

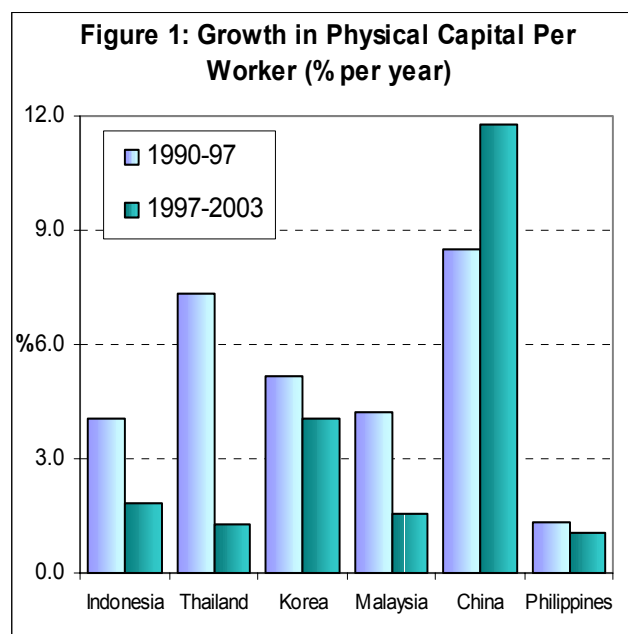
**Reviving private investment is a critical challenge facing countries in the East Asia and Pacific region.** Growth in physical capital per worker (capital intensity) contributed a large part of East Asia's extraordinary output growth performance in the first part of the 1990s and before.<sup>23</sup> Since the 1997-98 East Asian financial crisis, however, capital per worker growth has fallen in many countries of the region, although not in China or Vietnam (Figure 1), running at only 1-2 percent a year in several. Private investment has been depressed, averaging 14 percent of GDP in 2003 as compared to its pre-crisis average level of 25 percent.

This special focus paper looks at the investment climate in East Asia, focusing in particular on those determinants of private investment that are amenable to policy change. The determinants of investment are wide-ranging, and a good summary of international experience is given in the World Bank's World Development Report (WDR) 2005 *"A Better Investment Climate for Everyone"*. This special focus illustrates some of the global messages of the WDR with information from Investment Climate Assessments (ICAs) undertaken by the World Bank in five East Asian economies, using data from over 6500 registered firms.<sup>24</sup> It looks in particular at policies and institutional changes that can affect the investment climate by (i) reducing policy-related risks and uncertainties, (ii) reducing policy-related costs of doing business, and (iii) raising investment returns.

## **II. Recent trends in Investment in East Asia**

**Growth in physical capital per worker has slowed dramatically since the 1997 financial crisis** in the five crisis-hit countries, Indonesia, Korea, Malaysia, Philippines, Thailand (Figure 1). In the Philippines, investment has been weak since the early 1990s and capital per worker has grown at barely 1 percent per year. In the four other middle-income countries of Southeast Asia, capital intensity growth has fallen from 4-7 percent per year to less than half that rate. One exception is Korea, where investment has recovered somewhat more robustly after the crisis. The third category of countries includes China and Vietnam, which did not have crises and where physical capital per worker has continued increasing very rapidly, in the case of China averaging around 10 percent since 1990. While a detailed capital stock figure is not available for Vietnam,

high investment rates suggest that capital intensity has grown rapidly there as well.



Source: Bosworth and Collins (2003); World Bank calculations.

**Aggregate investment patterns are mirrored by Foreign Direct Investment (FDI) trends.** FDI has played a significant role in several East Asian economies, providing resources and technology, both in the host industry and through linkages with the rest of the domestic private sector. However, FDI has declined substantially in most countries since 1997, except in China, following global trends. (Table 1). Excluding China, FDI inflows to the six largest developing economies have been cut in half from an average of around \$16.5 billion a year in 1998-2000 to the recent trend of around \$7.5 billion in 2001-2003. Indonesia and the Solomon Islands have even witnessed a consistent outflow of FDI since 1997. One exception to this trend has been in resource rich economies, where FDI in mining, oil and other natural resources has followed improvements in legislation in Mongolia, PNG, and Vietnam.

