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## Investment Regulation through Trade Agreements: Lessons from Asia

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## Investment Regulation through Trade Agreements: Lessons from Asia

By

Pierre Sauvé\*

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\*Pierre Sauvé, World Trade Institute, Berne, Switzerland is ARTNeT Advisor on Investment. This article draws on research commissioned by the Swiss Secretariat of Economic Affairs (SECO) that the author is currently pursuing in association with a team of policy analysts based at the London School of Economics and Political Science (LSE) in London, U.K., and the Peterson Institute for International Economics, in Washington, D.C. Thanks in particular are due to Lauge Skovgaard Poulsen from the LSE for the excellence of his background research and for producing the information synthesized in tables 3 to 8.

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## *Introduction*

Developing countries in Asia have a large stake in maintaining an open global system of trade and investment. The integration of the region into the world economy has been driven largely by market forces, particularly by private foreign direct investment and the related rise of intra-industry trade. When assessing the growth of Asia's trade and the respective roles of policy, technology and markets in influencing patterns of regional integration, a key conclusion that emerges is that technological change, markets and the private sector, particularly multinational firms and FDI, have been crucial in deepening integration. To date, empirical studies suggest that bilateral and regional trade and investment agreements have had only a limited impact on Asia's integration process, the most significant liberalization efforts having been unilateral in character.

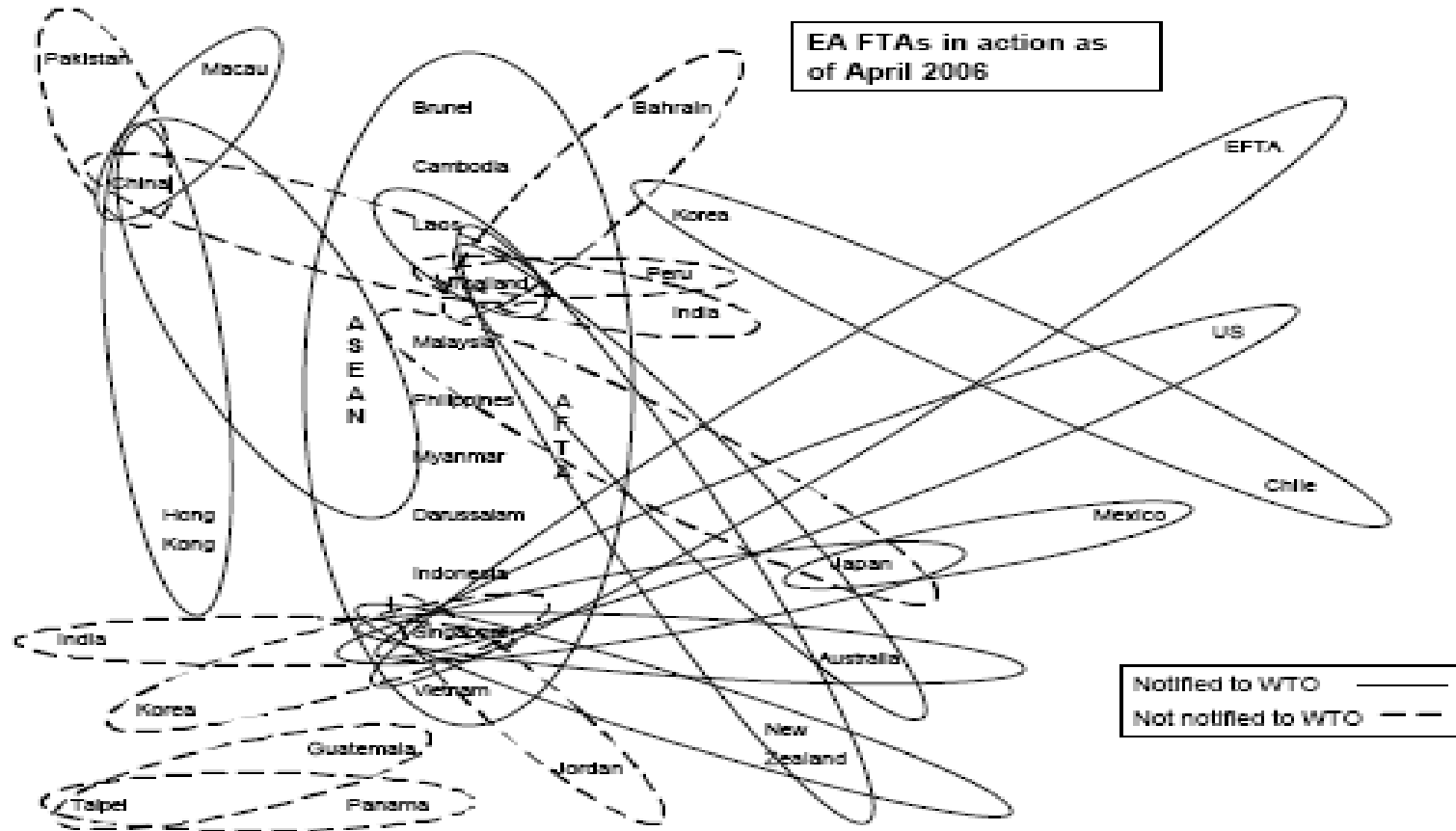
Increasing trade integration within East and South- East Asia has been closely associated with changes in industrial organization and the spread of international production sharing, or the fragmentation of vertically integrated supply chains. The attractiveness of East and South- East Asia as production and investment locations has been enhanced by a variety of measures that reduce the friction and cost of trade, such as investment in ports and other infrastructure, the establishment of special economic zones and bonded industrial warehouses and duty drawback schemes. These arrangements have allowed investors to take advantage of economies of scale and specialization.

There are, however, unmistakable signs that the dynamics of Asian integration are changing, not least because of the protracted difficulties encountered in multilateral trade negotiations and the concomitant shift towards greater reliance on preferential routes to trade and investment integration, but also in the light of the emergence of, and competitive threats and opportunities from, China and India as regional giants.

Countries in Asia and in other regions are increasingly experimenting with preferential trade and investment agreements, most often on a bilateral basis. Such a trend is currently on a strong upswing throughout Asia and increasingly spans several regions. Indeed, Asia's "noodle bowl" of overlapping trade agreements is not only expanding, but is increasingly involved with complex agreements in other parts of the world (see figure 1 and table 1). Such cross-regional agreements are driven by a variety of concerns such as energy security, access to minerals and other natural resources. They may also represent efforts by

Asian countries to "lock in" reforms by making them part of formal trade and investment treaties with a major developed country or region. Many such agreements are also motivated by political considerations, as countries seek to cement diplomatic alliances by providing economic benefits to partners.

Figure 1. On the rise: preferential trade agreements in Asia, April 2006



Source: Nicolas 2006.

**Table 1. A typology of Asian preferential trade agreements**

Bilateral		Regional/Plurilateral	
Exclusively East Asian	Geographically diverse	Exclusively East Asian	Geographically diverse
<p>Japan-Singapore (2002)</p> <p>Japan-Malaysia (2005)</p> <p>Japan-Philippines (2006)</p> <p>Japan-Brunei Darussalam (2007)</p> <p><i>Japan-Indonesia</i></p> <p><i>Japan-Republic of Korea</i></p> <p><i>Japan-Thailand</i></p> <p><i>Japan-Viet Nam</i></p> <p>Republic of Korea-Singapore (2006)</p> <p>Malaysia-Republic of Korea (2005)</p> <p>Thailand-China (2003)</p> <p>Thailand-Lao People's Democratic Republic (2001)</p> <p>China-Hong Kong, China (2004)</p> <p>China-Macao (2004)</p>	<p>China-Pakistan (2005)</p> <p>China-Chile (2006)</p> <p><i>China-Australia</i></p> <p><i>China-New Zealand</i></p> <p><i>Indonesia-Australia</i></p> <p>Japan-Mexico (2005)</p> <p>Republic of Korea-Chile (2004)</p> <p>Republic of Korea-United States (2007)</p> <p><i>Japan-Australia</i></p> <p><i>Japan-India</i></p> <p><i>Republic of Korea-Mexico</i></p> <p><i>Republic of Korea-Canada</i></p> <p><i>Malaysia-Australia</i></p> <p><i>Malaysia-New Zealand</i></p> <p><i>Malaysia-Pakistan</i></p> <p><i>Malaysia-United States</i></p> <p>Singapore-New Zealand (2001)</p> <p>Singapore-Australia(2003)</p> <p>Singapore-United States (2004)</p> <p>Singapore-Jordan (2004)</p> <p>Singapore-India (2005)</p> <p><i>Singapore-Bahrain</i></p> <p><i>Singapore-Canada</i></p> <p><i>Singapore-The United Arab Emirates</i></p> <p><i>Singapore-Egypt</i></p> <p>Singapore-Kuwait</p> <p><i>Singapore-Mexico</i></p> <p><i>Singapore-Pakistan</i></p>	<p>ASEAN Free Trade Area (1992)</p> <p>China-ASEAN [(2004 (goods) and 2006 (services))]</p> <p>Republic of Korea-ASEAN (2006)</p> <p><i>Japan-ASEAN</i></p>	<p>Asia-Pacific Economic Relation Cooperation (1989)</p> <p>Singapore-European Free trade Association (2003)</p> <p>Republic of Korea- European Free trade Association (2005)</p> <p><i>Thailand- European Free trade Association</i></p> <p><i>ASEAN-India</i></p> <p><i>China- Gulf Cooperation Council</i></p> <p><i>China-Southern Africa Customs Union</i></p> <p>Trans-Pacific (Singapore, Brunei Darussalam, New Zealand, Chile) (2005)</p> <p><i>European Union-ASEAN</i></p> <p><i>European Union-India</i></p> <p><i>European Union-Republic of Korea</i></p>

	<p>Singapore-Panama (2006)</p> <p><i>Singapore-Peru</i></p> <p><i>Singapore-Qatar</i></p> <p><i>Singapore-Sri Lanka</i></p> <p>Thailand-India (2003)</p> <p>Thailand-New Zealand (2005)</p> <p>Thailand-Australia (2005)</p> <p>Thailand-Bahrain (2002)</p> <p>Thailand-Peru (2005)</p> <p><i>Thailand-United States</i></p>		
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*Source:* Nicolas (2006); updated by the author.

