations, created mixed (if not wrong) signals to investors, and led to greater uncertainty for them. We have shown some evidence for the Philippines that tend to support the thesis that the country had a basically weak foundation unlike the other Asian countries. In fact the apparently strong foundations of the Korean and Thai economies explain why the rebound of these countries is faster than that of Mexico in its crisis of 1995.6

On the other hand the three Asian countries, which have experienced declines in their FDI inflows, either had weak fundamentals or had other intervening factors, which
fostered a more uncertain environment for foreign investors. Both the political and economic problems of Indonesia have deterred FDI after apparent continued confidence early in the crisis. The equally political and economic problems of Malaysia have neither been conducive to further FDI into the country. In the case of the Philippines both fundamentals and others may explain declines in FDI.

3. FDI IN THE PHILIPPINES: TRENDS AND DETERMINANTS

There have been many studies on FDI in the Philippines attempting to explain its behavior over time and in different periods of the country's history (Aldaba, 1995; Alburo, Bautista, and Gochoco, 1992). The Asian economic crisis triggered by the events in Thailand in the second quarter of 1997 occasions another look into FDI in the Philippines, this time within the context of the divergence in the movement of FDI flows into the five Asian countries. This new inquiry relies on the notion that factors associated with the eruption of the crisis may have also affected variations in the movements of FDI flows. In an earlier paper we pointed out that while it is true that FDI flows are influenced by long-term profitability prospects, the broader environment, and real economic conditions, financial resources are fungible and can be used, however temporarily, for speculative and hedging purposes, for short-term profits in stock exchanges, or for the non-tradable sectors (Alburo, 1998a).

As shown in Figure 2 above the quarterly data on FDI into the Philippines have been showing oscillations since 1995 and with a downward trend into the time when the Asian crisis erupted. These fluctuations are not as apparent when looked at from yearly data as Figure 3 reveals. When compared with the yearly movements of portfolio investments it would appear that the FDI flows have been quite stable. Figure 3 shows that there is a sharp drop in FDI by 1998 in both the BOI-approved projects and the actual flows recorded in the Balance of Payments.

It has also been shown elsewhere that there have been changes in the composition of FDI stocks that may have been influenced by the same factors that triggered the crisis (Alburo, 1998a). For example, the manufacturing sector has lost its dominant share in both BOI-approved equity investments and in the actual recorded FDI inflows in the Balance of Payments (10.9 percent share in 1997 compared with a 74 percent share in 1992). Similarly, the non-tradable sectors of public utilities and construction received a large share of FDI in 1997. In the increases in foreign-equity investments in commerce, real estate experienced a significant expansion. All these clearly indicate that the behavior of FDI in the years prior to the crisis seems to have followed the behavior of short-term capital flows, i.e., movements into non-tradables and the "bubble" economy. But this does not adequately explain why FDI flows declined in the Philippines and not in Thailand and Korea. After all the latter two countries also had the same manifestations of a "bubble" economy and expansion of non-tradables sectors. What then may have been responsible for the divergence in flows between the Philippines and the other two that can not be attributed to political events (Indonesia) or critical uncertainty (Malaysia)?
Explanations of FDI invariably begin with a paradigm as to what motivates transnational corporations to establish factories by equity participation instead of simply exporting products. Without reviewing all issues that surround the empirical investigations of FDI there are several factors that often are considered essential. First there is the role of domestic markets not only as a basis for sales but more importantly as potential for backward linkages, the procurement of local supplies and the availability of trainable workers. As the rationale for FDI changed from a desire to overcome protectionist barriers to a globalized production operation, domestic markets became less important than availability of complementary resources from skilled labor to local capital. Second, there is the importance of a stable long-term policy environment that is conducive of globalized production, marketing, and distribution operations among firms located in different countries. The policy environment relating to trade and investment, among others, is especially crucial for the flows of FDI to be smooth over a long horizon. Finally, of equal importance is the adequacy of infrastructure for foreign investors to work in, ranging from port facilities to telecommunications. These are the ancillary services and industries that support the evolution of FDI into these countries.

In the more formal analysis of FDI, the market factor is proxied by a country's gross domestic product. Other explanatory factors include per capita income, some surrogate variables for infrastructure, and others such as indicators for bureaucratic efficiency (combining ratings for judiciary, red tape and corruption) and political stability. To the extent that there is interest in validating the export orientation of FDI, formal analysis examines the relationship between FDI flows (or stocks) and export flows as well as the other factors described above. There may be variations in applying this procedure across different source countries for FDI depending on the trading arrangements between firms and subsidiaries. The exercises done for the Philippines show that while internal markets have contributed to the variations in FDI for the decade of the seventies and eighties, FDI has not been positively associated with exports. FDI and exports are in effect substitutes reinforcing the positive contribution of internal markets to the inflows of FDI into the country.

In the context of the Asian crisis however we would like to understand whether the factors that have influenced the flows of short-term capital have also influenced the movement of FDI. These factors include movements of stock prices, rates of returns on industries, and availability of commercial credits. Of course stock price indices are often significantly correlated with overall economic growth and therefore have the same interpretation as domestic markets. The use of stock price index however is closer to the notion of what fund managers use to decide on the movements of short-term capital. Rates of returns measure the immediate profitability for financial investments instead of the actual calculation of profit streams that FDI is supposed to generate. The availability of commercial credits may reduce FDI inflows since transnational firms can source their capital needs locally. The flows of FDI into particular sectors of the economy may have some additional characteristics such as the rate of protection accorded. Where FDI is import-substituting this will be a determining factor in its inflows.

It has earlier been pointed out that in both investment applications for incentives (and approved by the BOI) and the actual recorded inflows, there has been a noticeable
decline in the manufacturing sector as location. In the BOI-approved equity investments, the sharp fall in the sector's importance started as early as 1993 so that by 1997 this sector had only an 11 percent share. On the other hand in the actual recorded FDI inflows, the decline in this sector started in 1995 so that by 1997 manufacturing's share was 16 percent. This delayed decline is consistent with the lag in the translation of approved investments and becoming realized in terms of actual inflows. Overall, there has been a noticeable increase in FDI inflows into non-tradables sectors of the economy – 72.6 percent of the 1997 inflows went into banks and other financial institutions, public utilities, and construction. Public utilities include investments in communications, transport (land, water, air), electricity, and others. In addition to these, commerce (and within it real estate) experienced an increase in flows of FDI. These shifts in the location of FDI (approved and actual) parallel the direction of short-term funds that has been the pattern for the Asian countries affected by the crisis. The interesting question is the degree of importance of these different factors in explaining the flows of FDI over a longer period of time than the immediate crisis. This will test the stability of the behavior of FDI as well as allow some comparability with earlier behavioral explanations.

A technical analysis was conducted on FDI inflows using log-linear multiple regression techniques for the period 1985-1997. The FDI data that was used were the actual recorded inflows at the central bank and not the BOI-approved foreign equity values. The log-linear regressions were run for the aggregate FDI flows and for seven sub-categories of them – banks and other financial institutions, commerce, agriculture, forestry, and fishery, public utilities, manufacturing, construction, and mining. The postulated variables affecting FDI were industry rates of return, effective protection rates, stock price indices, and commercial credit flows.

The results of the technical analysis (reported elsewhere) reveal some interesting insights into the behavior of FDI into the Philippines. First, movements of the country's stock prices have exerted a positive effect on FDI. To the extent that variations in stock prices are associated with variations in economic output (e.g., GDP) then one can interpret this factor as an indicator of the domestic market. But more important than this is that the dynamic growth of stock markets in the region in the last few years (through privatization, liberalization, deregulation) have apparently stimulated FDI as well, not perhaps in terms of actual stock purchases but as a reflection of anticipated markets and a long-run expansion. This is no direct evidence that FDI actually went into stock purchases.

Second, a similar effect can be derived from the movements in rates of returns by industry. Increased rates of returns among industries in the sample data lead to increases in FDI inflows. These differential rates of returns give a range of signals to the foreign private sector that are objective. They suggest the likely trajectory of its investments in specific sectors. Although it is true that industry rates of returns may be influenced by current policies they indicate specific parameters for FDI to consider in deciding where to locate investments within the country.

Third, FDI decisions will also rely on the cost structure of the country relative to other FDI destinations. As costs in the Philippines fall relative to the rest of the alternative
destination, the more likely will FDI flow into the country. One measure of this relative international cost is the country's real effective exchange rate. However calculated, it is expected that as this exchange rate depreciates, more FDI flows into the country other things being equal. This factor affecting FDI is not included in the technical analysis. In other technical analysis explaining FDI however the direction of the influence of the real effective exchange rate is as expected, that is, as it depreciates FDI flows into the country also increase.

In the fourth place, and related to the exchange rate, an important element that usually distinguishes whether FDI is export promoting or import substituting is the effect of the country's protection structure on foreign investment flows. Two important questions are relevant here: (1) is the protection system a significant factor to the flows of FDI? And (2) how important is the protection system relative to other factors in driving the flows of FDI? If the country's protection system is insignificant in relation to FDI, this does not mean that the country is open. It may only happen that for FDI inflows it does not matter (e.g. when FDI flows into processing zones). It may also happen that despite a decline in protection FDI declines as well (and vice-versa) in which case the behavior of FDI in terms of export promoting or import substituting would not be so clear.

Finally, transnational corporations often avail of the accessibility of credit from local sources, a point usually made by those who oppose FDI. The argument is that the use of local credits by foreign investors defeats the purpose of FDI which is to bring in foreign capital. Moreover the participation by foreign investors in the local capital market displaces some domestic investors. Thus if local credit influences FDI, the relationship between the two is negative. That is, as local credit increases FDI flows decline. This does not mean however that the potential number of FDI projects falls. After all, bundled with FDI are capital but management, technology, and other pecuniary assets of the foreign firm. The value of FDI (i.e., capital) may fall but only because of the availability of local capital sources. In the context of the Asian crisis excessive credit expansion was partly a contributory factor. In fact for the Philippines domestic credit expansion surged prior to the crisis meaning that firms had been absorbing capital at a fast pace as the crisis unfolded in the region (Alburo, 1998b). The question is whether foreign firms intending to invest long-term in the country had equally behaved in the same manner as other firms as easy credit became readily available. This more precise behavior can not be easily validated empirically. Nevertheless it is worth noting in interpreting the importance of domestic credit availability to FDI inflows.