China of course has continued to be a magnet for FDI. Indeed, China's accession to the WTO, large domestic market, strong growth, skilled workforce and the innovative potential of its economy make it very attractive to FDI. China received 85 percent of total FDI flows to the East Asia region in 2003, and became the world's largest recipient, attracting around US\$54 billion worth of FDI.

<sup>23</sup> Bosworth and Collins, 2003.

<sup>24</sup> Investment Climate Assessments have been completed for Cambodia (2003), China (2002, 2003), Indonesia (2004), Malaysia (2003) and the Philippines (2003). They are in progress in Mongolia and Thailand and will soon be launched in Lao PDR and Vietnam.

**Table 1: Recent Trends in FDI in EAP: FDI Inflows as % of GDP**

	1994-1997	1997-2001	2002-2003
Cambodia	5.4	5.7	2.8
China	5.3	4.2	4.0
Fiji	2.0	1.9	1.2
Indonesia	2.1	-1.7	-0.1
Korea, Rep.	0.4	1.5	0.6
Lao PDR	5.7	2.6	1.2
Malaysia	6.5	3.4	2.9
Mongolia	1.7	3.7	9.0
Papua New Guinea	3.1	4.1	1.9
Philippines	2.0	2.2	1.3
Solomon Islands	3.6	-2.3	-0.6
Tonga	1.2	1.6	1.6
Thailand	1.4	4.4	1.1
Vietnam	9.1	4.9	3.6

**Services are a new engine of FDI in East Asia.** One new phenomenon is the growing importance of services in FDI in the region. The share of services has increased from 43 percent of the region's total inward FDI stock in 1995 to 50 percent in 2002. Growth was more pronounced in countries like Thailand, Hong Kong (China) and Singapore, but even in Malaysia, Philippines and Korea the share of services in FDI is substantial (Table 2).

**Table 2: Share of services in total inward FDI (Stock)**

Economy	1990-2002 (Percentage)		
	1990	2000	2002
Cambodia <sup>a</sup>	..	39.7	36.4
China	..	..	31.4 <sup>a</sup>
Hong Kong, China	..	92.0	93.0
Indonesia	..	..	..
Lao PDR	..	..	..
Malaysia	35.4	..	..
Mongolia <sup>a</sup>	100.0	37.0	41.3
Myanmar <sup>a</sup>	23.0	35.1	34.7
Papua New Guinea <sup>a</sup>	3.4	..	..
Philippines <sup>b</sup>	23.5	45.2	43.9
Republic of Korea	37.8	34.9	42.0
Singapore <sup>c</sup>	58.5	63.3	..
Thailand	47.6	62.2	56.8
Vanuatu	..	..	..
Viet Nam <sup>a</sup>	20.6	..	..

Source: UNCTAD, FDI database (www.unctad.org/fdistatistics).

<sup>a</sup> Approval data.

<sup>b</sup> Data refer only to equity.

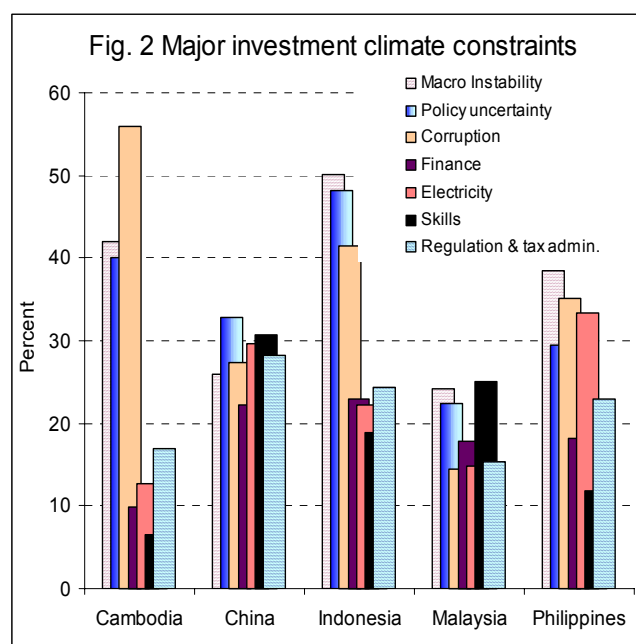
<sup>c</sup> Data for 1990-1996 refer only to equity

while data for 1997-2000 refer to total direct investment.