Note: Entries in italics refer to agreements under negotiation.



As Asia's preferential trade and investment agreements are still for the most part at an early stage, it is difficult to assess their effects empirically and assign structural influences to their core provisions. Yet as they are implemented, such agreements will begin to have an impact on both regional and global trade and investment flows. Accordingly, it is important that preferential trade and investment liberalization be conducted in such a way that it supports, rather than contradicts, the openness that has so far been a defining characteristic of Asia's trade expansion and its integration into world markets.

This article takes stock of recent trends in the investment dimensions of deepening economic integration in Asia. It first explores the forces underlying the recent trend towards regional integration in Asia, in particular the distinction between *de facto* (driven by markets) and *de jure* (driven by formal institutional arrangements) forms of integration. The article then reviews the salient features of attempts to liberalize investment in Asia, focusing on the process of investment liberalization conducted among ASEAN countries through the Asian Investment Agreement (AIA) and between individual ASEAN countries and a set of key third country partners in Asia. Further, it draws on a sample of 19 key preferential trade agreements that demonstrate various degrees of comprehensiveness governing the protection and liberalization of cross-border investment activity.

The article concludes by assessing the possible effects of the recent shift towards *de jure* or treaty-driven forms of investment liberalization and rule-making, offering insights notably on the implications of ongoing trends for third-country investors and service providers operating in the region.

## A. Understanding the rise of Asian regionalism

A major transformation in the global governance of cross-border trade and investment activity has occurred since 1995. The first major development was the creation of the World Trade Organization (WTO), the global institution governing the conduct of international trade, in 1995. Rules contained in the Marrakesh Agreement establishing the WTO<sup>1</sup> feature

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<sup>1</sup> See large instruments embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, done at Marrakesh on 15 April 1994 (GATT Secretariat publication. Sales No. GATT/1994-7/

the most ambitious and comprehensive multilateral provisions ever ratified. Somewhat paradoxically, the second major development in international trade relationships during the same period has been the proliferation of bilateral, regional and other preferential trade agreements among nations. As the Doha Development Agenda (DDA)<sup>2</sup> of WTO continues to sputter, it is likely that recourse to preferential trade and investment liberalization will proliferate further in coming years. Such developments are forcing many WTO member states to review and reassess their trade policy strategies and priorities.

The creation of preferential trade agreements (PTAs) is by no means new. However, as figure 2 below shows vividly, the sheer number and the speed with which such agreements have been negotiated since 1995 are simply astonishing. All but one WTO member – Mongolia – today conduct some measure of their trade relations on a preferential basis under one or more PTAs, and it is estimated that more than half of world trade activity today is governed by preferential rules. This section analyzes the recent history, characteristics and political economy of regional and bilateral trade integration from the viewpoint of two core concepts: integration of markets vs. integration by agreements, with a particular focus on Asia.

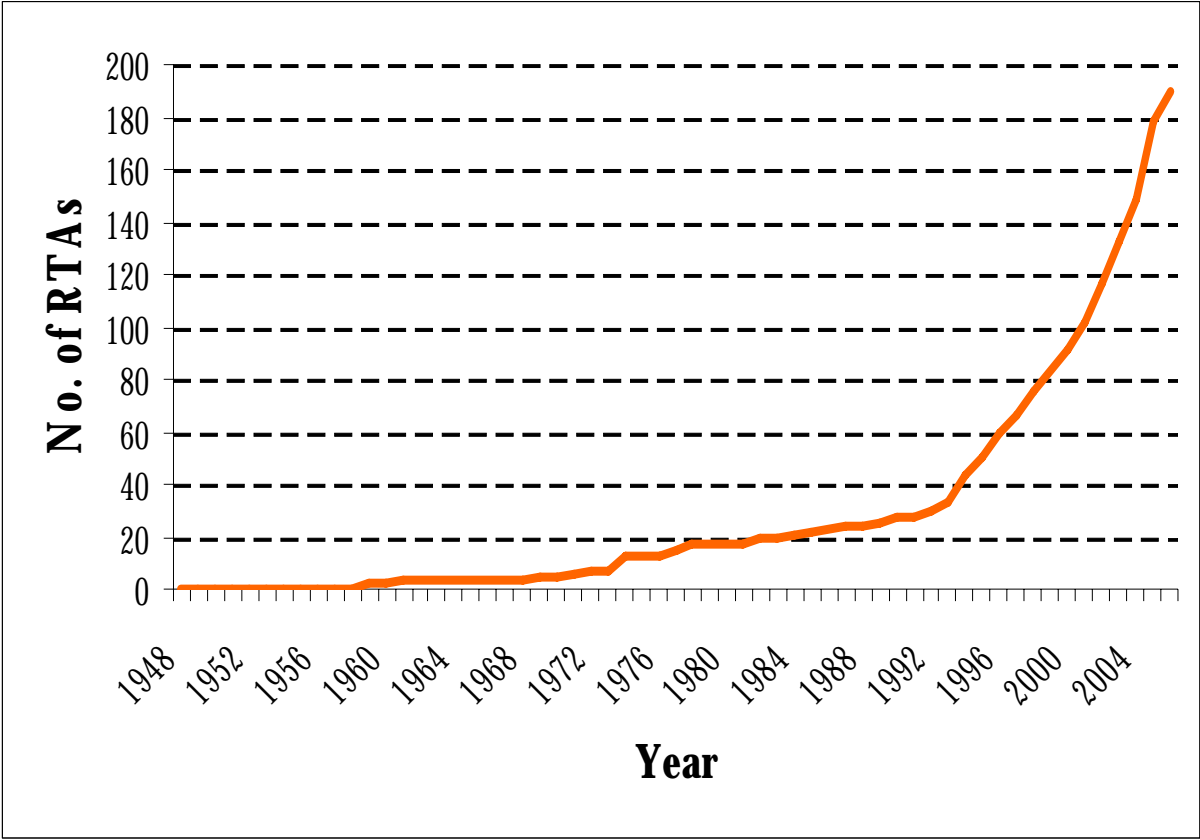
As its name suggests, the concept of integration of markets focuses on the idea that economies can integrate among themselves by relying primarily on the forces of the marketplace, i.e. by allowing the private sector to be the vanguard of trade and investment integration. This has at times been dubbed *de facto* integration. The second core concept is integration by agreements, which focuses on trade integration centered on recourse to *de jure* trade and investment treaties. This channel of integration emphasizes the primacy of legal instruments to further economic integration among countries.

There is little doubt that the two channels of integration are closely related and ultimately complementary in nature. The integration of markets without formal trade and investment agreements can create uncertainty for businesses inasmuch as the institutional foundations of an integrating area may not be sufficiently clear, transparent or predictable. At the same time, *de jure* integration can be meaningless if the underlying economic forces are not favourable towards integration, as the early experiences at trade integration in Africa and Latin America in the 1960s and 1970s have so clearly revealed.

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<sup>2</sup> See A/C.2/59/3, annex.

**Figure 2. Evolution in the number of multilaterally - notified preferential trade agreements, 1948-2006**



*Source: World Trade Organization, (2007).*

In today’s globalizing environment characterized by deeper forms of integration among nations and the operation of regional and global innovation and production networks, the question arises as to the better means of integration in driving trade integration. Is there a logical sequence for policymakers to consider when examining these two channels of integration? Given that East and South-East Asia and Latin America are fertile regions in which various types of PTAs have proliferated in recent years, it is useful to review the experiences of these two regions in addressing these questions.

Asia has lagged behind Latin America in concluding formal trade agreements because key trading powers in the region, such as Japan, the Republic of Korea; Singapore; and Hong Kong, China, had traditionally been more supportive of an open multilateral system, while China and Taiwan Province of China only recently joined the WTO.

The process of regional integration in Asia can be regarded as *de facto* in character even though by the end of 1990s most countries in the region had shown considerably greater interest in *de jure* forms of regionalism. The recent momentum towards formal (*de jure*) regional integration has been accompanied by a proliferation of bilateral PTAs not only within Asia but also with extra-regional countries, in particular with Latin America.

After a first wave of largely failed attempts to promote treaty-based forms of regional integration in the 1960s and 1970s, Latin American countries renewed *de jure* integration efforts in the early 1990s, with two agreements – namely the 1994 North American Free Trade Agreement (NAFTA, linking Canada, Mexico and the United States, itself an extension of the 1988 Canada-United States Free Trade Agreement) and the 1995 Common Market of the South (MERCOSUR),<sup>3</sup> linking Argentina, Brazil, Paraguay and Uruguay, setting a process in motion that would witness the emergence of a large and growing number of bilateral and regional PTAs among Latin American countries and with extra-regional countries by the end of the 1990s.

It is noteworthy that, given the different models of regional integration that have predominated in the two regions, intraregional trade in Latin America remains considerably lower, at around 25 per cent, of that observed in East Asia, despite Latin America's putative first mover advantage in *de jure* integration (see table 2).

**Table 2. East Asian and Latin American intraregional trade, various years**

<b>Year</b>	<b>Share of intraregional East Asian exports in total East Asian exports</b>	<b>Share of intraregional Latin American exports in total Latin American exports</b>
<b>1985</b>	34.1	10.0
<b>1990</b>	39.7	10.9
<b>1995</b>	48.1	17.2
<b>2000</b>	46.4	13.1
<b>2006</b>	51.7	13.1

Source: United Nations Commodity Trade Statistics Database, various years.