Aside from analyzing the behavior of aggregate FDI into the Philippines, seven sectors were examined. Three of these sectors are considered tradables - manufacturing, agriculture, forestry and fishery, and mining. Four sectors comprised non-tradables - banks and other financial institutions, commerce, public utilities, and construction. We looked at the yearly data for the period 1985-1997 allowing for the pooling of the data coming from the various sectors.

Based on the pooled data for all sectors, the strongest determinant of FDI flows during the period is effective protection rate. Indeed the numbers indicate that a percentage
increase in the rate of protection would lead to an increase in FDI by four times, all other things being equal. This means that as the economy is sheltered from competition more FDI is expected to come in. A broad interpretation of this result is that FDI in the Philippines appears to remain import substituting. It will be recalled that this is the character of FDI in the decade of the sixties, seventies and eighties (Aldaba, 1995). There are of course pockets of the economy for which FDI coming in has been driven by a global production network and therefore export creating - for example electronics, telecommunications, and some garments (Alburo, 1999). Alternatively FDI coming into the export processing zones are expected to be export creating.

The analysis covering the sample of tradable sectors - agriculture, forestry, and fisheries products, manufacturing, and mining - reinforces the aggregate results. In the individual sector results, the effective protection rate appears to be the dominant determinant of FDI flows into these sectors. What have apparently driven FDI into the tradable sectors of the Philippines between 1985 and 1997 have been the prospects of a dynamic internal market and import substitution production.

The second factor driving FDI flows is the movement of stock prices in the country. Recall that this variable is associated with the growth factor such as GDP. However the responsiveness of FDI to this variable is not as strong as the protection system in the country. But needless to say this actually reinforces the importance of domestic market in the flow of FDI. Thus if both effective protection rates and the stock price indices are complementary factors that induce FDI flows, there is almost a five times increase in foreign investments for every increase in both effective protection rate and stock price index by one percentage point. In terms of sectors, stock prices have a secondary strong effect on FDI in manufacturing.

The other factors, with diminishing but still significant effects on FDI, are the amount of commercial credits and industry rates of returns. The amount of commercial credits leads to a reduction in the amount of FDI inflows - a one percent increase in commercial credit reduces FDI by about 0.6 percent. On the other hand an increase of one percent in rates of returns increase FDI by about 0.25 percent. The implication here seems to be that while access to domestic credits and rates of returns may be important in determining FDI, these are not as critical as the potentials of the domestic market and the magnitude of protection accorded. Indeed the future rates of returns can alter with changes in the market and in the protection system.

For the tradable sectors, stock price indices and commercial credits are pacing the movement of FDI in specific sectors with rates of returns having the least inducement for capital flows. This is consistent with the results from the aggregate data. In specific sectors of the study, rates of return are least important since it is the future prospects and profit streams that dictate FDI.

The FDI flows into the non-tradable sectors tell a different story. The factors that seem to smoothly explain FDI into the tradable goods sector do not matter to the FDI flows into the non-tradable sectors. Ignoring their significance, both the stock price indices and
the rates of returns are the two immediate factors. The former depicts the magnitude of the domestic markets in FDI inflows. This is true for inflows into the commerce sector (including real estate). The latter depicts the static profitability potentials. This is true for inflows into banks. The availability of commercial credits into the sectors is the next factor especially for the construction and public utilities sectors. It is not easy to interpret this factor. On the one hand the two sectors apparently are capital intensive and require substantial domestic capital infusion which magnitudes might not be forthcoming from foreign investors. On the other hand, joint ventures and business arrangements in these sectors sometimes limit FDI into management contracts (i.e., construction management, public utility management) which bring in technology, sector expertise, proprietary equipment, etc. If so the amount of commercial credit from domestic sources increases FDI since this credit provides the leverage for the foreign counterpart.

Overall, the most important finding from the technical analysis of FDI flows into the Philippines between 1985 and 1997 is that its behavior has remained the same as in the past 25 years. The strongest drive for foreign investments into the country has been its domestic market insulated from the rest of the world by an effective protection system. While it is true that there have been substantial progress in the country's liberalization program, FDI for domestic markets seems to be the dominant rationale to foreign investors. In an earlier comparable technical analysis of FDI in the Philippines, GDP, real effective exchange rates and effective protection rates have been the strongest determinants (Aldaba, 1995). This was during the period 1973-1992. It remains true up to 1997. This is not to say that there may be no sub-sectors for which FDI for exports have evolved to be important in the behavior for foreign investors (e.g., electronics). But it has not been a pervasive determinant for all FDI.

This finding in part explains why disinvestments have been taking place in the country i.e.; FDI that came in the sixties and the seventies is “pulling out”. In a contemporary period of globalization where components of production take place in different countries for eventual export to subsequent markets, there is little room for import-substituting FDI. Indeed even production techniques are globalized and there is no room either for transnational factories that do not recognize global economies of scale. Consequently once these import-substituting FDI driven plants achieve full depreciation and obsolescence, they are not replaced. Given the country's pronouncements of trade liberalization, no matter its uncertainty, the behavior of FDI is to locate elsewhere where the trade regime may be more fully committed to the globalization of production and investment, and where more modern (and globalized) facilities have been installed. This may be a reason for the different behavior of FDI into the Philippines in the midst of the Asian crisis which does not seem to be the case for the worst hit countries Korea and Thailand or for Indonesia and Malaysia.

4. **BILATERAL INVESTMENT TREATIES AND IMPACT ON FDI**

In recent years there has been a growing interest in, and in fact an expansion in the number of bilateral investment treaties (BITs) entered into between any two countries. The World Investment Report (WIR) says that there are over 1,500 of these BITs and over three-
quarters of them date from the decade of the nineties (UNCTAD, 1998). In 1990 there were only around 400 BITs but this swelled to 1,400 by 1996. The content of these BITs has also converged as their numbers have increased - specifying the scope of investment, national treatment, most-favored-nation provision, dispute settlement provisions, transfer of payments, etc. The general perspective of these BITs is that they do not really alter decisions made to invest in specific countries.

The notion is that BITs provide an important framework by which investors make their decisions. The mutual specification of provisions, the explicit government endorsement, and the accompanying institutional arrangements are seen to facilitate the movement of FDI between the countries signing the agreements. The expectation therefore is that BITs positively draw in FDI.

There is indeed a striking coincidence when BITs have proliferated and the time when FDI has been surging. Given the fact that FDI flows have substantially increased in much of the decade of the nineties, the stability and security of investment agreement may have been responsible in part for these flows. After all, these BITs improve the policy context for which FDI flows into the countries entering into the agreements.

The experience in the Philippines with respect to the formulation of BITs appears to follow the worldwide increase in these BITs. Figures 4a and 4b show the number of BITs that the Philippines signed between the eighties and the nineties, and what the global number of BITs has been during much of the same period, respectively. Notice that the pattern of bunching of the BITs is similar.

Table 3 identifies the BITs that the country signed, the dates entered into, and the countries with which these bilateral agreements were made. Of the 23 BITs, 12 of the countries were partly sources of FDI into the country - 10 countries from Europe, Canada and Australia. The rest of the other countries were essentially countries with which there was not much by way of FDI going into or going out of the Philippines. Indeed for the major sources of FDI (United States, Japan, Hong Kong, Taiwan) there were no bilateral treaties. Yet these major sources had continuously sent capital into the country in the form of FDI without the benefit of what appears to be important provisions of any BIT.

For example, both the most-favored-nation and national treatment clauses specify how FDI will be treated. Similarly there are provisions which specify the special privileges, incentives and other treatment for the investments of the particular countries entering into the agreement. On the face of it, these BITs seem to embody important parameters by which investors base their decisions.

In the case of the Philippines, the BITs entered into appear to have similar provisions across different countries. Thus the value of these may have been the signaling effects of policies with respect to FDI coming from a specific country. Conversely, without these BITs, there would be some uncertainty as to the manner and magnitude of the FDI forthcoming. Yet the FDI especially from those countries with which the Philippines had no
BIT expanded during much of the decade of the eighties and nineties when BITs were few and far between.

In order to test the importance of BITs in generating FDI, the World Investment Report (WIR) details the results of technical analysis, using time series and cross section data from over 100 countries, relating FDI flows and BITs, along with other independent variables. Other variables were more important than BIT in determining the flows of FDI such as market size, exchange rates etc. In short, the BIT did not really influence the flows of FDI into the country signing the treaties.

There are several reasons why there is no significant relationship between BITs and FDI. The first is that much of the BITs have proliferated in the nineties. This is not only the Philippine experience but also in other developing countries. During the same period many of the developing countries unilaterally liberalized their investment regimes and thus effectively making bilateral arrangements quite redundant. Their influence not only diminished but were in fact substituted by a more institutionalized setting where what were once thought as embodied only in bilateral agreements were now standard features that investors expect from all host countries. Universal investment laws were more predictable and clearly non-discriminatory.

Second, one result of the explosion of BITs is the fact that many countries enter into many bilateral agreements with provisions that may be similar. In this case the unique elements of bilateral agreements become ineffective. One trade partner enters into a BIT with another, which in turn enters into another BIT with another country and so on. This effectively dilutes any perceived benefit from bilateral arrangements.

Third, it is possible that there may be a long lag before any investment flows may be forthcoming from a BIT. There may be enabling conditions that are necessary before any FDI would be forthcoming. In this case no relationship would be identifiable until after a lapse of time. While this may not seem plausible, it is not impossible. How general is this condition is the more important question.

Finally, it is useful to point out that these BITs provide certain parts of an investment environment important parameters (as incorporated in the BIT). But they do not change the fundamental factors that are crucial to investment decisions. In other words, the signaling effect is what the BITs influence.

Most of the BITs that the Philippines entered into do not appear to have been instrumental in bringing in FDI for reasons pointed out about the generalized results of BITs. In addition the BITs of late have been with countries for which either state visits were the reason or trade delegations have asked. It is not clear that these BITs accomplished what they were intended for.

Bilateral investment treaties have therefore lost much of their supposed effects and impacts on FDI flows. And in the case of the Philippines these BITs may have had more value as ritual than any other substance. To the extent that there are special provisions in
BITs there may be some impact. However these BITs are apparently standardized, contain
similar provisions, and follow common formats for all countries.

This does not mean bilateral arrangements do not matter for FDI. One particular
aspect affecting FDI and dictated by treaties is the issue of double taxation. Analogous with
BITs, Double Taxation Treaties (DTTs) have rapidly risen as well in the nineties. And by
1997, the WIR tallies 1,794 treaties concluded. What is important about these types of
treaties is their effect and impact on FDI. While both the numbers and expansion of BITs
and DTTs are comparable their FDI effects are entirely different.