### III. Improving the Investment Climate in East Asia

#### The East Asia and Pacific region generally fares well in international comparisons of investment climate.

According to the A.T. Kearny 2003 ranking, 9 of the 25 most preferred destinations for FDI in the world were in East Asia. Besides China, the front-runner since 2002, Japan (15), Thailand (16), South Korea (18), Vietnam (21), and Malaysia (24) appear in the top 25 lists. However, results from the five investment climate surveys completed in the region suggest that serious impediments to private sector-led growth still exist. These surveys summarize the views of firm managers about constraints to investment and firm performance, classified in terms of whether an issue is considered to be "serious" or "very serious". Figure 2 shows the most binding constraints reported in the five countries. While the ranking is relative and may not be comparable across countries, it does offer policymakers a practical quantitative approach to prioritizing and sequencing reform across a broad range of possible problem areas. One clear result is that a single, one-size-fits-all approach would not be sensible for the region. The range of critical issues is as diverse as the countries themselves.



Source: Investment Climate Assessments, World Bank.

Macroeconomic instability continues to be a concern for a large proportion of firms in Cambodia, Indonesia and the Philippines. Uncertainty about government policies or regulations is also a concern for a substantial number of

firms in these economies, as it is in China.<sup>25</sup> *Corruption* is also an important concern in Cambodia, Indonesia and the Philippines. Corruption can often increase the uncertainty of the business environment, it also has a major impact on inflating the cost of doing business. Finally, firms in Malaysia and, to a certain extent, China identified *skills shortages* as an obstacle to their operations. Skills shortages are a key barrier to higher innovation and investment returns.

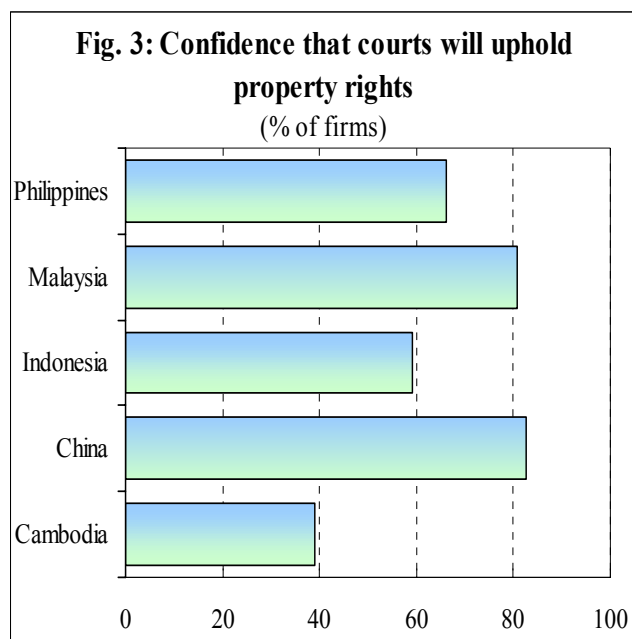
#### a. Reducing Policy Uncertainty and Other Policy-Related Risks.

Policy-related risks are risks stemming from policy uncertainty, macroeconomic instability and capital markets, and insecure property rights and arbitrary regulation. Perhaps the most basic requirement for a strong investment climate is **to ensure a stable macroeconomic environment**. Even though macroeconomic conditions have steadily improved since the shock of the 1997-98 financial crisis, 50 percent of firms in Indonesia still report concerns about macroeconomic instability as a major or severe constraint, partly because of some further volatility in inflation, interest rates and the exchange rate during the post-crisis period. For example, the exchange rate fell quite sharply and inflation rose in 2000 and early 2001, when the credibility of the administration was damaged by financial scandals and growing political tensions between the legislature and the President. There is a growing body of evidence documenting the powerful negative effects on private investment and growth of high political and economic instability<sup>26</sup>. In a sample of 79 countries over the period 1960-2000 Hnatkovska and Loayza (2004) find that a one standard deviation increase in volatility reduced annual per-capita GDP growth by 0.7 percentage points. When the fiscal or/and external balance is unsustainable, investors anticipate higher implicit taxation or expropriation through seignorage, default or banking crisis and adopt a “wait and see” attitude. In addition, the country’s risk and interest rates rise, further depressing private investment.