<sup>3</sup> MERCOSUR was created by the signing of the Treat of Asuncion in 1991, and the transition phase to implement the common market was to begin in 1995.

The (timid) starting point of Asian de jure integration came with the ASEAN Free Trade Area (AFTA) initiated by the member countries of the Association of Southeast Asian Nations (ASEAN) in 1992. This process had been preceded by the launch in 1989 of the Asia-Pacific Economic Cooperation forum (APEC) (Petri, 2006). Although APEC is not a formal regional trade agreement, it provides a rather unique institutional setting – a best practice club of sorts – aimed at promoting trade and investment liberalization, economic and technical cooperation and regulatory convergence on a voluntary basis among its 21 member economies. While APEC is not a PTA in legal terms, it features a roadmap, known as the Bogor Goals, to achieve free trade and investment in the region by 2010 for its developed country members and by 2020 for its developing country members.<sup>4</sup>

The recent surge in Asian PTA negotiations can be seen as the region's response to a number of important factors. First, the halting pace of multilateral negotiations at WTO, combined with the success of deeper integration initiatives within the European Union and NAFTA, have raised interest in the efforts at closer economic integration with “like-minded” countries, including in the neighborhood (Bergsten, 1997). The most recent generation of PTAs typically covers a number of policy areas that go well beyond existing multilateral disciplines and offer deeper market access commitments (OECD, 2007). This includes “behind the border” subjects such as services, investment and competition policy that can lower service link costs between production networks, thereby enhancing export competitiveness in countries reliant on export-led growth models of development (Kimura and Ando, 2005; Thorbecke and Yoshitomi, 2006).

A second main reason behind the rising interest in institutionalized integration in related to the much keener sense of Asian interdependence that took root in the aftermath of the Asian financial crisis of 1997-1998 which, combined with the “benign neglect” of

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<sup>4</sup> At Osaka in November 1995, an agreement was reached on a set of fundamental principles to bring about the liberalization of trade and investment among APEC member economies. If the Bogor Goals are realized and the commitments of the 21 member economies are fully implemented, APEC countries could enjoy a substantial improvement in aggregate welfare through free trade and investment opportunities in the region, without however having entered into formal treaty arrangements. APEC adopted “open regionalism” as its underlying paradigm with the intention of sharing the benefits of free trade with non-members and thus trying to comply with the most favoured nation (MFN) principle of the WTO. The work of APEC in trade and investment liberalization has not however achieved the hoped-for success so far. However, this need not necessarily be viewed as a failure of “open regionalism”, but rather the result of the broadening of APEC's agenda, which now includes such topics as security, trade facilitation and best practices in regulatory reform.

multilateral financial institutions such as IMF, resulted in increased support for heightened regional coordination and integration (Van Hoa, 2002; Nicolas, 2007).

Before 1997 most economists considered economic cooperation in Asia (through trade and investment) as an example of a successful de facto regionalism, i.e., explained by the predominant interplay of market forces. However, the financial crisis of 1997-1998 revealed the weaknesses of informal regional cooperation arrangements. The financial crisis and its subsequent contagion to a number of economies in East and South-east Asia painfully demonstrated that the East Asian economies were closely intertwined and that a resolution of the crisis called for heightened regional cooperation in the trade and financial fields.

A rising sense of Asian identity emerged in the aftermath of the crisis. After the proposal to create an Asian monetary fund failed to materialize because of objections from the United States, ASEAN leaders responded by inviting China, Japan and the Republic of Korea to join a cooperative framework known as “ASEAN+3”, in an effort to achieve greater economic cooperation in the region. The ASEAN+3 summit in November 1999 produced the “Joint Statement on East Asian Cooperation” which covered a wide range of areas for regional cooperation. In the early 2000s, other new economic situations-such as the quick recovery and recurring growth in Republic of Korea, the emergence of China as an economic superpower and the continued stagnant state of the Japanese economy – provided fresh impetus to new forms of Asian economic regionalism, including PTAs.

Although the financial crisis might have been the direct cause, a number of additional factors have contributed to the breakthrough and proliferation of the policy-led regionalism in Asia. First, regionalism was the natural result of decades of fast growth and the industrial transformations and economic restructuring that came in its wake. In a very tangible manner, de facto regionalism has paved the way and greatly facilitated the region’s subsequent quest for de jure integration. The developments depicted above have created a new centre of East Asian economic activity that has begun to pose a genuine competitive challenge to North America and Europe in terms of its contribution to world output, trade and FDI. This is so even as two-way trade and FDI linkages between Asia and both regions have deepened.

A third factor encouraging the trend towards de jure integration in Asia is also closely connected to the fallout from the financial crisis, and is linked to region-wide perceptions of

“benign neglect” on the part of international financial institutions, particularly IMF, in the aftermath of the Asian crisis. Asian policymakers perceived that major international institutions and the main global trading powers, particularly the United States, fell short in their support for the region on the path to deepened cooperation, particularly in the monetary and financial fields.

A final impulse is more inherently defensive in nature, owing to rising concerns throughout Asia over the competitive threats, including in terms of FDI attractiveness, of China’s rise as the manufacturing hub of the world and of India’s growing assertiveness in services innovation and trade. There can indeed be little doubt that the rise of China and its growing economic and political influence and assertiveness in the region and beyond, appear to have elicited a more favourable view of regional and bilateral cooperation and agreements. This is particularly true in Japan where the private sector began to express fears over the loss of market share, wild swings in currency values and declining FDI attractiveness (Pangestu and Gooptu, 2004; Masuyama, 2004; Gaulier and others, 2005; Damuri and others, 2006).

For countries such as India, Malaysia and Thailand, which compete with China for horizontal FDI, Eichengreen and Tong (2006) note that those countries have experienced greater difficulties in attracting foreign investment in manufacturing as a result of China’s emergence. Their version of the China threat – that of an “FDI sucking sound”, has arguably provided them with a strong incentive to pursue unilateral reforms at the domestic level and enter into PTAs to cement such reforms.

Using the Asian Development Bank’s Asian Regional Integration Centre Free Trade Agreement database, Kawai (2007) recently identified several key features of East Asian PTAs, focusing on their configuration, outward-orientation, scope (or “WTO+” commitments) as well as the their rules of origin regimes. Box 1 below summarizes the ADB findings.

## **Box 1. Salient features of East Asian preferential trade agreements**

### **Configuration**

East Asian preferential trade agreements can be divided into bilateral and plurilateral (regional) agreements. Bilateral refers to agreements between two countries, whereas the term “plurilateral” covers agreements involving more than two customs territories (e.g. Australia-New Zealand-Chile-Singapore-Brunei Darussalam FTA), one territory (or territories) and a trading bloc (e.g. European Free Trade Association-Republic of Korea) or two trading blocs (e.g. European Union-Association of Southeast Asian Nations). On the whole, Asian countries are primarily opting for simple bilateral PTA configurations rather than the more complex plurilateral ones, as the former may be easier and speedier to negotiate and may be preferred by leading trading partners. There were 25 bilateral PTAs concluded by East Asian countries as of mid-2007, representing 76 per cent of all concluded PTAs). Among those currently under negotiation, bilateral PTAs also predominate, making up 80 per cent of the total. There are eight plurilateral agreements among concluded PTAs in East Asia, and an additional eight other agreements under negotiation.

### **Orientation**

Looking at East Asian PTAs, the high degree of outward orientation is striking. Of all concluded PTAs, 22 were with countries or groups of countries outside East Asia in mid-2007. The outward orientation of East Asian PTAs under negotiation is even higher at 85 per cent. Having launched PTA negotiations with India, Australia and New Zealand, ASEAN as a group has most recently commenced PTA negotiations with the European Union. Singapore has concluded eight cross-regional PTAs with a wide geographical spread from North America and Latin America to the China, Japan, Middle East. Republic of Korea and Thailand, have also all concluded PTAs with trading partners in Latin America. China has concluded a PTA (goods only) with Pakistan and is negotiating PTAs with the member countries of the Cooperation Council for the Arab States of the Gulf as well as Iceland. The above trends lend support to East Asia’s purported aim of maintaining strong commercial ties with the rest of the world, even as integration deepens internally.

### **Scope**

The 33 PTAs (covering goods and/or services) concluded in East Asia may be broken down into four subcategories based on their scope of coverage: (a) goods-only; (b) goods and services; (c) goods, services and the so-called “Singapore Issues” (e.g. trade facilitation, trade and investment, trade and competition, transparency in government procurement); and (d) goods, services, Singapore Issues and deepened regulatory cooperation in areas such as labour standards, trade and environment, small and medium-sized enterprises, regulatory harmonization or convergence. Two-thirds of the PTAs agreed by East Asian countries as of mid-2007, a total of 21 agreements, featured WTO-plus provisions beyond trade in goods and services (the treatment of trade-related intellectual property-related matters being subsumed under the goods trade). Of the total, nine feature disciplines on the Singapore Issues only, while 12 are yet more comprehensive in scope, featuring disciplines on both the Singapore Issues and regulatory cooperation matters.



### **Rule of origin regimes**

Rules of origin exist to determine which goods will enjoy preferential tariff treatment and thus prevent trade deflection among PTA members. Three such regimes can be found in PTAs: (a) a change in tariff classification (CTC) rule defined at a detailed level in the Harmonized System level; (b) a regional (or local) content or value-added rule requiring a product to satisfy a minimum regional (or local) value added (VA) in the exporting country or region of a PTA; and (c) a specific process (SP) rule mandating a particular production process for individual goods or product categories. Of the 28 free trade agreements concluded in East Asia, the majority (18) have adopted a combination of the three rules of origin regimes depicted above rather than applying one specific regime. Of the remaining, three have adopted the value added rule, another three use a combination of value added and CTC rules, while another four combine value added and specific process rules. The simplest rule of origin can be found under AFTA and the ASEAN-China FTA, which specifies a 40 per cent regional value content across all tariffs. Many agreements involving Japan, the Republic of Korea and Singapore tend to use a combination of rules of origin.