In DTT there is an agreement on an allocation of profits from FDI subjected to
taxation by the home and host countries. How this will be carried out is what the DTT is all
about. Whether by tax-exemption method or tax credit, the aim is to relieve foreign capital
from being taxed twice - by home and by source country.

Because this kind of treaty is particularly important to foreign investors, technical
analysis of the relationship between DTT and FDI reveals a positive and significant
correlation. The importance of DTT to FDI has been increasing over the years, say,
between the sixties and seventies, and the nineties. This is to be expected. As barriers to FDI
come down, decisions on FDI, especially over a longer period of time, may depend
increasingly on the tax system of the host country. Thus DTT would in turn become a
determining factor to the flows of FDI.

Aside from differences in effects, it also appears that BITs are generally concluded
between developed and developing countries while DTT started out as agreements between
developed countries. Since BITs usually stipulate provisions that implicitly provide security
and guarantee to investors it is not surprising that it is concluded between developed and
developing countries. On the other hand as FDI encompassed developed and developing
countries, the number of DTTs concluded between them and among developing countries
expanded and the DTT is concluded among all types of countries.

The WIR also observes that there is an inverse relationship between DTTs and BITs
concluded i.e., countries with a high propensity to sign DTTs have a low propensity to sign
BITs. This can only mean that countries see through the value of DTT. Given this finding
and the lack of significant relationship between BIT and FDI, it means that DTT is viewed
as important to the flows of FDI.

How important are these two instruments to attract FDI? The lack of strong
relationship between BIT and FDI, using the experience of many countries, and over time
for a number of countries, simply show that other factors are far more important than an
investment treaty. The existing BITs in the Philippines, which do not involve the major
sources of FDI for the country, reinforce the overall behavior among many countries. Other
than the documentation that goes with diplomatic visits between officials of two countries
through BIT, one can not expect an influence on the flows of FDI.
5. **RESPONSES TO THE CRISIS**

This section traces some of the responses that the Asian countries affected by the crisis took in its immediate aftermath. In fact it may be due to these responses that the pattern of FDI in the quarters following the crisis looked the way it is, as described in Section 2 above. The Asian crisis however took place at a time when there were broad changes in the behavior of FDI itself independent of the factors that may have triggered it. We first look at this larger framework before going into some of the details of the country responses.

By the late nineties, there was limited room for the expansion of FDI in terms of stocks so that any acceleration of flows required exploring new areas. Thus host countries extended the open policies to areas which were once considered sensitive (e.g., telecommunications, transport), and allowed other forms of FDI participation which were once considered less preferable (e.g., mergers and acquisitions, subsidiaries, privatization programs). Even then the scope of FDI liberalization had begun a diminishing point which led to the consideration of other policies to also influence the flows of private capital. These would include monetary and fiscal policies, exchange rate policies, spatial policies, and technology policies.

The responses to the crisis among the five affected Asian countries can be divided into two groups. The first are those responses that were policy-based and were meant to be neutral as to their impacts. These were essentially macroeconomic policies (monetary and fiscal) and related adjustments. For example, in the Philippines, the monetary authorities set a ceiling of 20 percent of bank portfolios for all real estate loans in June 1997 on the eve of the crisis. Subsequently, interest rates were raised to quell speculation and restore confidence (Alburto, 1998b; Paderanga, 1998). The monetary authorities imposed a reduction in the allowable overbought foreign exchange position of banks, opened a non-deliverable forward hedging facility, and other measures to address regulatory and prudential issues confronting the banking sector.

The second are those that have been taken to insure those foreign direct investments would continue to flow into the country and would be least affected by the immediate and long-term effects of the crisis. The notion is that foreign investments have long-term interests in the country but nevertheless are sensitive to the economic environment that a crisis might create in the short-run. Moreover there is always the option for long-term investors to be influenced by the parameters of short-run investments climate. Thus these responses are specifically geared to particular economic agents and rely on specific instruments for effectiveness.

The first of these is a reduction in the limitation of foreign share holdings in firms whether listed in the stock markets or not. Indonesia eliminated its 49 percent limits on firms other than financial firms while Korea abolished its ceiling on individual and aggregate foreign ownership of listed Korean shares. Indonesia instituted this response in September 1997 while Korea removed this ceiling in May 1998. In fact the granting of 100 percent...
foreign ownership in Indonesia extends to non-bank financial firms such as insurance companies while Korea allowed the establishment of subsidiaries of foreign banks and securities firms.

Second, the affected Asian economies began a process of opening to foreign investments several sectors, which were previously considered sensitive and reserved for domestic capital. Indonesia opened its retail and wholesale trading as well as its palm oil sectors to foreign investments though restricted to joint ventures with Indonesian nationals and companies. The number of Korean industries restricted to FDI was reduced from 42 to 31 with actually only 13 absolutely closed. Malaysia allowed 100 percent foreign equity ownership in new manufacturing projects (except those in the specific exclusion list), nor will there be any export requirements. But this change is only for applications during the period July 1998-December 2000.

Third, there was a relaxation in the limits to foreign equity ownership as well as the modality of the ownership. Malaysia raised the limit on foreign equity from 30 percent (other than those exempted such as export oriented firms) to 49 percent in telecommunications. The country will consider raising it up to 61 percent for other companies provided such foreign equity reverts back to 49 percent within five years. The Philippines raised the allowable foreign equity participation up to 60 percent for investment houses and finance and leasing companies subject to reciprocity rights. Korea fully permitted mergers and acquisitions (M & A) another vehicle for foreign equity participation.

Fourth, ownership of public enterprises was opened to foreigners. Korea allowed foreign participation in equity transactions in large public enterprises and key industries. In general all affected Asian countries opened to foreigners the participation in the privatization programs of public enterprises subject to the maximum equity limits as provided in existing laws or as revised.

Finally, there were a variety of other measures instituted including automatic approval systems, further tax incentives, one-stop services for those which did not have these (e.g., Korea), removal of government approval for foreign takeovers above certain capital ceilings, and specific country restrictions (e.g., Bumiputra policy in Malaysia).

These measures, to the extent that they have significantly varied across the affected countries, may in part explain the degree of FDI inflows into these countries after the crisis erupted. For example, Korea had the largest number of M & As between January 1998 and April 1999 in terms of number of deals and their value. Thailand followed this. During this period FDI flows into Korea amounted to US $ 27B covering those deals while US $ 10.6B flowed into Thailand (Far Eastern Economic Review, 1999). Of course not all of these flows were “new” money or purely acquisitions since they include foreign purchases of bonds and stock in public offerings.

Yet despite the Philippines ranking third in the value of M & As during this same period, the behavior of FDI into the country did not change (though admittedly this is not all captured in the data used in this study). On the other hand, there is no pressure for the
country to actually engage in “fire sales” as the hardest-hit countries so that it is market consolidation that drives foreign investment modes through M & As, not corporate distress. The buying and selling of assets in the country are part of larger operations than exploitation of opportunities that the crisis has opened.

Still and all, in terms of the specific mergers and acquisitions route for FDI, the behavior of foreign direct investment is consistent with the actual trends that have been analyzed in the previous section. Korea and Thailand had been the beneficiaries of these flows while the remaining three affected countries had the least flows in terms of the values of M & As. This all the more supports the underlying explanation for the behavior of FDI in the immediate period of the crisis.

6. CONCLUSIONS AND DIRECTIONS

The Asian crisis had a profound effect on the five Asian countries and a contagious impact on the remaining other East and Southeast Asian countries. With respect to the flows of FDI however it appears that the impulse reaction of flow reduction was simply short-lived. Foreign investment interests regained in the aftermath of the crisis. Indeed these flows even exceeded their usual behavior prior to the crisis. However there were clearly significant variations to these flows among the five affected countries. In particular, there were increases in the flows to Korea and Thailand while there were reductions into Indonesia, Malaysia and the Philippines despite the fact that all these countries suffered from the same virulent manifestations that led to the crisis.

One possible explanation is that the three countries which had seen reductions in FDI inflows after the crisis had extraneous forces that discouraged investments - the political climate in Indonesia, the uncertainty of policy pronouncements in Malaysia, and the vestiges of protection in the Philippines which do not jibe with the contemporary rationale for FDI. Conversely, the two countries experiencing surges of FDI had had strong “fundamentals” to begin with, which exerted a dominant force in drawing in these flows. A more elaborate technical analysis of the behavior of FDI into the Philippines seems to support the hypothesis of a strong import-substituting reason for the flows.

For sure each of these five countries instituted adjustment policies in reaction to the crisis and avoid reductions in FDI inflows. While there are differences in the way changes in FDI systems were fashioned in these countries, by and large the adjustments were comparable. In other words these may not have been enough to make a difference in the FDI inflows among the five Asian countries.

The point is that the underlying factors (e.g., long-term prospects, policy stability, infrastructure, overall environment, etc.) that drive FDI inflows have remained important and are apparently independent of the underlying causes of the crisis in the first place. Put differently, the country fundamentals have been influencing FDI inflows more than any other factor. In still other words, the transitory nature of the crisis did not deter the relative attractiveness of the Asian countries to foreign direct investments as reflected by their inflows subsequent to the outbreak of the crisis.
The examples of the policy determination of Korea and Thailand in addressing the
problems associated with the crisis seem to have counted more as a measure of strong policy
apparatus and stability which in turn determined investor behavior. Similarly, a lack of this
manifestation in the cases of the other three countries provided hesitation for FDI inflows
there.

The technical analysis of FDI inflows into the Philippines does not constitute a
validation of these observations. The results, extended into the short period of the crisis,
simply affirm previous findings about the long-term behavior of FDI. It supports the
observed view on FDI inflows after the crisis among the five affected countries. Moreover
given the similarity of responses and the concomitant inflows, the FDI behavior into the
Philippines seems stable.

It may however turn out that normal FDI flows would be coming back into these
countries including the Philippines. As the room for flows that the immediate responses
generate begins to exhaust, as reforms change the volume of short-term capital movements,
and as other policy changes take effect, FDI flows into Korea and Thailand stabilize and
those into the three other countries recover.

The options exercised by the five countries in attracting FDI inflows amidst loss of
confidence occasioned by the crisis have been varied but comprehensive, as shown in the
previous section. These options however are becoming more limited in view of many
regional and global developments related to the movement of foreign direct investments
across countries.