The firm level surveys report **uncertainty about the content and implementation of policies** as one of the leading investment climate constraints in several economies, including Indonesia, China, Cambodia and Philippines. In Indonesia, 48 percent of firms are particularly concerned about it, and in China one third of firms report the same (although, as will be seen, they report fewer problems in some specific areas that generate uncertainty in other

economies). Firms’ reluctance to invest under uncertainty stems from irreversibility effects. Once an investment is made, firms may get stuck with excess capital or low returns if they misjudge demand, or if their very success makes them a target for rent-seekers – i.e. for corrupt bureaucrats and politicians. Drilling down, policy uncertainty is often correlated with firms’ views about stable property rights and about stable interpretation of government regulations.

**Effective property rights** will tend to increase productive investment, as investors will anticipate being able to appropriate the returns of their activity. Poorly defined or ill-protected property rights, judicial manipulation or outright crime amplify risks and dampen investment. As shown in figure 3, countries with the lowest confidence in the legal system are also those in which the investment rates are lowest. Less than 60 percent of firms in **Indonesia** are confident that their property rights can be protected. Foreign investment has been particularly adversely affected by well-publicized cases of highly arbitrary rulings in commercial cases before the courts. The rate is even lower in Cambodia where less than 40 percent are. Importantly, even though they report concerns about policy uncertainty in general, in this specific area fewer Chinese firms lack confidence about the protection of their property rights in practice. Property rights, often used as proxy for institutions, have been shown to be a “fundamental cause of long-run growth”(Acemoglu, Johnson, and Robinson, 2004).



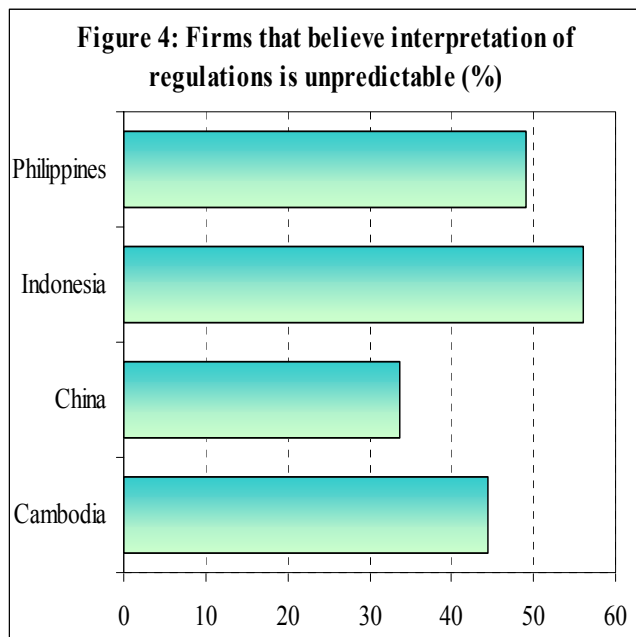
Source: Investment Climate Assessments, World Bank

Consistent implementation of government regulations is another source of policy uncertainty. In some countries, the gap between formal policies and what happens in practice is

<sup>25</sup> While the definition of policy-related risk does not include political risk, it is important to note that political stability is a pre-condition to a predictable policymaking.