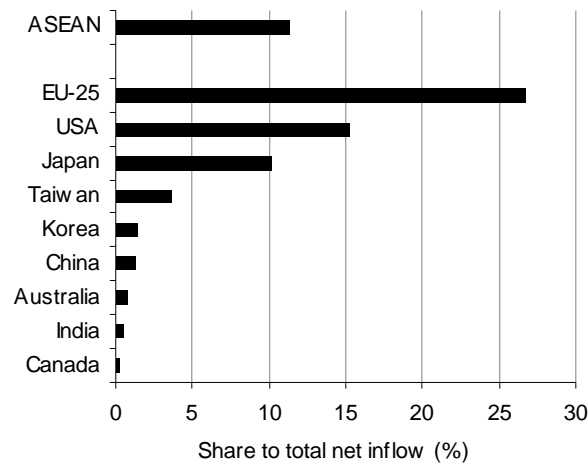
Source: Kawai, 2007.

Note: The ADB defines “East Asia” as comprising the following group of countries: China including the Special Administrative Regions of Hong Kong, China and Macau, Japan, the Republic of Korea, Mongolia and Taiwan, Province of China.

## **B. Recent trends in FDI flows to Asia**

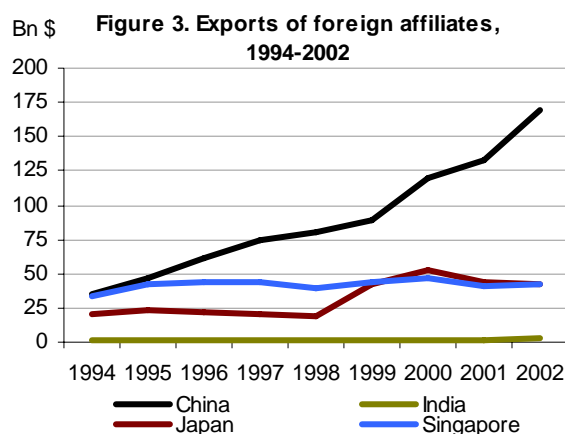
FDI flows to Asia and Oceania reached a new high in 2006 of US\$230 billion up 15 per cent from 2005. The share of the region in total FDI in developing countries thus rose from 59 per cent to 63 per cent. Most FDI in and from the Asian region continues to come from and be directed towards Japan, the European Union and the United States. However, apart from Japan, other Asian countries are increasingly investing within the region (see figure 3). Taiwan Province of China thus invested more than US\$4 billion in ASEAN countries during the period 2001-2005, making the island economy the sixth largest investor in the ASEAN block. Republic of Korea and China are also investing heavily in the region, having become the ninth and tenth most important investors, respectively, in ASEAN between 2001 and 2005. During the same period, intra-ASEAN FDI was more than \$13 billion, constituting 11 per cent of the total FDI to the region.

**Figure 2. ASEAN FDI net inflow from selected countries/regions, 2001-2005**



Source: ASEAN 2006, tables 26 & 27

FDI has provided a major boost to Asian trade in recent decades (ADB, 2006). As noted previously, production networks within the region have spurred trade in parts and components to other Asian countries, whereas vertical supply chains with countries outside the region have increased trade in capital goods, intermediate goods and final products. Through their global distribution and marketing chains, multinationals investing in Asia have played an important part in this process. This is reflected in the growing role of foreign-owned firms in exports from developing Asian countries (see figure 4 and ADB, 2006).



Notes: For Singapore, data only refer to manufacturing.

Source: UNCTAD 2006

### C. Preferential investment liberalization in Asia: salient features

This section focuses attention on the key investment provisions found in a sample of 19 preferential trade and investment agreements (PTAs) in Asia and assesses their implications for third-country investors. As investors in services are often treated separately, interactions between the investment and service chapters of the agreements reviewed are also discussed. Box 2 below lists the sample of Asian agreements featuring the investment provisions under review. This section draws on ongoing work by the author for which the core findings are summarized in tables 3 to 8 below (Sauvé and others).

By and large, the incipient research findings support the main insights found in Kumar (2007) which drew attention to an investment rule-making landscape in Asia characterized by increasing complexity and diversity but with a continued bias towards investment liberalization and the ability of third-country investors to broadly share in the benefits of ongoing trends in regional integration.

**Box 2. Investment in Asian preferential trade agreements: agreements under review**

Japan-Malaysia Economic Partnership (2006)

Japan-Mexico Economic Partnership (2005)

Japan-Singapore New-Age Economic Partnership Agreement (2002)

Thailand-Australia Free Trade Agreement (TAFTA) (2005)

European Community-Chile Association Agreement (2003-2005)

Commission mandate to negotiate an European Community preferential trade agreement with ASEAN (excluding Myanmar, Lao People's Democratic Republic and Cambodia) (2007)

Free Trade Agreement between European Free Trade Association (EFTA) and Singapore (2003)

Free Trade Agreement between EFTA and the Republic of Korea (2006) (Norway is not a party to the investment chapter)

Trans-Pacific Strategic Economic Partnership among Brunei Darussalam, Chile, New Zealand and Singapore (May 2006) (not notified to the WTO)

The New Zealand-Singapore Closer Economic Partnership (2001)

Free Trade Agreement between the Republic of Korea and the Republic of Chile (2004)

Free Trade Agreement between the Republic of Korea and the Republic of Singapore (2006)

India-Singapore Comprehensive Economic Co-operation Agreement (2005)

Framework Agreement on ASEAN Investment Area (AIA) (1998) and the ASEAN

Framework Agreement on Services (AFAS) (1995) as amended by the 2003 Protocol

Draft for Free Trade Agreement between the United States and the Republic of Korea (2007)

Free Trade Agreement between the United States and Singapore (2004)

Proposal by the United States for an investment chapter in a PTA with Thailand (2006)

Services chapter of the China-ASEAN Free Trade Area (ACCEC; 2007)

### *1. Definition and rules of origin for investment*

Most PTAs in the region use a broad and “asset-based” definition of investments in the investment chapter, whereas a narrower “enterprise-based” definition of service investments is used in the services chapters (see table 3). Most definitions of commercial presence require ownership or control by natural or legal persons covered under the agreement as defined under its rules of origin/denial of benefits clauses (see below). The European Commission’s recent mandate to negotiate an European Union-ASEAN agreement applies an enterprise-based definition of investors, but is highly transparent as one single chapter governs all investors.

In general, rules of origin (denial of benefits clauses) applied to investors and their investments (including Mode 3 commercial presence for FDI in service industries) under Asian PTAs are fairly liberal (see table 4). The most restrictive origin criterion for juridical persons – ownership and control – is applied in only two of the PTAs reviewed. Third-country juridical persons constituted or otherwise organized under the laws of a party with substantial business operations there – or in some cases those of any party – therefore enjoy preferential treatment under most agreements, conferring de facto MFN treatment to third country investors and contributing to minimizing the investment-distorting effects of PTAs. Rules of origin for natural persons extend benefits to permanent residents in some agreements, including those of EFTA (with the possibility of reservations for particular types of service suppliers). This is not the case for past or currently negotiated agreements of the United States or European Union, however.

It is important to contrast the “benign” rule of origin provisions found in the services and investment chapters of Asian PTAs (which are similar to those of most PTAs in general with the exception of a few South-South PTAs such as Mercosur, the Andean Pact or the China-Hong Kong CEPA, which have tended to adopt slightly more restrictive denial of benefits clauses designed to confer first mover advantages to investments that are owned and controlled by juridical persons that are nationals of the integrating area) to those governing rules of origin in goods trade, whose restrictive nature in selected sectors have been shown to carry considerably greater risks for trade- and investment-distortive conduct (the paper reverts to the issue of rules of origin for goods trade in section D below).

Moreover, even if rules of origin (denial of benefits) for investment are liberal overall, market access restrictions – such as maximum levels for foreign equity participation - still restrict coverage substantially in some service industries (though considerably less frequently in manufacturing). In contrast, some Asian countries such as Singapore have made significant market access commitments in the services sector.

## *2. Key treatment provisions*

Third-country service providers (modes 1, 2 and 4) covered under Asian PTAs can expect to be granted national treatment less often than investors (mode 3). Many agreements in the region list national treatment for services on a positive list basis and for investment on a negative list basis, whereas some agreements typically include national treatment on a negative list basis for both services and investments. Whereas an in-depth analysis of each country's sector and sub-sector schedules is necessary to establish whether obligations are more far-reaching in one agreement than another, agreements predicated on negative listing suggest wider coverage (Fink and Molinuevo, 2007; Roy, Marchetti and Lim, 2006).

Tables 5 to 7 below summarize the key treatment provisions found in Asian PTAs. Most PTAs include most-favoured-nation (MFN) clauses. There is no apparent pattern, however, as to which types of agreements exclude MFN provisions and whether agreements are based on negative or positive-list approaches. Several agreements, notably those entered into by EFTA countries with partners in the region (Republic of Korea and Singapore), include a wide exception to MFN treatment for all other PTAs in clauses related to regional economic integration organization exceptions. NAFTA-inspired agreements, such as the United States agreements with the Republic of Korea and Singapore, allow the parties to benefit from better treatment granted to third parties in another PTA signed after-but not before-the entry into force of the PTA. As more recent agreements tend to include wider commitments, the NAFTA-type approach to MFN treatment, if still imperfect, is better able to multilateralize preferential commitments. That said, the tendency towards permitting broad exemptions to MFN treatment reduces its practical relevance in the context of Asian PTAs.