In the ASEAN region, the conclusion of the ASEAN Investment Agreement (AIA)
would lead towards more harmonization of investment regimes, incentives, regulatory
environments, and promotional schemes among the ASEAN member countries. This means
that individual countries become more constrained in instituting unilateral measures meant
to attract foreign investments. On the other hand, this means that simplification of
procedures, consistency in rules and incentives, and harmonization of sectoral policies will
induce larger FDI in more integrated and homogenized markets. Though the AIA still has a
long way to go, the Agreement provides a new parameter for FDI flows into the ASEAN
region including those affected by the Asian crisis.

In the APEC region, the previous adoption of a non-binding Investments Code, the
pursuit of Individual Action Plans, and the likely adoption of a Competition Principles will
also see a more harmonized environment for FDI into the wider Asia and Pacific region
which includes all the affected Asian countries. While the Investments Code and the
Competition Principles are not binding on the APEC members, they are not end in
themselves. There is likely going to be expectations that the APEC region will transform
them into specific policy directions that will again alter the environment for FDI flows into
the area.

Globally, part of the built-in agenda of the World Trade Organization (WTO)
Uruguay Round is the possibility of a global set of rules and disciplines defining the flow of
capital including FDI. The failed Multilateral Agreement on Investment (MAI) does not mean that the contracting parties to the WTO will not agree upon a new search. Indeed some of the agenda are already a precursor of FDI-related initiatives such as the review of the Trade Related Investment Measures (TRIMS).

The Philippines, being a member of ASEAN, APEC, and the WTO is going to be confronted with these global arrangements and initiatives. There will be a review of its FDI policies, its past behavior, and the record arising from the recent Asian crisis. It is likely that the country’s decisions on internal FDI policies and external positions to global FDI issues will hinge on these actions. That will be the subject of another study.
Figure 1
Foreign Direct Investment Inflows
(1985-1998)
Figure 2
Foreign Direct Investment Inflows
(1985-1998)

a: INDONESIA

b: MALAYSIA

c: PHILIPPINES
<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Account Balance</strong></td>
<td>-24.5</td>
<td>-41.4</td>
<td>-55.2</td>
<td>-27.1</td>
<td>30.6</td>
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<tr>
<td><strong>External Financing, net</strong></td>
<td>45.2</td>
<td>84.6</td>
<td>95.2</td>
<td>18.1</td>
<td>25.9</td>
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<tr>
<td><strong>Private Flows, net</strong></td>
<td>37.9</td>
<td>79.2</td>
<td>97.1</td>
<td>-11.9</td>
<td>-0.3</td>
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<tr>
<td>Equity Investment</td>
<td>12.1</td>
<td>15.4</td>
<td>18.7</td>
<td>2.1</td>
<td>16.4</td>
</tr>
<tr>
<td>Direct Equity</td>
<td>4.7</td>
<td>4.9</td>
<td>6.3</td>
<td>6.4</td>
<td>6.9</td>
</tr>
<tr>
<td>Portfolio Equity</td>
<td>7.4</td>
<td>10.5</td>
<td>12.4</td>
<td>-4.3</td>
<td>9.5</td>
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<tr>
<td>Private Creditors</td>
<td>25.8</td>
<td>63.8</td>
<td>78.4</td>
<td>-14.0</td>
<td>-16.8</td>
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<tr>
<td>Commercial Banks</td>
<td>23.4</td>
<td>49.9</td>
<td>55.7</td>
<td>-26.9</td>
<td>-19.8</td>
</tr>
<tr>
<td>Nonbank Private Creditors</td>
<td>2.4</td>
<td>13.8</td>
<td>22.7</td>
<td>12.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Official Flows, net</td>
<td>7.3</td>
<td>5.4</td>
<td>-1.9</td>
<td>30.0</td>
<td>26.2</td>
</tr>
<tr>
<td>Int’l Financial Institutions</td>
<td>-0.4</td>
<td>-0.3</td>
<td>-2.0</td>
<td>22.5</td>
<td>23.2</td>
</tr>
<tr>
<td>Bilateral Creditors</td>
<td>7.7</td>
<td>5.8</td>
<td>0.1</td>
<td>7.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Resident Lending/other, net</td>
<td>-15.2</td>
<td>-29.2</td>
<td>-21.6</td>
<td>-30.5</td>
<td>-4.6</td>
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<tr>
<td>Reserves excl gold (- = increase)</td>
<td>-5.4</td>
<td>-14.0</td>
<td>-18.4</td>
<td>39.5</td>
<td>-51.9</td>
</tr>
</tbody>
</table>

**Memo:** Short-term credits, net

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</thead>
<tbody>
<tr>
<td>7.3</td>
<td>40.4</td>
<td>38.5</td>
<td>-41.7</td>
<td>-42.8</td>
</tr>
</tbody>
</table>

*e* = estimate; *f* = forecast

Five Asian Economies: Indonesia, Korea, Malaysia, Philippines, Thailand

Source: Institute of International Finance
### Table 3
**SIGNED INVESTMENT AGREEMENTS**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>DATE SIGNED</th>
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<tbody>
<tr>
<td>RP Finland</td>
<td>March 25, 1998</td>
</tr>
<tr>
<td>RP Myanmar</td>
<td>February 17, 1998</td>
</tr>
<tr>
<td>RP Belgium</td>
<td>January 14, 1998</td>
</tr>
<tr>
<td>RP Denmark</td>
<td>September 26, 1997</td>
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<tr>
<td>RP Russia</td>
<td>September 12, 1997</td>
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<td>RP Bangladesh</td>
<td>September 8, 1997</td>
</tr>
<tr>
<td>RP Germany</td>
<td>April 18, 1997</td>
</tr>
<tr>
<td>RP Switzerland</td>
<td>March 31, 1997</td>
</tr>
<tr>
<td>RP Chile</td>
<td>November 20, 1995</td>
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<tr>
<td>RP Canada</td>
<td>November 9, 1995</td>
</tr>
<tr>
<td>RP Iran</td>
<td>October 8, 1995</td>
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<tr>
<td>RP Thailand</td>
<td>September 30, 1995</td>
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<tr>
<td>RP Czech</td>
<td>April 5, 1995</td>
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<td>RP Australia</td>
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<td>RP France</td>
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<tr>
<td>RP Korea</td>
<td>April 7, 1994</td>
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<td>RP Romania</td>
<td>May 18, 1994</td>
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<tr>
<td>RP Kingdom of Spain</td>
<td>October 19, 1994</td>
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<tr>
<td>RP People's Republic of China</td>
<td>July 20, 1992</td>
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<td>RP Republic of Vietnam</td>
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<td>RP Republic of Italy</td>
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<td>RP Kingdom of Netherlands</td>
<td>February 27, 1985</td>
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<tr>
<td>RP Kingdom of Great Britain</td>
<td>December 3, 1980</td>
</tr>
<tr>
<td>And Northern Ireland</td>
<td></td>
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</tbody>
</table>

Cultural Agreement
Manila Economic and Cultural Office
And Taipei Economic and Cultural Office
Figure 3
FDI: BOI- and BSP- Registered

Sources: Bangko Sentral ng Pilipinas
Board of Investments
Executive Summary

THE PHILIPPINES IN A GLOBAL INVESTMENT ENVIRONMENT

Florian A. Alburo

(Part 2)

TRADE AND INVESTMENT

The last three decades have seen substantial changes in the global landscape for trade and investment. Those countries, which actively participated in world trade, witnessed dramatic modifications if not transformation in the relationships among trading nations.

Unfortunately, the country's investment regime is not quite consistent with the dynamic changes taking place globally. In particular as the relationship between global trade and global investment becomes more complementary than in the past, the attainment of the country's development objectives will be constrained. As investment behavior remains rooted in the past, it would be difficult for the country to move dynamically in a globalized world where barriers to trade are no longer the norm.

In the past (especially in the immediate post-war years), the major sources of capital flows to developing countries have been development assistance resources from capital abundant countries and multilateral institutions. In addition many of the developing countries, including the Philippines, were pursuing development strategies based on import substitution. Trade was initially natural resource based and quite independent of foreign investment flows. Indeed whatever FDI that came in were actually trade-reducing in the sense that they were “jumping tariff” and other protective walls to produce import substitutes. Only when trade regimes became more liberal did FDI also become trade inducing. In the more recent period of the nineties and the advent of globalization trade and FDI have moved together in complementary and mutually reinforcing and interactive ways. At the same time the character of international trade has changed towards more integration among spatially separate production units.

There are at least three factors that have driven this relationship in the last few years. One is technology revolution that has changed in properties - shorter life cycle, emphasis on re-engineering and large investment outlays in its creation. Thus FDI is gaining a more critical role as vehicles for the widespread use of the technology revolution in developing countries. The second is information revolution that has also changed in properties - real-time, universal and lower costs. This has reconfigured the nature of the firm, production, investment and organization. Finally, the spate of liberalization drives and deregulation among developing countries and even in emerging markets is defining a different environment for international commercial transactions. All of these factors contribute to increasing the importance of the trade-investment relationship. One can surmise that with both trade and investment liberalization there should be greater complementarity between
them. There are however variances across industries and countries that it is unlikely that liberalization takes place in both trade and capital movements. Moreover as one country undertakes these measures to draw in FDI, other countries similarly follow but, unlike trade, often FDI is more limited and therefore competition is tight.

Increasing both trade and FDI in a mutually reinforcing way would redound to a better achievement of the country's development objectives. Among the elements that would impinge on a more synchronized trade and investment movements include the broad FDI environment in the country, the various responses of the country to the recent crisis in Asia, and the kinds of modalities of foreign investment that have appeared in recent times, to which we now turn.

ENVIRONMENT FOR FDI INTO THE PHILIPPINES

The increases in FDI were part of a larger expansion of FDI to other emerging markets and not really unique to the Philippines. In fact if we compare the FDI flows into the Philippines with the rest of the Asian countries, these are only small relative to those flowing into other countries.

Many if not most, developing countries make liberal use of fiscal and trade incentives, among others, in attracting FDI. During the period when the increases in FDI were taking place there were no major changes in the incentive system in the Philippines beyond those specified under existing rules (Omnibus Investment Code). Indeed incentives may not have been so critical to the FDI inflows. This means that host countries including the Philippines will shift policy attention from incentives per se towards more macro-economic issues that relate to foreign investments. The Philippines is increasingly facing competition from other FDI hosts in the region including those from newly emerging markets. There is need for continuous adjustments as all countries simultaneously out-compete each other to attract limited FDI resources. With the limitations that now beset incentives (which tend to be matched by a second country each time one country enacts one), host countries will offer investment regimes that are dynamic and constantly moving (Chia and Freeman, 1999).