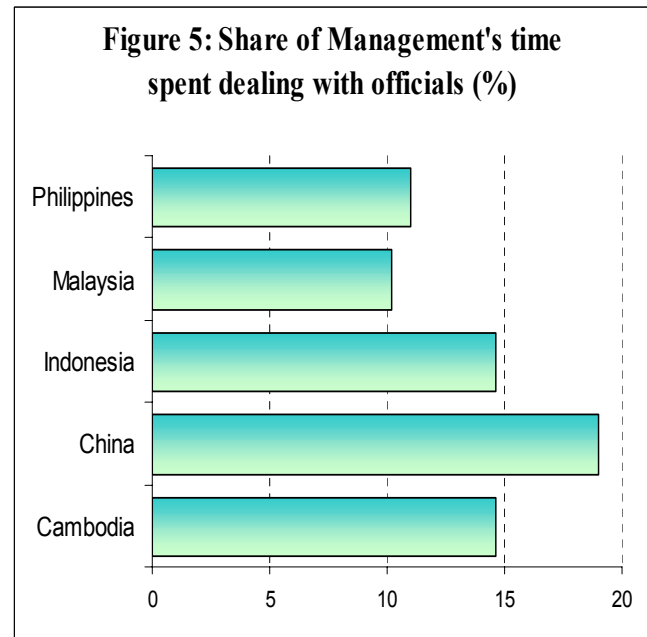
<sup>26</sup> Economic instability is generally proxied by volatility in various macroeconomic variables.

perceived to be large. As shown in figure 4, around 56 percent of firms surveyed in Indonesia do not believe the interpretation of rules is predictable. This may to some extent be an inevitable reflection of the great political changes Indonesia has undergone in the last five years. Policy making is now taking place in a brand new political and institutional context, with powerful new players such as the elected legislature and regional governments contesting the previously almost unchecked power of the executive over economic policy, with all players now also competing for the favors of the electorate. The sooner policy making and implementation settle down to predictable rules and procedures, the better for business activity. In the Philippines, another country where firms report high concerns, studies often attribute policy uncertainty to sudden changes in policies or regulations designed to advantage a favored firm at the expense of its competitors, as different branches or agencies of government vie for access to bribes or to push the interests of different patrons, or as firms seek special privileges and favors with respect to large one-off concessions, infrastructure contracts or sales of public assets.<sup>27</sup> Firms are more likely to start making long-term investments when they are convinced that government policy actions will follow predictable rules of the game.



Source: *Investment Climate Assessments, World Bank*

<sup>27</sup> See, for example, Balisacan and Hill (2003) and references therein.



Source: *Investment Climate Assessments, World Bank*

In China, implementation effectiveness and predictability is less of a problem, and the main source of policy uncertainty stems from the **heavy regulatory burden**. As shown in figure 5, the representative manager spends nearly 19 percent of his/her total time dealing with red tape in China. However, the burden does not appear to be shared equally across regions. Firms in more advanced regions appear to have lower regulatory burdens than less advanced ones. This might create further divergence between rich and poor provinces, and encourage the flow of capital to regions where there is less red tape. In Cambodia, where this ratio is 14 percent, the regulatory burden on firms is so heavy that it overwhelms other visible deficiencies such as finance, infrastructure, and human capital/skills.

**Countries can mitigate some risks over the medium term.** Provisions to use foreign arbitration and special commercial courts in case of conflict, for example, may reassure a reluctant foreign investor to settle in a country even if the efficiency of its overall judicial system is in question. Also, developing better capital markets (bond markets, leasing, credit rating agencies) could help diffuse financial crisis risks. In high profile investments, such as in infrastructure or mining, very detailed concession contracts are one avenue to specify and allocate risk to the party best able to mitigate it. But recent experience has shown that even these types of contracts have their shortcomings and are subject to re-contracting when conditions change radically. New public-private approaches may be needed for these types of projects.

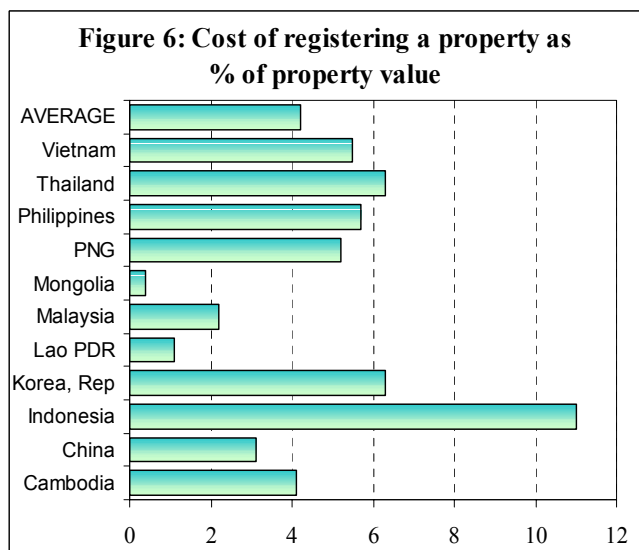
**b. Reducing the cost of doing business**