*For both national treatment and MFN clauses, semantic differences across agreements may have important implications. Negative list service chapters typically use the term “in like circumstances” instead of the GATS language, “like service suppliers and*

*services”, which tends to be used in positive-list agreements, such as in EFTA agreements and AIA. If future jurisprudence establishes that the first term is broader in scope, then third-country service suppliers may have obtained lower coverage. On the other hand, future jurisprudence might also clarify whether, mentioning both “services” and “service providers” entails wider coverage than referring only to the latter as is the case in United States agreements with Singapore and the Republic of Korea.*

### *3. Provisions on investment protection*

In contrast to treatment standards, provisions on investment protection typically do not vary depending on whether the investment is in services or in other sectors (see table 8). Most of the sample PTAs reviewed feature key investment protection provisions, including umbrella clauses<sup>5</sup>, transfer provisions, overall treatment standards, expropriation clauses and compensation requirements. Apart from certain exceptions, protection provisions are largely comparable to those found in bilateral investment treaties.

Transfers of capital in connection with foreign investments are also protected in a relatively consistent and robust manner across Asian PTAs. Agreements guarantee investors the right to transfer current and capital transactions without delay, and to use particular currencies at specified exchange rates, subject to common exceptions in the case of serious balance-of-payments, exchange rate or monetary policy difficulties.

It is not clear from available case law whether “fair and equitable treatment” is an independent treatment standard. If it is, then third-country investors might have obtained stronger protection rights under some PTAs than investors covered under agreements that don’t include this standard; or include it but mention that it is similar to established customary international law, as is the case in United States agreements.

Apart from the European Union agreements, all reviewed PTAs with investment coverage broadly mimic standard bilateral investment treaty provisions on direct and indirect expropriation and compensation requirements. However, the EFTA-Singapore agreement refers to ‘de facto’ rather than ‘indirect’ expropriation and does not specify compensation

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<sup>5</sup> An umbrella clause stipulates that the host country assumes the responsibility to respect other obligations it has with regard to investments of investors of the other contracting party and thus not only in connection with an investment agreement.

requirements in detail. Whether this has important implications is not clear from available jurisprudence, but it is doubtful in this case, given Singapore's overall investor-friendly environment and the fact that the two terms are often used interchangeably.

#### *4. Provisions on dispute settlement*

Except for European Union agreements, all PTAs with investment coverage reviewed in this paper offer investors the choice of investor-to-state dispute settlement under the World Bank's International Centre for the Settlement of Investment Disputes (ICSID) or ad hoc procedures using UNCITRAL rules in most instances (see table 8). Service investors will not be able to bring a dispute to investor-State arbitration if it relates to matters not covered by the investment chapter, as is sometimes the case in agreements with separate, self-contained, chapters covering all aspects relating to trade and investment in financial services (following the NAFTA precedent). The latter thus have to rely on ad hoc State-to-State arbitration. Service companies tend to enjoy access to investor-to-State arbitration for all aspects covering investment in services (with the exception of financial services), whereas national treatment and MFN provision for commercial presence are not covered by the investor-to-State mechanism in other agreements.

In contrast to United States agreements, some PTAs require consent by the disputing parties – though only in the case of pre-establishment disputes for some agreements – and do not always include explicit transparency provisions. Many agreements moreover do not allow for consolidation of two or more separately-submitted claims with a question of law or fact in common and arising out of the same events or circumstances.



**Table 3. Investment and commercial presence: definitions and relationships**

Agreement	Definition of investment	Definition of commercial presence in services chapter	Relationship between investment in services and horizontal investment disciplines
<b>Japan-Malaysia</b>	Asset based– open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence.	Service chapter prevails in case of inconsistencies with the investment chapter’s obligations on national treatment, most favoured nation, and performance requirements.
<b>Japan-Mexico</b>	Asset based– closed list: includes FDI, portfolio investment and various forms of tangible and intangible property.		Investment disciplines apply.
<b>Japan-Singapore</b>	Asset based– open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence.	Relationship not expressly defined. Singapore has scheduled a reservation giving precedence to the services disciplines in case of inconsistencies with investment chapter’s obligation on national treatment and performance requirements.
<b>Thailand-Australia Free Trade Agreement</b>	FDI as defined by IMF.	GATS definition of commercial presence.	One single schedule of commitments for services and investment.
<b>European Community-Chile</b>	Direct investment include branches	GATS definition of commercial presence. Ownership or control not necessary.	Services chapter solely governs commercial presence.
<b>Draft European Community mandate for European Community-ASEAN<sup>1</sup></b>	Builds on GATS provisions of commercial presence and extends them to investors in non-services sectors. Ownership or control not necessary.		One schedule of commitments for services and investment.
<b>EFTA-Singapore</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence.	The investment chapter’s national treatment and most favoured nation obligations do not apply to commercial presence in any service sector.
<b>EFTA-Republic of Korea</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence.	The investment chapter’s national treatment and most favoured nation obligations do not apply to commercial presence in sectors covered by the services chapter.
<b>Trans-Pacific Strategic Economic Partnership (SEP)</b>	Investment chapter still under negotiation.	GATS definition of commercial presence. Ownership or control not necessary.	No investment disciplines yet, only services disciplines apply
<b>New Zealand – Singapore</b>	Asset based–open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence. Ownership or control not necessary.	The investment chapter’s national treatment and most favoured nation obligations do not apply to commercial presence as governed by services chapter.
<b>Chile – Republic of</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and		Investment disciplines apply.

<b>Korea</b>	intangible property.		
<b>Republic of Korea – Singapore</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.		Investment disciplines apply.
<b>India – Singapore</b>	Asset based-open list: Includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence.	Service chapter prevails in case of inconsistencies.
<b>AIA/AFAS</b>	Asset based- open list. Excludes portfolio investment.	Not explicitly defined, but implicitly follows GATS.	Does not apply to investment in services.
<b>United States- Republic of Korea draft</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	GATS definition of commercial presence for financial services.	Investment disciplines apply.
<b>United States- Singapore</b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.		Investment disciplines apply.
<b>United States- Thailand<sup>2</sup></b>	Asset based-open list: includes FDI, portfolio investment and various forms of tangible and intangible property.	No draft available.	National treatment provision in investment chapter does not apply to services. Service chapter prevails in case of inconsistencies.
<b>Services chapter of the China-ASEAN Free Trade Area draft</b>	Investment chapter still under negotiation.	GATS definition of commercial presence.	No investment disciplines yet, only services disciplines apply

Notes:

- a) Excluding Myanmar, Lao People's Democratic Republic and Cambodia.
- b) United States proposal

**Table 4. Rules of origin/denial of benefits1**

Agreement	Natural persons		Juridical persons		
	Extended to domestic nationals (or “citizens”)	Extended to permanent residents	Limited to domestically owned or controlled service suppliers/investors	Extended to judicial persons constituted under domestic laws and having substantial business operations in the domestic territory	Other provisions
<b>Japan-Malaysia</b>	Yes	No (Japan) Yes (Malaysia)	No	Yes	Parties can deny FTA benefits to service providers and investors from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply. Investment chapter does not extend benefits to branches of enterprises of third States.
<b>Japan-Mexico</b>	Yes	No	No	Yes	Parties can deny FTA benefits to investors from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply.
<b>Japan-Singapore</b>	Yes	No (Japan) Yes (Singapore)	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any party (services chapter only)
<b>Thailand-Australia Free Trade Agreement</b>	Yes	No	Yes (for services and main investment disciplines)	Yes (for investment chapter)	
<b>European Community-Chile</b>	Yes	No	No	Yes	
<b>Draft European Community mandate for European Community-ASEAN2</b>	Yes	No	No	Yes	Benefits also extended to juridical persons with substantial business operations (“possesses a real and continuous link”) in the territory of any party.
<b>European Free Trade Association-Singapore</b>	Yes	Yes for investors. Not automatically for service suppliers.	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any party (services chapter only)
<b>European Free Trade Association - Republic of Korea</b>	Yes	Yes for investors. Not automatically for service suppliers.	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any WTO member, if service supplier is owned or controlled by person of a party (services chapter only).
<b>Trans-Pacific SEP3</b>		Yes	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any party (services chapter only).

<b>New Zealand – Singapore</b>	Yes	Not automatically.	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any party (services chapter only).  No substantial business operations test in investment chapter.
<b>Chile – Republic of Korea</b>	Yes	Yes	No	Yes	Parties can deny FTA benefits to investors from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply (investment chapter only).
<b>Republic of Korea – Singapore</b>	Yes	Yes	No	Yes	
<b>India – Singapore</b>	Yes	Yes	Yes (for services supplied through commercial presence and investment disciplines)	Yes (for services supplied cross border and through consumption abroad)	Benefits can be denied if the juridical person is owned or controlled by persons of the denying party (only for modes 1 and 2 in services).
<b>AFAS/AIA</b>	Yes	Yes for investors. Not automatically for service suppliers.	No	Yes	Benefits also extended to juridical persons with substantial business operations in the territory of any party (services chapter only). Investment chapter allows for cumulated equity calculations.
<b>Unite States- Republic of Korea draft</b>	Yes	No	No	Yes	Parties can deny FTA benefits to service providers and investors from non-parties with which a party does not maintain normal economic relations or where certain trade sanctions apply.
<b>United States- Singapore</b>	Yes	No	No	Yes	Parties can deny FTA benefits to service providers and investors from non-parties with which a party does not maintain diplomatic relations or where certain trade sanctions apply.
<b>Services chapter of the China-ASEAN Free Trade Area draft<sup>3</sup></b>	Yes	No	Yes (for commercial presence)	Yes	

Notes:

- a) Excludes Myanmar, Lao People's Democratic Republic and Cambodia
- b) Only for services (investment chapter not finalized)