The Asian crisis however adds different dimensions to the environment for FDI into the Philippines and in the rest of the developing world especially Asia. First, despite the common assertion that the crisis had affected only portfolio capital and that FDI is immune from such short-term vagaries of capital movements, the fact is that FDI into Asia did fall in 1998 within one year of its outbreak. All the affected Asian countries suffered declines in FDI inflows.

Second, there is evidence of a shift in the natural sources of FDI into the region arising out of the crisis. The regional composition of FDI shows that the United States is becoming an increasingly important source of capital. In the aftermath of the crisis Europe has also been another alternative FDI source as Japan's inflows declined. This re-emergence of the US and Europe as significant FDI sources must be seen in the light of the importance of the newly industrializing economies (Hong Kong, Korea and Singapore) which for a decade before the
crisis have been sources of foreign capital in the region. And many of the ASEAN nations are now also sources of FDI to each other and to the newer members of the Association.

Third, the crisis has led to some incremental liberalization of foreign investment regimes, which have implications for the larger behavior of FDI. Two measures were implemented among the affected countries. One was further opening of what were considered sensitive sectors of the economy such as telecommunications, public transport, other public utilities, public infrastructure, mining, oil, and energy. The other was the opening of what were once closed areas i.e., areas or sectors protected for local investors. However, because the Philippines was not directly affected by the crisis, its changes in regulatory framework were not as substantial as the other countries.

TOWARDS NEW RULES

The search for new efficiencies in production was apparent in the movement of FDI across the affected countries. What foreign investors look for in a country's investment environment is a set of rules as well as incentives that dictate the behavior of foreign capital. To the extent that these rules vary across host countries foreign investors can direct their capital where maximum benefits are derived. Worse, they can pit one country against another in terms of the rules for foreign capital.

On the other hand, host governments try to bring in limited capital by altering their investment environment. In the end what foreign investors look for are universal rules of investment that are subscribed by as many host countries as possible. The underlying structure of an economy therefore becomes the basis for the real flows of foreign investments.

The Philippines has attempted to subscribe to as many of common rules for investment with other countries. For one, the countries with which these treaties were concluded were those the Philippines had small trade and investment links to begin with. The APEC principles recognize a need for more neutrality of the investment environment in the region. The second regional effort to harmonize foreign direct investment environment is the ASEAN Investment Area (AIA). The Framework Agreement formally adopts the ASEAN region as an investment area from where a common environment is to be created. Beyond the Asian region have been proposals for a global set of rules for foreign investments. Whether in fact there will be a General Agreement on Investments (GAI) similar to the General Agreement on Trade in Services (GATS) in the realm of the WTO remains to be seen. A GAI would effectively re-define the global environment for FDI including the basis for capital flows into the country (Bora and Urata, 1999).

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1 The Framework Agreement on the ASEAN Investment Area (AIA) was signed in 1998 along with three schedules (Co-operation and Facilitation Programme, Promotion and Awareness Programme, and Liberalization Programme).
OPTIONS FOR THE PHILIPPINES

The lack of global rules and multilateral framework on investments imply that the Philippines can fashion a unilateral policy on foreign investments. There are of course trade-offs to a single policy direction since foreign capital freely moves across countries in response to differing policies. This means that, while the Philippines can design its own investment environment, it would also be dependent on what other countries do to their own investment environments and so on interactively into a possible retaliatory behavior.

Beyond the investment environment that the country can design are the actual locations for investments. Through profiling, analysis of the markets and resources, some identification of potential products and industries can be undertaken. A next step would then be to influence policy and other measures so that investments (domestic and foreign) flow into these directions. Although these identified products or industries do not substitute for the kind of market scan that investors actually carry out they provide an initial filter for associated package of incentives provided.

The Philippine Export Development Plan (PEDP) for 1999-2001 (PEDP, 1999) uses clustering for determining the location of industries and products around the country. The clustering considers materials, labor, technology and physical factors in locating and prioritizing products and industries. Four cluster groups have been identified in the PEDP.

What is important to point out in this clustering of industries is the identification of location by different regions of the country. By recognizing the industrial potentials of the regions the PEDP also recognizes the need for investment resources into them at different places in the country. Implicit in this method then is really an industrial policy pronouncement.

The use of clustering to direct potential investments also creates a more efficient basis for the provision of public infrastructures and private capacities. Thus it is possible that clusters of industries have common procurement systems, common financing facilities, common quality control systems, common training facilities, joint promotion and marketing arrangements. Many of these need not be provided by the government and can indeed be sourced through private capital and joint ventures as long as the scale economies are sufficiently large. Domestic and foreign investors can then be attracted to examine these prospects.

The clustering suggests a number of domestic options for the country and a few directions as to how the country may position itself in the global search for multilateral investment framework.

First, the explicit use of the structure and characteristics of the different regions of the country as basis for the clustering shifts some of the emphasis on investment promotion, provision of incentives, and infrastructure from the national and central government to the local government levels. The shift means that local governments can identify more infrastructures that support investments and industrial production according to the plan.
Second, the clustering not only identifies where industries can potentially be located but it also leaves room for the evolution of other industries as capacities are acquired. The evolution itself may emanate from two sources. One is from below i.e., domestic sources such as income expansion, vertical and horizontal interchanges among regions (and firms within regions), and indirect sources (e.g., multiplier effects from remittances from abroad). The other is external i.e., global demand and international transactions. The former seems less difficult to manage being a natural result of internal growth where industries need no special incentives to proliferate and investments respond to latent market signals. The latter is not readily natural since global demands need to be attracted and institutional arrangements made up to influence investments into industries whose markets lie elsewhere and beyond domestic borders. The PEDP therefore puts more discretion on the part of local governments to lay down alternative ways to bring in capital for industrial development. By focusing policy instruments on regional locations as direct investment recipients a new context has been drawn up. Though national policies will remain important there is now a conscious effort to encourage local policies not only to supplement but become a primary drawer of resources.

Finally, and related to the previous points, the country can become part of a global production system through various modalities that are defined in these clusterings and thus through various nodes of location. Japanese global networks on electronics connect directly with Region 4 as identified in the clusterings. American and European production systems on oleochemicals interact with Region 10. More important is the converse to these. The regions can directly seek out these networks and global production systems and rely less on national directives and initiatives. What is now crucial to all of these is the capacity among local governments to map out policy strategies and investment packages that influence capital resources.

The reconfiguration of the trade, investment and industrial policy regimes reflected in the clustering approach gives a twist to the possible positions that the country may want to take in global or regional rules on investments. For one, it may be useful and important to have the flexibility to subject foreign investments to some conditions in exchange for fiscal and non-fiscal incentives. This means that the country may not want to agree to a phase out of trade-related investment measures. With the increasing role of local governments in bringing in capital it may be too early to remove these measures. Fortunately the AIA does not have any of these TRIMS that may require the Philippines to remove after a specified period of time. The AIA itself, while incorporating a liberalization program (i.e., reduction and elimination of restrictive investment measures), does not really deal with purely performance-related investments. Both the MAI and the APEC Non-Binding Investment Principles provide for the minimization of performance requirements as conditions for investments. But the former is now irrelevant while the latter remains non-binding among APEC economies.

In some cases incentives are actually accorded domestic investments. But this is probably less compelling as domestic industries evolve than foreign investments.
For another, there are likely to be more investment incentives that would be proposed in the light of the clustering of industries according to the PEDP. This would not be of particular interest nationally (as their revenue implications restrain more incentives) but at the local levels where capital is scarce and the inducement to offer incentives would be stronger. Regional and global proposals for moratorium on incentives or some rules and disciplines for them would therefore not be appropriate given this setting for investment incentives. Without a concomitant understanding of what unilateral incentives imply for capital flows local governments will likely oppose a Philippine position to reduce or eliminate incentives as part of the country’s investment environment. Indeed there is no likelihood now than before that multilateral rules on investment eliminating incentives would pass up as a government policy. It is of course true that there is less discretion on the part of local officials to give fiscal benefits greater than that of the national level. But as long as the perception is there and that there are significant revenue attractions local governments can provide, the country’s position in the international milieu will be constrained.

In summary, the country is not expected to agree to a global investment environment that removes its ability to direct capital into industries it may deem important to its development. It is also unlikely to agree to eliminate performance measures as condition for investment flows. This does not mean that the Philippines would not subscribe to a position that expands its environment for capital resources more globally. Thus it agrees to more transparency, non-discrimination and other usual provisions for as long as the important parts of incentives, performance requirements, and industrial planning remain part of its policy arsenal.
THE PHILIPPINES IN A GLOBAL INVESTMENT ENVIRONMENT

(Part 2)

1. TRADE AND INVESTMENT

The last three decades have seen substantial changes in the global landscape for trade and investment. Those countries, which actively participated in world trade, witnessed dramatic modifications if not transformation in the relationships among trading nations. The Philippines, in more ways than one, has been a part of this process.

In this paper we try to situate the Philippines within the context of the global investment environment over the decade of the nineties. The argument that we attempt to pursue here is that in more recent times investment behavior in the Philippines can not be separated from the larger trade behavior despite the fact that investment may still have the vestiges of the country’s past behavior. Thus it is essential that the country’s environment is consistent with the global environment. Unfortunately, the country’s investment regime is not quite consistent with the dynamic changes taking place globally. In particular as the relationship between global trade and global investment becomes more complementary than in the past, the attainment of the country’s development objectives will be constrained. As investment behavior remains rooted in the past, it would be difficult for the country to move dynamically in a globalized world where barriers to trade are no longer the norm.

After tracing the changing relationship between trade and investment, the next section describes the international investment environment for the FDI into the Philippines. This has changed, in part, as a result of the recent crisis. The fourth section describes some of the emerging attempts to define new rules for FDI. One is regional, based on agreements with ASEAN members and on attempts in APEC to define FDI rules. The other is global, based on attempts to arrive at some multilateral understandings of how FDI will be treated. In the final section we try to operationally define some of the options for the Philippines in the context of its trade development plans and what kinds of policies may be useful to consider in the light of the changes shown in the previous sections.