**Costs associated with weak contract enforcement, corruption, crime, unreliable infrastructure, and burdensome regulations are powerful deterrents to investment.** The World Development Report 2005 estimates that these costs can amount to over 25 percent of a typical firm’s sales ---or more than three times what it pays in taxes. For example, the cost of dispute resolution in the Philippines is one of the highest in the world. In such legally costly environments, firms prefer contracting and partnership arrangements that restrict exposure and lower the cost of exit. As a consequence there are lower levels of technology transfer, lower supply of capital, and slower integration into production networks.

**Reducing the cost of starting and operating businesses.**

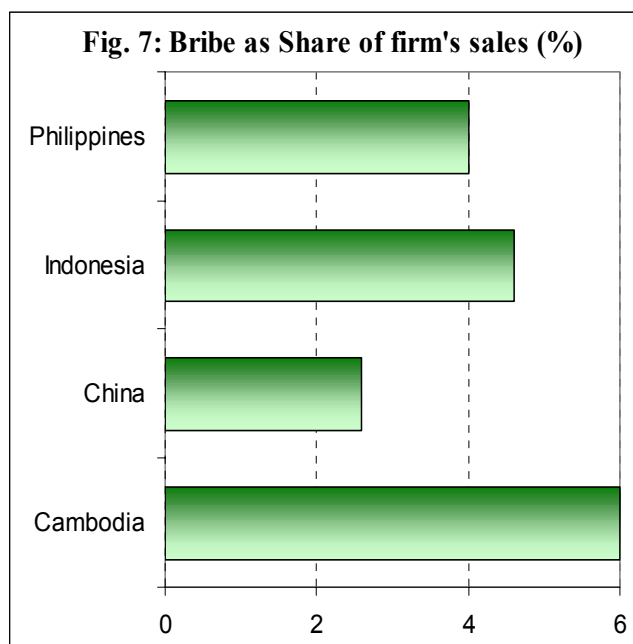
The cost of registering a business is prohibitive for some countries, coming close to 500 percent of per capita income in Cambodia or close to 150 percent in Indonesia. Also, as shown in figure 6, the cost of registering a property can exceed 5 percent of the value of the property in the Philippines and Indonesia.

**Curbing Corruption** is also likely to be an important element in improving the investment climate. While on a world scale the region may not be the most corrupt ---East Asian countries rank in the bottom half (least corrupt) of the distribution across all countries studied by the World Bank, the issue is serious enough to warrant analysis and scrutiny. In Cambodia, around 55 percent of firms find corruption a key problem, 41 percent in Indonesia, 35 percent in the Philippines. Corruption is bad for investment and growth because of the direct cost of bribes (Figure 7) and also because of the corrosive impact of corruption on discriminatory rules and other forms of rent-seeking and state capture.



Source: Doing Business Database, World Bank

In Cambodia, firms report paying up to 6 percent of their sales in bribes, over twice that of Bangladesh and by far the highest among all Asian comparators<sup>28</sup>. Indonesia and the Philippines also report rates higher than 4 percent. Given the fact that the average operating income is only 5-10 percent in most competitive environments, the impact of bribes can be very substantial. One consequence of pervasive corruption in Cambodia is little long-term investment in productive assets outside of protected sectors. Ultimately, firms prefer to remain small and informal, denying the government revenues, and reinforcing low civil service salaries and poor public sector regulatory performance, which in turn contributes to weaknesses in the investment climate. There is a growing body of evidence documenting the powerful negative effects of corruption on private investment and growth. For example, Taturan (2000) estimates that a reduction in corruption in the Philippines to the low levels prevailing in Singapore would raise the ratio of investment of GDP by 6.6 percent and the rate of annual per-capita GDP growth by 1.65 percent. Also, results obtained on firm-level data suggest that Chinese firms that report having to offer informal payments to obtain loans had significantly lower productivity levels and labor growth rates, see World Bank (2002, China ICA).