**Table 5. Treatment of investment**

	Establishment				Post-establishment			
	National treatment		Most favoured Nation		National treatment		Most favoured Nation	
	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list
Japan-Malaysia		+		+(Not vis-à-vis ASEAN members for Malaysia)		+		+(not vis-à-vis ASEAN members for Malaysia)
Japan-Mexico		+		+(Not past agreements, and three sectors in future agreements)		+		+(not past agreements, and three sectors in future agreements)
Japan-Singapore		+		Request		+		Request
Thailand-Australia Free Trade Agreement	+			+		+		+
European Community-Chile (does not replace BITs)	+		No most favoured nation clause or request		+		No most favoured nation clause or request	
Draft European Community mandate for European Community-ASEAN <sup>1</sup> (does not replace Bilateral investment treaties)	+			+(Regional economic integration organization-like clause)	+			+(Regional economic integration organization -like clause)
European Freetrade Association-Singapore		+		+(Regional economic integration organization clause)		+		+(Regional economic integration organization clause)
European Freetrade Association-Republic of Korea (replaces and suspends Swiss Bilateral investment treaties)		+		+(Regional economic integration organization clause)		+		+(Regional economic integration organization clause)
Trans-Pacific SEP	No investment disciplines yet.							
New Zealand – Singapore		+		+		+		+
Chile – Republic of Korea (replaces and suspends Bilateral investment treaties)		+		+(Regional economic integration organization clause)		+		+(Regional economic integration organization clause)
Republic of Korea – Singapore		+		Request		+		Request
India – Singapore	+	+	Singapore	Request	+			Request
ASEAN Investment		+		+		+		+

<b>Area</b> <i>(does not replace Bilateral investment treaties)</i>				(intraregional)				(intraregional)
<b>United States- Republic of Korea Draft</b>		+		+(not past agreements, and three sectors in future agreements)		+		+(not past agreements, and three sectors in future agreements)
<b>United States- Singapore</b>		+		+(not past agreements, and three sectors in future agreements)		+		+(not past agreements, and three sectors in future agreements)
<b>United States- Thailand<sup>2</sup></b>		+		+(not past agreements, and three sectors in future agreements)		+		+(not past agreements, and three sectors in future agreements)
<b>Services chapter of the China-ASEAN Free Trade Area draft</b>	Investment chapter under negotiation. No draft available.							

*Notes:*

- a) Excludes Myanmar, Lao People's Democratic Republic and Cambodia
- b) United States proposal

**Table 6. Treatment of services<sup>1</sup>**

Agreement	Establishment						Post-establishment					
	Market access		National treatment		Most favoured nation		Market Access		National treatment		Most favoured nation	
	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list	Positive list	Negative list
Japan-Malaysia	+		+			+		+			+	
Japan-Mexico				+		+			+			+
Japan-Singapore	+		+			Request		+		+		Request
Thailand-Australia Free Trade Agreement	+		+			Request		+		+		Request
European Community-Chile	+		+		No most favoured nation clause or request			+		+	No most favoured nation clause or request	
Draft European Community mandate for EC-ASEAN <sup>2</sup>	+		+			+		+		+		+
European Free Trade Association-Singapore	+		+			+		+		+		+
European Free Trade Association-Republic of Korea	+		+			+		+		+		+
Trans-Pacific SEP		+		+		+			+		+	
New Zealand – Singapore	+		++		No most favoured nation clause or request				+		No most favoured nation clause or request	

<b>Chile – Republic of Korea</b>				+		Request				+		Request	
<b>Republic of Korea – Singapore</b>		+	(not mode 3)		+	(not financial services)		Request	+		+	(not financial services)	Request
<b>India – Singapore</b>	+			++				Request	+		+		Request
<b>ASEAN Framework Agreement for Trade in Services</b>	+			+				+			+		+
<b>US-Republic of Korea draft</b>					+	(not mode 1 in financial services)		+(Not past agreements, and 3 sectors in future agreements)			+	+	+(Not past agreements, and 3 sectors in future agreements)
<b>United States-Singapore</b>					+	(not mode 1 in financial services)		+(Not past agreements, and 3 sectors in future agreements)			+	+	+(not past agreements, and 3 sectors in future agreements)
<b>Services chapter of the China-ASEAN Free Trade Area draft</b>	+			+				+			+		+

Notes:

a) Excludes Myanmar, Lao People's Democratic Republic and Cambodia



**Table 7. Specifications in treatment standards**

Agreement	National treatment				MFN				National treatment/MFN to other party		National Treatment/ most favoured nation to other party	
	Services treatment to 'like'		Investment treatment to 'like'		Services treatment to 'like'		Investment treatment to 'like'		National treatment/MFN to other party		National Treatment/ most favoured nation to other party	
	Circumstances Service suppliers/ services	Circumstances Investors/ Investments	Circumstances Service suppliers/ services	Circumstances Investors/ Investments	Circumstances Service suppliers/ services	Circumstances Investors/ Investments	Circumstances Service suppliers/ services	Circumstances Investors/ Investments	Service suppliers service suppliers and services	Service suppliers service suppliers and services	Investors	Investors and investments
Japan-Malaysia		+	+			+	+			+		+
Japan-Mexico	+		+		+					+		+
Japan-Singapore		+	+			+	+			+		+
Thailand-Australia Free Trade Agreement		+	+			+	+			+		+
European Community-Chile		+	+		No most favoured nation clause or request					+	"legal or natural persons"	
Draft European Community mandate for European Community-ASEAN <sup>1</sup>	Like investors (incl. service suppliers) and "all measures affecting establishment" <sup>2</sup>				Like investors (incl. service suppliers) and "all measures affecting establishment"							"investors" and "all measures affecting establishment"
European Free Trade Association-Singapore		+	+			+	+			+		+
European Free Trade Association-Republic of Korea		+	No reference to factual comparisons			+	No reference to factual comparisons			+		+
Trans-Pacific SEP	+		No investment disciplines yet.		+		No investment disciplines yet.			+	No investment disciplines yet.	
New Zealand – Singapore		+	+		No most favoured nation clause or request		+			+		+
Chile – Republic of Korea	+		+		Does not mention factual comparison in request		+			+		+

<b>Republic of Korea – Singapore</b>	+		+		Does not mention factual comparison in requests					+		+
<b>India – Singapore</b>		+	+		Does not mention factual comparison in requests					+		+
<b>ASEAN Framework Agreement for Trade in Services / Association of Southeast Asian Nations</b>	“discriminatory measures”			+		+		+		+		+
<b>United States- Republic of Korea draft</b>	+		+		+		+		+			+
<b>United States- Singapore</b>	+		+		+		+		+			+
<b>United States- Thailand<sup>3</sup></b>	No draft available		+		No draft available		+		No draft available			+
<b>Services chapter of the China-ASEAN Free Trade Area draft</b>		+	No investment disciplines yet.			+	No investment disciplines yet.			+	No investment disciplines yet.	

*Note:*

a) Excludes Myanmar, Lao People’s Democratic Republic and Cambodia

**Table 8. Investment protection and dispute settlement**

Agreement	Umbrella clause	Transfers	Standard of treatment/ Fair and equitable	Compen- -sation	Expropriation		Dispute settlement		Scope of application of investment protection disciplines to goods and services
					Direct	Indirect	State-State	Investor-State	
Japan-Malaysia		+	+	+	+	+	+	+	All protections apply.
Japan-Mexico		+	+	+	+	+	+	+	All protections apply.
Japan-Singapore		+		+	+	+	+	+	All protections apply.
Thailand-Australia Free Trade Agreement		+	+	+	+	+	+	+ (Post-establishment only)	Protection applies to commercial presence.
European Community-Chile		+	References to BITs				+		Protection applies to free transfers.
Draft European Community mandate for European Community-ASEAN <sup>1</sup>	?	?	References to BITs				+		Protection applies to free transfers.
European Free Trade Agreement-Singapore	+	+	+	+	+	'de facto'	+	+	Protection applies to commercial presence.
European Free Trade Agreement-Republic of Korea <i>(replaces and suspends Swiss BIT)</i>	+	+	+	+	+	+	+	+	Protection applies to commercial presence.
Trans-Pacific SEP	No investment disciplines yet.								
New Zealand – Singapore		NT and most favoured nation		NT and most favoured nation			+	+	Protection applies to commercial presence.
Chile – Republic of Korea <i>(replaces and suspends BIT)</i>		+	+	+	+	+	+	+	All protections apply.
Republic of Korea – Singapore		+	+	+	+	+	+	+	All protections apply.

<b>India – Singapore</b>			+			+	+	+	+	+ (Not for NT or post-establishment)	The services chapter incorporates selected protections of the investment chapter to be applied to commercial presence. The protection of the investment chapter applies to other investments.
<b>AIA</b> <i>(does not replace BITs)</i>			+		+	+	+	+	+	+ (Post-establishment only)	Protection applies to investment in services.
<b>United States-Republic of Korea Draft</b>			+		+	+	+	+	+	+	Protection applies to commercial presence.
<b>United States-Singapore</b>			+		+	+	+	+	+	+	Protection applies to commercial presence.
<b>United States-Thailand<sup>2</sup></b>			+		+	+	+	+	+	+	Protection applies to commercial presence.
<b>Services chapter of the China-ASEAN Free Trade Area</b>	No investment disciplines yet.										

Note:

- a) Excludes Myanmar, Lao People's Democratic Republic and Cambodia
- b) United States proposal

## D. The rise of preferential trade and investment agreements and their likely impacts

The general consensus in policy research circles is that the process of economic integration in Asia has so far been driven primarily by economic forces due to the FDI-induced integration of production networks, as well as by the impetus flowing endogenously from continued region-wide growth which, *ceteris paribus*, naturally increases trade and investment activity at the regional level (Dobson and Yue, 1997; Kimura and Ando, 2003; Damuri and others, 2006). A report by the Asian Development Bank (2002) finds that, while PTAs have the potential to increase intraregional trade and investment flows, as observed most markedly in the case of the European Union and NAFTA, their impact on the Asia-Pacific region to date has been small.