In the past (especially in the immediate post-war years), the major sources of capital flows to developing countries have been development assistance resources from capital abundant countries and multilateral institutions. In addition many of the developing countries, including the Philippines, were pursuing development strategies based on import substitution. Trade was initially natural resource based and quite independent of foreign investment flows. Indeed whatever FDI that came in were actually trade-reducing in the sense that they were “jumping tariff” and other protective walls to produce import substitutes. Only when trade regimes became more liberal did FDI also become trade inducing. In the more recent period of the nineties and the advent of globalization trade and FDI have moved together in complementary and mutually reinforcing and interactive ways.
At the same time the character of international trade has changed towards more integration among spatially separate production units.

In an earlier paper we have shown that there has been an increasing relationship between exports and FDI in the nineties with the latter measured as the actual flows as recorded in the nation’s Balance of Payments (Alburo, 1998). Although this is more prevalent in some industries than in others (e.g., electronics and telecommunications), there is no doubt about the positive relationship.

There are at least three factors that have driven this relationship in the last few years. One is technology revolution that has changed in properties – shorter life cycle, emphasis on re-engineering and large investment outlays in its creation. And as its diffusion takes place and it becomes standardized, countries are quick to adopt it. Often for proprietary reasons technologies are carried as part of FDI. Thus FDI is gaining a more critical role as vehicles for the widespread use of the technology revolution in developing countries. The second is information revolution that has also changed in properties – real-time, universal and lower costs. This has reconfigured the nature of the firm, production, investment and organization. For example these factors are neutral (up to some limit) with respect to the size of the firm. Both small and large firms can capitalize on technology and information processes. The nature of inventory management has changed because of real-time information. Organizationally, this has allowed firms to increase efficiency through streamlining functions and staff work across a wider geographical base. Finally, the spate of liberalization drives and deregulation among developing countries and even in emerging markets is defining a different environment for international commercial transactions. Through lower if not zero tariff rates, phase out of non-tariff barriers, and elimination of administrative controls, foreign investors now find it easier to move goods across boundaries allowing for better management and marketing of goods. All of these factors contribute to increasing the importance of the trade-investment relationship. One can surmise that with both trade and investment liberalization there should be greater complementarity between them. There are however variances across industries and countries that it is unlikely that liberalization takes place in both trade and capital movements. Moreover as one country undertakes these measures to draw in FDI, other countries similarly follow but, unlike trade, often FDI is more limited and therefore competition is tight.

The converse is also true i.e., to the extent that there are impediments to trade they would also constitute impediments to investment. In certain sectors such as those that are vertically integrated, trade restrictions often impede FDI inflows since they inhibit the quick mobility of essential inputs and intermediate components to production processes located in the country. Similarly where there are investment restrictions in these sectors their trade potentials are not fully realized apart from the unrealized foreign investments. This is apart from the general constraints to FDI inflows such as notifications, screening, and other procedures which may be considered to be analogous to administrative hurdle traders go through to have goods released from government authorities.

We find that during the period 1992 through 1997 when we tested the relationship between exports and FDI, the correlation coefficient is 83.9 percent indicating a positive association.
as postulated. Yet when the FDI composition is broken down we find that there has been some shift in the location of investments away from the traditional manufacturing sector (which constitutes the larger portion of the country’s exports) towards the non-tradable sectors such as construction, and business and finance.

Figure 1 depicts the relationship between exports and FDI during the period and it clearly shows the positive association. This result however needs some qualifications. The period reflects a time when the Asian crisis was brewing and may have distorted the behavior. Yet this was also the time when FDI began to increase significantly and therefore can not be easily tested in the prior years. It would be ideal to use some sectoral data on FDI and exports to determine the degree of association between the two. This is not possible either since FDI information into specific manufacturing sectors that match the trade information is not available. But the direction is instructive and gives essence to the trade and investment nexus. It is possible to trace the magnitudes of FDI on the basis of approvals by the Board of Investments (BOI). However approvals do not automatically translate into actual foreign exchange inflows in the Balance of Payments sense. The matter of using approvals (appropriately adjusted to account for actual flows) to relate to exports would require difficult assumptions especially at the aggregate level of the data used in Figure 1. Besides, approvals do not seem to have a strong relationship to actual FDI flows.

Increasing both trade and FDI in a mutually reinforcing way would redound to a better achievement of the country’s development objectives. Given the positive relationship of the two in the Philippines in recent times an important direction would seem to be to define ways of further enhancing the entry of FDI especially in a post-crisis Philippines.

Among the elements that would impinge on a more synchronized trade and investment movements include the broad FDI environment in the country, the various responses of the country to the recent crisis in Asia, and the kinds of modalities of foreign investment that have appeared in recent times, to which we now turn.

2. ENVIRONMENT FOR FDI INTO THE PHILIPPINES

Foreign equity investments recorded in the Balance of Payments almost tripled between 1992 and 1994, and then went on to increase 1.45 times between 1994 and 1996 before falling slightly in 1997. This is a record increase from a low base although beginning in 1993 portfolio investments far outpaced FDI inflows. The increases in FDI were part of a larger expansion of FDI to other emerging markets and not really unique to the Philippines. In fact if we compare the FDI flows into the Philippines with the rest of the Asian countries, these are only small relative to those flowing into other countries.

Many if not most, developing countries make liberal use of fiscal and trade incentives, among others, in attracting FDI. During the period when the increases in FDI were taking place there were no major changes in the incentive system in the Philippines beyond those specified under existing rules (Omnibus Investment Code). Indeed incentives may not have been so critical to the FDI inflows. Moreover there now seems to be diminishing returns to incentives that host governments put up to attract FDI. As noted by UNCTAD, for
example, the room for greater investment liberalization measures gets less and less as these begin to have fewer impacts (UNCTAD, 1998). This means that host countries including the Philippines will shift policy attention from incentives per se towards more macro-economic issues that relate to foreign investments. This means the broad and general environment for foreign investors start to become more important to investing in the country including relevant infrastructures.

The Philippines is increasingly facing competition from other FDI hosts in the region including those from newly emerging markets. There is need for continuous adjustments as all countries simultaneously outcompete each other to attract limited FDI resources. With the limitations that now beset incentives (which tend to be matched by a second country each time one country enacts one), host countries will offer investment regimes that are dynamic and constantly moving (Chia and Freeman, 1999).

The Asian crisis however adds different dimensions to the environment for FDI into the Philippines and in the rest of the developing world especially Asia. First, despite the common assertion that the crisis had affected only portfolio capital and that FDI is immune from such short-term vagaries of capital movements, the fact is that FDI into Asia did fall in 1998 within one year of its outbreak. All the affected Asian countries suffered declines in FDI inflows. But when broken down into quarterly figures these declines occurred only in the first two to three quarters after July 1997. Thereafter FDI started to recover but not across all of the affected Asian countries. For example there was not just recovery of FDI to their previous levels in Korea and Thailand, but there were in fact some surges of capital inflows. In the case of Indonesia, Malayasia, and the Philippines the return of FDI was at least sluggish. It would appear that FDI was indirectly affected by the crisis through the drop in economic activity, which was perceived to take a longer time frame thus also affecting profit prospects for potential investment ventures. Strong commitment to reforms and early measures may have revived confidence thus returning the flows of FDI. In short, FDI into the region dropped from US $ 84 B in 1997 to US $ 78 B in 1998 principally caused by the drop in FDI into the affected countries (disinvestment in Indonesia by US $ 1.3 B). These flows are still large when compared to the average of FDI between 1991 and 1995 of US $ 44 B proving that the region's crisis had not really affected FDI in a disturbing manner as had been anticipated as the crisis worsened in the latter part of 1997.

Second, there is evidence of a shift in the natural sources of FDI into the region arising out of the crisis. The regional composition of FDI shows that the United States is becoming an increasingly important source of capital. In the aftermath of the crisis Europe has also been another alternative FDI source as Japan's inflows declined. Again this has not been across all of the affected countries. In the Philippines while indeed the share of the US to FDI rose after 1994, this was not sustained as the share dropped in 1996 without a clear trend during the crisis-post crisis period. This re-emergence of the US and Europe as significant FDI sources must be seen in the light of the importance of the newly industrializing economies (Hong Kong, Korea and Singapore) which for a decade before the crisis have been sources of foreign capital in the region. And many of the ASEAN nations are now also sources of FDI to each other and to the newer members of the Association.
FDI flows into the Philippines in the nineties have also seen a rise in Asian country sources. Of the top six sources of foreign equity capital in terms of actual inflows, three come from Asia - Hong Kong, Singapore and Taiwan. In terms of recorded approvals for foreign investments, Asia-minus-Japan constituted the third highest sources in the early nineties. Immediately after the crisis, the 1997 approved equity investments show that the Europe and US topped the sources as had been expected. Japan in fact fell to fourth place as source even behind the composite of other Asian nations reflecting also Japan's own problem apart from the Asian crisis (Alburo, 1998).

This change in the FDI environment resulting from the crisis was more advantageous to the Philippines than other ASEAN neighbors in the sense that the former was exposed to this mixture of sources. In the case especially of the new ASEAN members, which had relied on Asian and ASEAN sources for FDI, no other sources had come in after the slowdown in inflows from the affected countries.

Third, the crisis has led to some incremental liberalization of foreign investment regimes, which have implications for the larger behavior of FDI. Two measures were implemented among the affected countries. One was further opening of what were considered sensitive sectors of the economy such as telecommunications, public transport, other public utilities, public infrastructure, mining, oil, and energy. The entry of FDI into these sectors was often in tandem with privatization schemes employed although the crisis clearly helped this along. The other was the opening of what were once closed areas i.e., areas or sectors protected for local investors. For example this would include banking and finance, air transport, broadcast communications and other strategic industries. Because the Philippines was not directly affected by the crisis, its changes in regulatory framework were not as substantial as the other countries. There were amendments to The Investment House Act and the Financing Company Act meant to alter allowable foreign equity participation (increasing this up to 60 percent for both investment houses and finance and leasing companies). Nevertheless this small change and the measures mentioned above actually have more significant impact on the environment for FDI. For one it means that foreign investors would now see "green field" investments less attractive than before given the opening of areas where investors need less overhead, information, and start-up risks than into new ventures. For another, the incremental liberalization allowed additional incentives and more FDI within the same country. This implies that more FDI would flow into those countries, which have taken incremental liberalization than otherwise leaving less foreign capital for the Philippines.