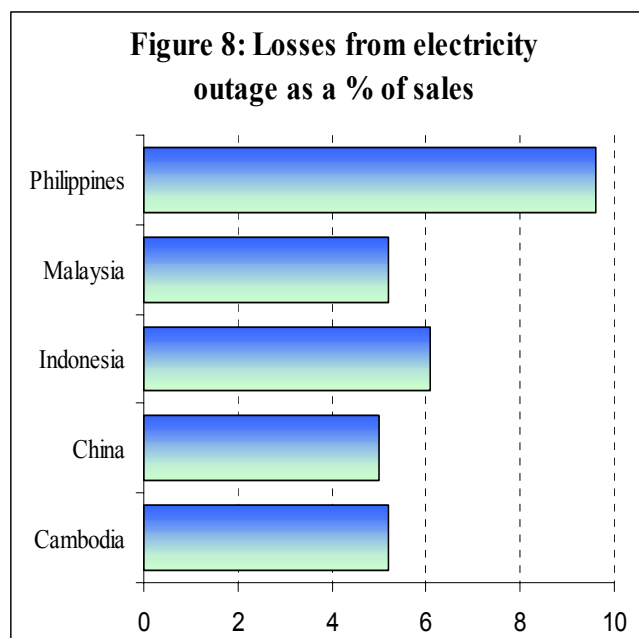


Source: Investment Climate Assessments, World Bank

**Better infrastructure, especially reliable power supply,** is perceived as a major issue in the Philippines and, to a lesser degree in China and Indonesia. In the Philippines the costs

<sup>28</sup> Of all countries surveyed by the World Bank, bribes average more than six percent of sales only in Algeria and Nicaragua.

associated with unreliable electricity supply alone amount to around 10 percent of a typical firm's sales (figure 8). This is comparable to India and Kenya. Public investment in infrastructure has been declining in the Philippines, and at less than 3 percent of GNP is one of the lowest in the region. The country ranks low for most infrastructure indicators. The World Economic Forum ranked it 68 out of 75 countries in the overall quality and sufficiency of infrastructure. With respect to its Asian neighbors, the country's rank in terms of service delivery is 8 out of 11 in the quality of electric supply, 6 out of 12 in telephone subscribers per 100 people, and 6 out of 12 in total road network. Problems arising from exercise of monopoly power also contribute to the high cost of inter-island shipping. Increasing investments in the physical infrastructure by revamping and rethinking Private Participation in Infrastructure (PPI) should be considered.

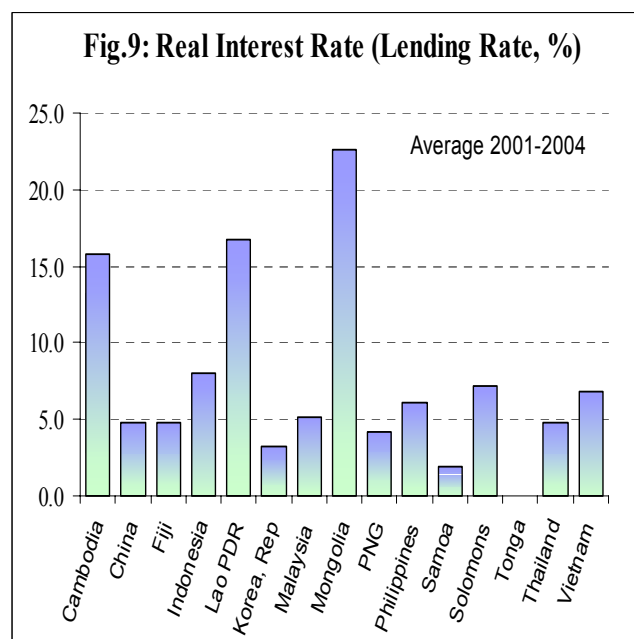


Source: *Investment Climate Assessments, World Bank*

**High interest rates are a major concern in some of the smaller countries in the region.** There is ample empirical evidence suggesting that inadequate access to finance, and high real interest rates, are harmful for investment and growth (Beck et al. 2004). In East Asia, Mongolia, Lao PDR and Cambodia have the least buoyant private sectors and the highest real domestic interest rates<sup>29</sup> (Figure 9). Mongolia still has the highest rate in the region, despite a noticeable decline from 27.4 percent in 2002 to 18.4 percent in the first seven months of 2004.