However, this dynamic is undergoing significant change as Asian countries increasingly turn towards bilateral PTAs rather than the “open regionalism” more systematically pursued by ASEAN and APEC (Scollay, 2004; ADB, 2006)<sup>6</sup>. In particular, Japan, India, the Republic of Korea, Singapore and Thailand have all been active in trying to facilitate economic integration – and to some extent counterbalance the rise of China, through negotiations of formal trade agreements featuring comprehensive disciplines on a bilateral or regional investment. The same countries have also been active signatories of bilateral investment treaties, both within and outside the region, as the scale of their own FDI outflows has grown.

Based on what we know about PTAs in general, the rush towards regional and bilateral integration could have important implications for the future of trade and investment flows in Asia. In a recent “meta-analysis” of all relevant econometric studies of preferential trade agreements, the World Bank (2004) found that regional/bilateral trade increases as a result. Such an outcome is confirmed by general equilibrium simulations and there is strong evidence that PTAs contribute to the increased regionalization of world trade patterns (Pelagidis and Papasotirou, 2002).

The more interesting question for third-country investors, though, is whether increased intraregional trade comes at their expense. Athukorala (2006) finds that even though there has been a rapid expansion of components trade within AFTA, this has been complemented by increased trade in final goods with countries outside the region.<sup>7</sup> Furthermore, as noted above, and observed by Dobson and Yue (1997) and Kawai (2007), increased regionalization in Asia is offset by continued dependence on non-Asian markets and multinational investors. The end result is that even as the Asian region continues to experience greater integration, its dependence on the global economy constrains inward-looking policy choices.

Will the recent shift towards PTAs change such a pattern? When compiling all the regression estimates of authoritative studies, the World Bank (2005) was unable in a recent study to reach any definitive conclusions as to whether PTAs are in fact trade- or FDI-

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<sup>6</sup> The APEC process can still be argued today as proceeding along open regionalism lines in the sense that its Member countries individual action plans are typically pursued on an MFN basis.

<sup>7</sup> Production-sharing leads to massive double counting of published trade data as goods cross multiple borders in the course of their production. If not controlled for, this will overestimate the importance of intra-regional trade, and underestimate the importance of extra-regional trade and thus generate misleading inferences as to regional integration trends in trade (Athukorala, 2003; Athukorala and Yamashita, 2006).

diverting per se. It seems that some agreements can induce such effects, while others do not. The devil, as always, lies in the details of individual agreements. So what, then, may explain some of the variations observed?

First, PTAs that are open to trade with third countries and cover practically all economic sectors are typically found to be less trade- and investment-diverting on average. Too high external tariff barriers relative to preferential tariffs and too many exceptions will tend to lead to trade and investment diversion and thus likely hurt third-country suppliers or compel them to adopt business models – via FDI – that they would otherwise not pursue. Also, since countries in Asia continue to rely significantly on extra-regional trade for their growth dynamism, trade diversion would hurt Asian countries themselves (Athukorala and Yamashita, 2006).

Until recently, the tendency had been towards declining margins of regional preference – for example between the average MFN and preferential tariffs – for ASEAN members, indicating that trade liberalization conducted multilaterally was moving faster than that conducted along regional lines (Kimura and Ando, 2003; Damuri and others, 2006). The recent acceleration of tariff cuts under AFTA, the proliferation of preferential trade agreements and the continued negotiated gridlock in Geneva, suggest that the relationship described above has been somewhat reversed over the course of the Doha Development Round of negotiations, which began in 2001.

At the same time, it must be emphasized that third-country traders and investors have benefited from the continued commitment of Asian countries to liberalize their trade and investment regimes, as well as their regulatory regimes in services, on an autonomous basis. Simply put, and as noted earlier in regard to liberal rule of origin/denial of benefits clauses, third countries have often enjoyed quasi- or de facto MFN treatment in their trade and investment relations with Asian countries.

To date, there is very limited evidence of trade and investment policy backsliding in Asia, such that the wedge between actual (applied) and bound policies and measures and the fact that third countries are not direct beneficiaries of the protective properties of policy bindings have not proven unduly problematic in most instances.

Many of the recent or currently negotiated Asian PTAs focus on economy-wide liberalization rather than creating “carve-outs” to serve particular rent-seeking sectors and interests (ADB, 2006; Plummer, 2006). For this reason, Frankel (1997), Fink and Primo Braga (1999), Li (2000), Clark and Tavares (2000), Gilbert, Scollay and Bora (2001) and Soloaga and Winters (1999) all find that AFTA has been more trade-creating than diverting. Also, recently concluded negotiations over an ASEAN-China PTA, while initially limited to goods trade (a services complement has since been added), liberalizes 98 per cent of all tariff lines and includes trade in agricultural products which can help to create momentum for further agricultural liberalization in the Asia-Pacific region (Cheong and Kwong, 2005; Feridhanusetyawan, 2005).

**Box 3.2 Tariff reductions in selected Asian preferential trade agreements**

**ASEAN Free Trade Area:** Negative list approach, 0 per cent target. The CEPT scheme allows countries to maintain temporary exclusions, a sensitive products list and general exclusion lists. Commodities are phased into inclusion gradually, and there is a longer time frame for the CLMV countries. ASEAN-6 reached 0-5 per cent tariff in 2003 and Viet Nam in 2006. Lao People's Democratic Republic and Myanmar are to do so in 2008, and Cambodia in 2010.

**Japan-Singapore:** Positive-list approach. Tariffs on Singapore's imports from Japan will be 0 per cent immediately. Complete tariff elimination in Japan with 10-year transition period. Japan maintains some exceptions, including meat and meat products, fruit and vegetables, dairy products, and cane and beet sugar.

**ASEAN-China:** Negative-list approach. Under the normal track, tariffs will be eliminated by 2010 for ASEAN-6. Under the sensitive track, tariff reductions will start in 2012, to reach 0-5 per cent tariff levels by 2018. ASEAN-4/CLMV countries are given five more years to follow a similar tariff reduction scheme. Tariffs on goods under the Early Harvest Programme, which includes agricultural products (Chapters 01 to 08 of the HS code), will be reduced to zero for ASEAN-6 and China.

**ASEAN-India:** Positive-list approach. Progressive elimination of tariffs in substantially all trade in goods. Under the normal track, tariffs will be reduced or eliminated by 2011 for Brunei Darussalam, India, Indonesia, Malaysia, Singapore and Thailand, and by 2016 for other ASEAN members. Specific treatment is foreseen for sensitive products. The early harvest programme follows a positive-list approach.

*Source:* Feridhanusetyawan, 2005. *Note:* ASEAN-6: Original free signatories of ASEAN plus Brunei Darussalam. ASEAN-4 or CLMV.

Of course, there are important exceptions to the trends depicted above. Some of the recent PTAs of Thailand and a number of agreements into which India has entered appear to have been driven more by mercantilistic than liberal ideals and feature highly selective preferential tariff dismantling rather than comprehensive liberalization, ultimately calling into question their compatibility with the disciplines of Article 24 of GATT (Sally, 2006). Nonetheless, most Asian PTAs – those in existence today and those under negotiation – tend to be liberal in character and maintain relatively small margins of preference for regional producers (ADB, 2006; Plummer, 2006; Kawai, 2007;

**Box 4. Rules of origin in AFTA and the Japan-Singapore PTA**

**AFTA:** Rules of origin are relatively simple and liberal. A product has to satisfy 40 per cent of its content originating from any member States. Cumulative rules of origin state that inputs for finished products eligible for preferential treatment in other member states shall be considered as originating in the member State where working or processing of the finished product has taken place, provided that the aggregate ASEAN content of the final products is not less than 40 per cent.

**Japan-Singapore:** Rules of origin are less liberal and rather complex. Liberal rules of origin typically apply a general rule that the local content of the product has to be at 40–50 per cent. In the Japan-Singapore agreement, rules of origin are product specific, or the originating content must be no less than 60 per cent of the total value of the materials. The material must undergo the final production process in the territory of either party. Simple cutting, mixing, and packaging are not considered sufficient transformation for rules of origin. Origin can accumulate bilaterally.

Source: Feridhanusetyawan, 2005.

Hapsari and Mangunsong, 2006; also box 3 above).<sup>8</sup>

An important question is whether such a benign policy environment will continue to define the norm or whether the region's recent conversion to PTA-centric forms of integration will raise new hurdles for third country traders and investors.

A second source of potential variance in the effects of PTAs relates to the design of rules of origin for goods trade. Lacking a harmonized global rule of origin regime, PTAs with too strict or complex rules-of-origin have been shown to exert trade-and investment-diverting effects that can nullify or

impair some of the new trade opportunities a PTA is supposed to create (Panagariya, 1998). One study has shown that the rules of origin adopted in the NAFTA were equivalent to an added tariff of 4.3 per cent (Estevadeordal and Suominen, 2004). It is therefore unfortunate that, apart from ASEAN members within AFTA, Asian PTAs have so far tended to eschew simple and transparent rules of origin for trade in goods (James, 2006). This is notably the case of an otherwise “benign” agreement such as that between Japan and Singapore (see box 4).

Moreover, even though AFTA rules of origin are relatively simple, the Asian Development Bank (2006) finds that one of the reasons why the promotion of intraregional trade in AFTA has not achieved its full potential relates to the costs of complying with regional rules of origin, especially when compared with the relatively small margins of preference granted by AFTA tariff concessions. It seems that only multinationals in very high-tariff sectors such as

<sup>8</sup> Though margins of preference under AFTA fell steadily between 1994 and 2001, a period during which Uruguay Round tariff cuts became effective, Hapsari and Mangunsong (2006), citing work by Damuri *et al.* (2006), report evidence of rising preference margins - hence of likely trade diversion - within ASEAN in 2002-03, a trend which the protracted state of the WTO's Doha Development Agenda is unlikely to counter.



automobiles have found it worthwhile to go through the bureaucratic procedures of obtaining an AFTA rule-of-origin certificate.