Finally, the Asian crisis' effects on FDI environment in the Philippines can be seen in the rise of mergers and acquisitions (M & A) as a pervasive mode of capital flows into the affected countries. Indeed M & A activities in emerging markets rose 7.7-fold between 1991 and 1997 compared with a 4-fold increase in global M & A for the same period. Several reasons are behind this growth of M & A. First, the collapse of asset prices across the crisis-affected countries coupled with large depreciation of local currencies immediately granted low prices of these assets in terms of foreign currencies. Second, the lifting of many restrictions to foreign ownership in developing countries meant more avenues to purchase existing and established firms, distribution networks, and other similar domestic market access. Finally, with the softening of commodity prices, over-capacity in certain manufacturing industries,
and reduction of trade, the natural tendency was towards mergers and alliances among similar firms across competitive industries.

The UNCTAD database shows that between the period July 1997 and June 1998, the Philippines had only a recorded two M&A of which the mode was simply minority acquisition. Compare this with 11 in Korea, 4 in Malaysia, and 9 in Thailand most of which were full acquisition or joint ventures. The search for new efficiencies in production was apparent in the movement of FDI across the affected countries. A host country like the Philippines needs to be able to provide the framework (legal, financial) for the acceptability of M & A as a means for bringing in foreign capital. How much the country has done needs to be looked at relative to some world standards.

3. TOWARDS NEW RULES

What foreign investors look for in a country’s investment environment is a set of rules as well as incentives that dictate the behavior of foreign capital. To the extent that these rules vary across host countries foreign investors can direct their capital where maximum benefits are derived. Worse, they can pit one country against another in terms of the rules for foreign capital.

On the other hand, host governments try to bring in limited capital by altering their investment environment. This in turn triggers other (competing) host governments to change their rules as well. In the end what foreign investors look for are universal rules of investment that are subscribed by as many host countries as possible. These rules are often common across many countries and they are just codified for simplification. The underlying structure of an economy therefore becomes the basis for the real flows of foreign investments.

The Philippines has attempted to subscribe to as many of common rules for investment with other countries. This diminishes uncertainty and creates stable conditions for all investors local or foreign. The thrust of these rules is really to reduce inherent biases against foreign investors or to reduce protection given to local investors.

In Bilateral Investment Treaties (BITs) that the country enters into with some of her trading partners a number of environmental conditions are commonly specified (or there is reciprocity to the provisions that the Philippines may provide). In the BITs that the country has signed there is a most-favored nation clause which insures that there is no discrimination in the investment coming from one country as opposed to coming from another. The national treatment clause gives equal privileges and rights to the investors from the partner country as those given to domestic investors subject to existing constraints imposed by the constitution and relevant laws. Other particular clauses pertain to provisions for capital repatriation, full compensation in cases of expropriation, and certain incentives. Through these provisions, among others, the environment for FDI into the country is supposed to improve.

In an earlier paper we pointed out that the BITs the Philippines has entered into were not of significant consequence in terms of potential FDI neither inflows nor the magnitude of trade
to warrant associated investments. For one the countries with which these treaties were concluded were those the Philippines had small trade and investment links to begin with. For another there did not seem to be any evidence that FDI picked up after these BITs were concluded even after allowing for a gestation period. Finally while these treaties had ceremonial values what was crucial did they affect the set of principles, which guided the FDI flows and their applicability beyond the countries.

In this context two regional attempts at defining broad principles and rules for FDI flows where the Philippines has participated in are worth mentioning. The Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles was signed at the Ministers Meeting in Bogor, Indonesia in 1994 (APEC, 1994). The principles set out certain parameters deemed important to foreign investors, which the APEC economies mutually agreed to fulfill. These fell into several categories: transparency, non-discrimination, national treatment, investment incentives, performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes, and entry and sojourn of personnel. Despite the fact that these principles were non-binding, their agreement among a large number of economies suggests that these were important to the flows of FDI into the region. The wording of the principles still matter even if the intent is not obligatory on the part of member economies. And these can eventually be translated into more binding commitments.

Among the more notable (and universally important) principles are the most-favored nation clause (non-discrimination between source economies), national treatment, expropriation and compensation, repatriation and convertibility, and transparency. The more thorny issues of competing incentives systems among the countries are not included in the principles. Indeed the provision on incentives deals more on the avoidance of relaxing health, safety and environmental regulations as incentives for bringing in foreign investments than an explicit recognition of harmonizing them across economies that compete for the same capital. One of the principles tries to reduce the use of performance requirements, which distort the expansion of trade and investments.

The APEC principles recognize a need for more neutrality of the investment environment in the region. These principles are supposed to achieve greater harmonization of the differing conditions in each of the APEC member economies. The existence and recognition of domestic laws, regulations and policies constrain the achievement of a more comparable environment.

The second regional effort to harmonize foreign direct investment environment is the ASEAN Investment Area (AIA). The Framework Agreement formally adopts the ASEAN region as an investment area from where a common environment is to be created. There are several aspects of the AIA that deserve attention. First, many of the Agreement’s provisions

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3 The Framework Agreement on the ASEAN Investment Area (AIA) was signed in 1998 along with three schedules (Co-operation and Facilitation Programme, Promotion and Awareness Programme, and Liberalization Programme).
are similar to the non-binding principles adopted by APEC - most-favored nation, national treatment, transparency etc. Absent from the AIA however is the principle of minimizing performance requirements tied with FDI. Absent from both is any reference to the proliferation of various fiscal incentives to draw in FDI and how this might be addressed. Second, the AIA postulates that all industries be opened to FDI immediately but subject to a negative list composed of sensitive industries and industries that are temporarily excluded (both lists to be submitted by member countries). The essence of the Agreement is to phase out the temporary exclusion list (TEL) according to some timetable (the original ASEAN-6 by 2010, Vietnam by 2013, Lao PDR and Myanmar by 2015). To the extent that the sensitive list is short and the TEL completely phased out, then the AIA would be liberalizing the FDI environment. Third, the Agreement covers collective and individual programs that effectively make all ASEAN countries as one investment area through common databases, joint investment promotion activities, exchanges of lists of promoted sectors/industries, etc. Finally, the AIA itself has been accompanied by other measures that also encourages investors i.e., the “bold measures” agreed upon by ASEAN Leaders at the Sixth Summit in Hanoi in December 1998 (which include three year corporate income tax exemption or minimum 30 percent corporate investment tax allowance, 100 percent foreign equity ownership, duty-free imports of capital goods, domestic market access, minimum industrial and leasehold period of 30 years, employment of foreign personnel, and speedy customs clearance). These cover applications received and approved by ASEAN investment agencies in 1999 and 2000.

Beyond the Asian region have been proposals for a global set of rules for foreign investments. The original attempts at forging a Multilateral Agreement on Investments (MAI) led by the Organization for Economic Cooperation and Development (OECD) countries is one. Although this fell apart for lack of consensus among the OECD countries it would be instructive to note some of the nuances of its provisions. For one the coverage of investments in the MAI is broader including all kinds of capital transactions across borders. This is unlike the AIA where the rules cover only portfolio investments. What are common are the usual provisions on transparency, most-favored nation, national treatment and others. What is unique in the MAI is an explicit attempt at defining rules on investment incentives which is not found in any of the other attempts at investment framework regionally or through BITs. For another the MAI also allows exceptions to FDI according to sectors as defined by the contracting party similar to the sensitive list in AIA. This list is integral to the agreement. Finally the MAI allows for more firm rights where it is possible for investors to call a host country for arbitration and departs from the usual ‘state-to-state’ resolution. This is a clear recognition of growing role of multinational corporations in cross-border trade and investment.

There are other regional and global rules on investment, actual or proposed, which are beyond the scope of this paper. Among these are the North America Free Trade Area (NAFTA) provisions on investments and the evolving investment negotiations in the Free

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Trade of the Americas Agreement (FTAA) which also specify principles and disciplines on foreign investments.

Whether in fact there will be a General Agreement on Investments (GAI) similar to the General Agreement on Trade in Services (GATS) in the realm of the WTO remains to be seen. Such a GAI would presumably cover provisions found in other agreements that the Philippines subscribes or has acceded. A GAI would effectively re-define the global environment for FDI including the basis for capital flows into the country (Bora and Urata, 1999). Table 1 summarizes the comparative picture of four different streams on rules on foreign investments that influence the direction of investment policies in the Philippines. With the exception of incentives (which are only tackled in the MAI) most of the provisions are common across different modes of proposed or actual investment rules.

One of the more contentious issues, and which would influence the possibility of a GAI is the agreement on Trade Related Investment Measures (TRIMS). This was implemented in 1995 with a review in 2000 i.e. a phase out of notified measures. The review would presumably touch on a time extension to the phase out, the list of measures that distort trade and the rationale for the phase out itself given the perceived need for these measures among developing countries. Although TRIMS may not have a direct bearing on new rules on investment, the continued use of trade related investment measures as a policy tool constrains efforts to forge a multilateral framework on investments. Indeed the TRIMs itself provides for exploring the use of investment and competition policies as a complement.

By subscribing to new rules on investments that are uniformly adopted by all host countries the Philippines would be reassured that foreign capital flows would only be concerned with real productivity differences and not with combinations of incentives, tax holidays, and other measures that would be distortionary. In effect the economic environment for these flows would somehow be comparable. The absence of these rules however regionally and globally indicates that the country may still have to rely on other environmental factors to attract FDI. The Philippines still has to compete with other countries in the region and in the rest of the world to bring in foreign capital. Thus both industrial and trade policies are crucial to identifying the manner in which investments would be forthcoming.

4. OPTIONS FOR THE PHILIPPINES

The lack of global rules and multilateral framework on investments imply that the Philippines can fashion a unilateral policy on foreign investments. There are of course trade-offs to a single policy direction since foreign capital freely moves across countries in response to differing policies. This means that, while the Philippines can design its own investment environment, it would also be dependent on what other countries do to their own investment environments and so on interactively into a possible retaliatory behavior.

Beyond the investment environment that the country can design are the actual locations for investments. Through profiling, analysis of the markets and resources, some identification of potential products and industries can be undertaken. A next step would then be to influence policy and other measures so that investments (domestic and foreign)
flow into these directions. Although these identified products or industries do not substitute for the kind of market scan that investors actually carry out they provide an initial filter for associated package of incentives provided.

The Philippine Export Development Plan (PEDP) for 1999-2001 (PEDP, 1999) uses clustering for determining the location of industries and products around the country. The clustering considers materials, labor, technology and physical factors in locating and prioritizing products and industries. Four cluster groups have been identified in the PEDP. A first is factor-driven industries with a traditional resource base, high labor intensity with relatively semi-skilled to highly-skilled workers, existing technology base, and stable or growing markets. Second are investment-driven industries utilizing second-wave technologies, medium to high labor intensity with relatively semi-skilled to skilled workers, and stable or growing markets. Third are innovation-driven industries that utilize knowledge-intensive technologies, high capital intensity, highly skilled labor, and growing to new/emerging markets. Finally there is a trend/opportunity-driven industries which emerge following a trend and for which tremendous world demand is present.

What is important to point out in this clustering of industries is the identification of location by different regions of the country. By recognizing the industrial potentials of the regions the PEDP also recognizes the need for investment resources into them at different places in the country. Implicit in this method then is really an industrial policy pronouncement.

Some 30-priority industries have been identified in the PEDP and considered their location from among the 16 regions in the country (12 regions, the National Capital Region, Cordillera Autonomous Region, CARAGA, and the Autonomous Region of Muslim Mindanao). Table 2 lists the number of industries by region bearing in mind that some industries have location advantages in more than one region. Notice the wide range of industry location from 1 in one region to 9 in the National Capital Region. When one aggregates these by major islands, Mindanao would be location for 25 industries with Luzon getting 21 industries and Visayas 19 industries. The industries that compose Table 2 do not include the so-called innovation-driven industries or trend/opportunity driven industries.

The use of clustering to direct potential investments also creates a more efficient basis for the provision of public infrastructures and private capacities. Thus it is possible that clusters of industries have common procurement systems, common financing facilities, common quality control systems, common training facilities, joint promotion and marketing arrangements. Many of these need not be provided by the government and can indeed be sourced through private capital and joint ventures as long as the scale economies are sufficiently large. Domestic and foreign investors can then be attracted to examine these prospects. Based on the classification of industries, however, it appears that the first group of industries (factor-driven) still dominate the clustering while in the third group (innovation-driven industries) only one region has been identified as having an advantage in their production. This limits the possible modes of FDI in the context of the speed of globalized industries.
Nevertheless this does not mean that there are no options for the Philippines in the domestic front for investments or in the global environment for foreign capital. The clustering suggests a number of domestic options for the country and a few directions as to how the country may position itself in the global search for multilateral investment framework.

First, the explicit use of the structure and characteristics of the different regions of the country as basis for the clustering shifts some of the emphasis on investment promotion, provision of incentives, and infrastructure from the national and central government to the local government levels. The shift means that local governments have to design a wide range of policies and programs that would draw in investments into the defined industries for those regions. The shift means that local governments can formulate incentive schemes for attracting both domestic and foreign investments along local government codes (independent of or in addition to national fiscal incentives). Invariably this will entail more non-fiscal incentives that local officials have more control and power. This shift means that local governments can identify more infrastructures that support investments and industrial production according to the plan.

Second, the clustering not only identifies where industries can potentially be located but it also leaves room for the evolution of other industries as capacities are acquired. For example, the PEDP identifies only Region 10 as where cutflowers industry can be located. Yet this ignores the fact that Region 7 is also a major source of this product not only for domestic demand but for exports as well. Indeed it is not difficult to imagine that as materials based production processes decline in importance and knowledge-based production emerges, regional characteristics become a poor predictor of industrial clustering. The point is that public infrastructure and other social and economic overhead capital may be more neutral in the evolution of industrial activities in the country. The evolution itself may emanate from two sources. One is from below i.e., domestic sources such as income expansion, vertical and horizontal interchanges among regions (and firms within regions), and indirect sources (e.g., multiplier effects from remittances from abroad). The other is external i.e., global demand and international transactions. The former seems less difficult to manage being a natural result of internal growth where industries need no special incentives to proliferate and investments respond to latent market signals. The latter is not readily natural since global demands need to be attracted and institutional arrangements made up to influence investments into industries whose markets lie elsewhere and beyond domestic borders. The PEDP therefore puts more discretion on the part of local governments to lay down alternative ways to bring in capital for industrial development. By focusing policy instruments on regional locations as direct investment recipients a new context has been drawn up. Though national policies will remain important there is now a conscious effort to encourage local policies not only to supplement but become a primary drawer of resources.

Finally, and related to the previous points, the country can become part of a global production system through various modalities that are defined in these clusterings and thus

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5 In some cases incentives are actually accorded domestic investments. But this is probably less compelling as domestic industries evolve than foreign investments.
through various nodes of location. Japanese global networks on electronics connect directly with Region 4 as identified in the clusterings. American and European production systems on oleochemicals interact with Region 10. More important is the converse to these. The regions can directly seek out these networks and global production systems and rely less on national directives and initiatives. What is now crucial to all of these is the capacity among local governments to map out policy strategies and investment packages that influence capital resources.

The reconfiguration of the trade, investment and industrial policy regimes reflected in the clustering approach gives a twist to the possible positions that the country may want to take in global or regional rules on investments. For one, it may be useful and important to have the flexibility to subject foreign investments to some conditions in exchange for fiscal and non-fiscal incentives. This means that the country may not want to agree to a phase out of trade-related investment measures. With the increasing role of local governments in bringing in capital it may be too early to remove these measures. Fortunately the AIA does not have any of these TRIMS that may require the Philippines to remove after a specified period of time. The AIA itself, while incorporating a liberalization program (i.e., reduction and elimination of restrictive investment measures), does not really deal with purely performance-related investments. Both the MAl and the APEC Non-Binding Investment Principles provide for the minimization of performance requirements as conditions for investments. But the former is now irrelevant while the latter remains non-binding among APEC economies.

For another, there are likely to be more investment incentives that would be proposed in the light of the clustering of industries according to the PEDP. This would not be of particular interest nationally (as their revenue implications restrain more incentives) but at the local levels where capital is scarce and the inducement to offer incentives would be stronger. Regional and global proposals for moratorium on incentives or some rules and disciplines for them would therefore not be appropriate given this setting for investment incentives. Without a concomitant understanding of what unilateral incentives imply for capital flows local governments will likely oppose a Philippine position to reduce or eliminate incentives as part of the country’s investment environment. Indeed there is no likelihood now than before that multilateral rules on investment eliminating incentives would pass up as a government policy. It is of course true that there is less discretion on the part of local officials to give fiscal benefits greater than that of the national level. But as long as the perception is there and that there are significant revenue attractions local governments can provide, the country’s position in the international milieu will be constrained.

In summary, the country is not expected to agree to a global investment environment that removes its ability to direct capital into industries it may deem important to its development. It is also unlikely to agree to eliminate performance measures as condition for investment flows. This does not mean that the Philippines would not subscribe to a position that expands its environment for capital resources more globally. Thus it agrees to more transparency, non-discrimination and other usual provisions for as long as the important parts of incentives, performance requirements, and industrial planning remain part of its policy arsenal.
5. **A CONCLUDING NOTE**

A global investment environment that "levels the playing field" would probably be one in which countries agree not to institute fiscal and non-fiscal measures that unduly influence the movement of capital. This is aside from the usual principles of national treatment, non-discrimination, and protection against expropriation, dispute settlement and many others. The Philippines has expressed subscription to this kind of environment through its own Bilateral Investment Treaties (BITs), in the emergence of investment principles in APEC, in the recently concluded ASEAN Investment Area Agreement, and in the WTO negotiations involving TRIMS and in the Multilateral Agreement on Investment (MAI). These take on importance since trade and investment are closely related, and the extent to which investment is open is also the extent to which trade might be enhanced. The recent fiscal crisis in Asia has also altered in significant ways the environment for FDI into the country.

But what drives investment environment in the coming years is perhaps the growing policy importance of local governments in industrial development. It seems clear that while there will be agreement to many of investment principles, it is not likely that performance requirements or incentives would be given up for global rules. Thus the various BITs and the AIA do not provide for these contentious items. In the end, despite evidence to the contrary the Philippines will continue to use "home-grown" discretionary policies to alter its investment environment in attracting FDI knowing fully well that similar measures will be taken by competing neighbors.
Table 1
Rules on Investments

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<th>AIA</th>
<th>MAI</th>
<th>BIT</th>
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Source: See Text
APEC: Asia-Pacific Economic Cooperation Non-Binding Investment Principles
AIA: ASEAN Investment Area
MAI: Multilateral Agreement on Investment
BIT: Bilateral Investment Treaty
### Table 2

**Number of Industries (By Region)**

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<td>National Capital Region</td>
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<td>Cordillera Administrative Region</td>
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<tr>
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<td>1</td>
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<td>2</td>
</tr>
<tr>
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<td>3</td>
</tr>
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<td>CARAGA</td>
<td>5</td>
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<td>Autonomous Region of Muslim Mindanao</td>
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Source: *Philippine Export Development Plan 1999-2001*

**Memo Item:**

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<th>Group</th>
<th>Number of Regions</th>
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<td>Group 3 Industries</td>
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Figure 1
Exports and FDI Flows

- Exports
- FDI flows (BSP)

Year

Million US Dollars (FDI)
0 200 400 600 800 1000 1200

Billions US Dollars (Exports)
0 5 10 15 20 25 30

1400

REFERENCES


REFERENCES


One is hard put in identifying studies which claim cause on overall fundamentals of the affected countries. What one finds is rather attribution to weaknesses in the financial systems. See Glick however for some classification of these schools.

An immediate assertion that lack of governance, corruption, and less-than-arms-length relationships between creditors and debtors can be traced to multilateral institutions (e.g., IMF, World Bank) and some of the bilateral governments (e.g., the United States).

The information in Table 1 is the quarterly average of FDI flows. Obviously quarterly data exhibit more fluctuations than annual values. Because of the limited period of the crisis we have used quarterly data for the purpose of more formal technical analysis.

This is apart from the reported increases in M&As between the beginning of 1998 and the first quarter of 1999. See Section 5 below.

For a quarterly tracking of the currency depreciation and appreciation for four of the five countries in this paper see Nomura, 1998.

In a brief comparison of the movement of quarterly GDP between the two countries, The Economist (1999) dubbed Korea “the Lazarus of the East.”

Since the multiple regression analysis was in logarithms, the coefficients reflect the elasticities of the variables and comparable. The effective protection rate had the highest significant coefficient.

Many of the specific measures described in the rest of the section are derived from the World Investment Report (UNCTAD, 1998), Annex Table A.VII.6.