Cuyvers and others (2005), Plummer (2006) and Baldwin (2006) note that one of the great challenges, for both Asian and non-Asian countries, is to prevent Asian PTAs from creating a “noodle bowl” of criss-crossing rules which would increase the costs of trade within Asian. If this is not done, many firms would find it cheaper simply to pay the MFN duty rather than comply with complex rules. The likely end result may be fewer new trade and investment opportunities in the region.

One means of minimizing the potentially adverse impact of PTAs on third-country producers is to have them integrate “deeper” and “wider” than is possible at the multilateral level: i.e., address more sectors, liberalize more comprehensively and address a wider set of regulatory impediments to trade and investment. Even if tariffs are fully removed, the business environment in Asia is still far from borderless (Kimura and Ando, 2003), partly because technical barriers accompanying inspection procedures for exports and imports are for instance prevalent (Wakasugi, 2007).

Moreover, it is most likely in non-goods trade – such as services, that the greatest benefits from integration can accrue. As noted previously, trade and investment in many key Asian service sectors is still restricted by excessive or discriminatory regulations. This can be problematic for service sector multinational enterprises, but also for firms in manufacturing and in other sectors that are tightly connected to production networks throughout the region.

One of the basic pillars of regional and international production sharing is low trade facilitation and service link costs. Gains from services liberalization in Asia (and elsewhere) have generally been found to exceed those from goods liberalization by significant margins, by up to a factor of five according to one study (Robinson and others, 1999). Dee and Hanslow (2000) find that APEC countries could realize gains of US\$110 billion from liberalizing services trade, and that China alone could benefit by as much as US\$70 billion by removing its stringent service sector restrictions. Chadha (2000), Brown *et al* (1996), Chadha and others (2000), Benjamin and Diao (2000) come to similar conclusions. Even though the largest economic gains from services liberalization come from non-preferential market

opening, PTAs can be useful tools for moving forward in what are often politically sensitive areas (McKibbin and Wilcoxon, 1996; OECD, 2002).

To convey a sense of shared will to engage in economic cooperation beyond the reciprocal exchange of market access commitments, the newer generation of preferential trade agreements in Asia, such as those agreed between Singapore and Japan, ASEAN and China, and ASEAN and Japan, as well as the India-ASEAN agreement, all explicitly use the term “comprehensive economic partnership” rather than “free trade agreement” (Feridhanusetyawan, 2005).

In services, Asian PTAs typically adopt a GATS+ approach, whether in terms of agreed rules or especially negotiated market opening commitments (Roy, Marchetti and Lim, 2006; Fink and Molinuevo, 2007). Many such agreements also feature cooperative initiatives relating to the movement of natural persons, including in the realm of mutual recognition agreements in regulated professions (UNCTAD, 2007), though this is not the case of recent US PTAs.

Japan, Lao People’s Democratic Republic, Republic of Korea, Singapore and Viet Nam have all made notable commitments on services trade and investment in their PTAs. On the other hand, countries such as Indonesia, Malaysia and Thailand have tended to schedule very limited commitments over and above those taken in the Uruguay round (with the obvious exception of AFAS for intra-ASEAN trade and investment in services).

The Singapore-Japan agreement is a prime example of a PTA that, apart from its chapters on investment and services, goes far “behind the border” in addressing infrastructure and rules, customs procedures and a variety of other indirect measures affecting trade flows. Such advances have prompted Hertel and others (2001) to conclude that the so-called “new-age” agreement between Singapore and Japan would not likely be trade-diverting overall and that third countries would not lose out.<sup>9</sup>

The rise of preferentialism in Asia has, with few exceptions, generally been characterized as a “WTO-plus” process (WTO+), which, *ceteris paribus*, should help to create

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<sup>9</sup> It should be noted, however, that such a result is based on *ex ante* calculations and not the actual effects of the agreement.

a better institutional setting for markets to function across borders and should therefore stimulate greater trade among partners, including third countries.

Turning more specifically to the possible impacts of deepening economic integration on investment behavior, Chase (2003) notes that bilateral or regional integration should be of particular interest to multinational firms since proximity has obvious benefits for investors spreading production across borders. Unfortunately, studies investigating the effect of PTAs on investment flows are relatively few. Stein and Duade (2001), Yeyati and others (2003), and Medvedev (2006) find that PTAs do increase intra-bloc investment. Similarly, a recent study by the OECD (2007) finds that PTAs with comprehensive investment provisions exert a strongly positive impact on induced FDI flows among partner countries. Such results would appear to indicate that the recent surge in Asian PTAs should increase investment flows among Asian countries. This is particularly the case since the most substantial impact on FDI seems to occur when PTAs coincide with domestic liberalization and concerted efforts at macroeconomic stabilization among member countries. These are the conditions that have generally obtained in Asia in recent years (Blomström and Kokko, 1997; 2001; Graham and Wada, 2000).

Once again, the interesting question for third countries is whether PTA-driven integration is due to investment diversion or creation? Some evidence suggests that investment diversion can become a source of genuine concern under some PTAs, with adverse third-country effects. For instance, the World Bank (2000) found that FDI declined in EFTA members following the phase-in of the European Union Internal Market Program (IMP) and did not recover until the establishment of the European Economic Area. In addition, Serven and Lederman (2005) show that NAFTA resulted in diversion of FDI from other countries in Latin America, as Mexico's share of United States-sourced investment remained stable throughout the 1990s while the share of other countries declined.

The evidence for PTA-induced investment diversion is not clear cut, however. Echoing the more recent findings of the OECD, Adams and others. (2003) and Dee and Gali (2003) show that strong investment provisions in PTAs have a net investment-creation effect. Kimura and Ando (2003; 2005) note that the generally low margins of preference among Asian countries will tend to mitigate biases against foreign firms. The existence of sophisticated production and distribution networks would encourage activities of *all*

multination enterprises in Asia could thus be in the interest of multinational investors in the region.

As noted above, the most recent vintage PTAs promote economic ties through various investment facilitation activities, some of which also benefit third-country firms. The framework agreement of the ASEAN Investment Area and the Singapore-Japan agreement both foresee information sharing, simplification and transparency of procedures and rules. Such provisions stand to benefit not only PTA members but also non-Asian multination enterprises investing in Asian markets as they enhance service links between production networks (Thorbecke and Yoshitomi, 2006). Te Velde and Bezemer (2004) thus find that membership in a PTA can lead to further extra regional FDI inflows, i.e. the increased opportunities for investment among partner countries also stimulate FDI from third countries. This is confirmed in the case of MERCOSUR, where most new FDI has come from outside the PTA (Chudnovsky and López, 2001) as well as in the case of the Canada-United States FTA (subsequently NAFTA), where FDI to Canada from Europe increased much more than that from the United States (Globerman, 2002).

Apart from PTAs, bilateral investment treaties (BITs) are another legal instrument used to promote economic integration. The aim of host countries in signing BITs is to enhance the investment climate (i.e. BITs may be seen as serving a “signalling” function vis-à-vis foreign investors) and attract more FDI by granting strong protection rights against discriminatory (investment liberalization) or confiscatory (investment protection) state conduct.

Most Asian countries have signed numerous BITs. China has, for instance, signed BITs with over 100 countries and the Republic of Korea and Malaysia with more than 60 each. Most such agreements are North-South in character and involve treaties entered into between Asian and OECD countries, but intra-Asian BITs are also becoming increasingly common, in response to the rise of a number of Asian-origin multinational firms.

In theory, BITs can be an important instrument in promoting FDI to Asia from multinationals headquartered in OECD countries and in enhancing host countries’ investment regimes. However, empirical studies devoted to the subject conclude that BITs exert an indeterminate influence on investment flows between signatories. Hallward-Driemeier (2003),

Tobin and Rose-Ackerman (2006) and Yackee (2006) find either no or even a negative impact of BITs on induced FDI flows.

In contrast, Neumayer and Spess (2005), Salacuse and Sullivan (2005) and Banga (2003) find strong and positive associations between the number of BITs a country has signed and its FDI inflows. Banga (2007) further finds evidence of a link between BITs and the recent FDI outflow performance of a number of Asian countries. However, association is different from causation, and Aisbett (2007) shows that these latter studies fail to take into account that BIT signatories tend to experience large FDI inflows before signing the agreement, and that have no marginal effect BITs by themselves after they have been signed.

Moreover, BITs do not seem to ‘substitute’ for property-rights - as Neumayer and Spess (2005) claim; that is, investors do not regard BITs as a sufficient safeguard against a general disrespect of property rights by host governments. This does not rule out, however, that investors can value the usefulness of BITs when deciding where to invest, particularly as confidence in the robustness of investor-State arbitration procedures increases in the context of heightened judicial activism.

Also, BITs should not be seen in isolation from broader integrating trends. One recent study suggests that BITs might influence investment behaviour when complemented by an investor-friendly political and economic environment (Tobin and Rose-Ackerman, 2006).

Further, there is scant evidence on whether BITs matter more for FDI flows in certain sectors, than in others (in either manufacturing or services), or for some types of investments rather than others (that is, resource- versus. efficiency- versus. market-seeking FDI). Expropriation risks are typically greatest in natural resource industries, for instance, such that BITs may have a particularly useful role to play in such sectors despite their more marginal use in other areas (Aisbett, 2007). Finally, it is still uncertain whether BITs with pre-establishment rights, such as those negotiated by Canada and the United States, exert greater impacts on investment flows relative to agreements limited to post-establishment rights.

The empirical evidence currently available thus suggests that BITs do not on the whole appear to exert determinative impacts on the investment decisions of multinational firms, though some of the finer elements of analysis, notably regarding their effect on various

types of investment (resource-versus market-versus efficiency-seeking FDI) are quite clearly worthy of greater analytical scrutiny.

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