Three main reasons might explain the high lending rates in Mongolia. First, the real funding cost is high. Compared with other East/Southeast Asian countries, Mongolia's national savings rate is low (18 percent), and so is its financial intermediation (financial sector assets total about 57 percent of GDP). In addition, the liberalization of the banking system has resulted in a large number of financial institutions (16 commercial banks, more than 100 NBFIs, and numerous credit cooperatives, etc.), fiercely competing for the very limited pool of savings. Financial intermediation is not efficient. The real level of non-performing loans (NPLs) may be much higher than what is reported, and operating expenses are rising rapidly. Weak banks need a large margin to survive and cover their costs. Lending remains a high-risk business. The society's credit culture is weak, and so is the legal and regulatory framework that is supposed to encourage a strong credit culture. Penalties for defaulting are low and not systematically applied. Banks' risk management capacity is also weak, and the usual practice is to keep high liquidity.

In the Philippines, high public sector debt and deficits may be generating some crowding out of the private sector. Access to external private finance is limited by country risk factors. High spreads on sovereign bonds—the highest in the region—make external borrowing difficult for all but a handful of private firms. Domestic capital markets and nonbank financial institutions are underdeveloped and concerns about corporate governance and sanctity of contracts inhibit risk capital and joint ventures.



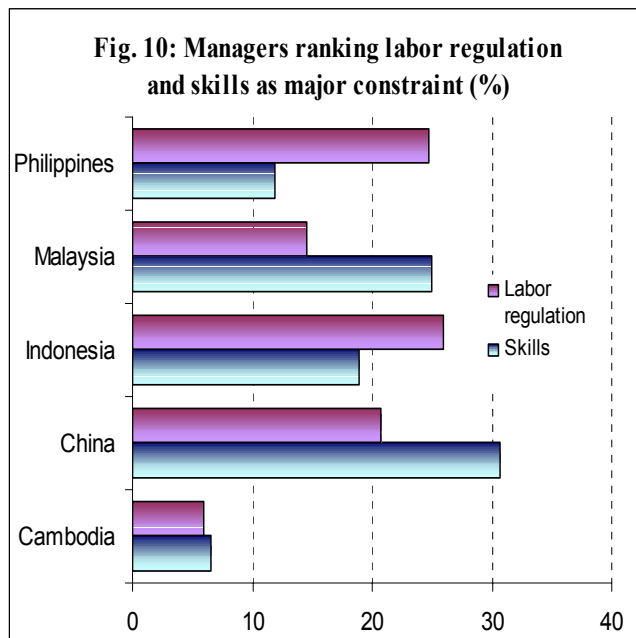
Source: *IFS (2004), IMF.*

<sup>29</sup> The interest rate is calculated from IFS (2004) as the lending rate - CPI (inflation). The interest rate for 2004 is an average of the first seven months of the year.

### c. Reducing barriers to innovation and higher returns to investing

In some cases, low investment rates can be explained by policy distortions that limit the supply of complementary production factors such as human capital or access to technology and innovation, thereby driving down private rates of returns on capital.

**Ensuring the appropriate supply of skills** that match an employer's desire to upgrade technology is critical to increasing investment returns. In Malaysia one out of four firms surveyed identify the skills and education level of workers as a major obstacle to their activity. The ratio is even higher at one in every three in China (Figure 10). The complaints of firms about skills shortage are consistent with analyses of the return to education, return to training, and trends on unemployment (World Bank, 2003). Results provide strong evidence that fast growing economies face tensions at the high end of their labor markets, resulting in high wage premiums to workers with tertiary education and to those who have received firm-specific training, leading correspondingly to lower returns to capital. In Malaysia, the return for tertiary education is nearly 18 percent versus 9.5 percent for secondary education and only 4.5 percent for primary education. This reflects the extent of skills shortages and the high value managers' place on skilled workers.



Source: *Investment Climate Assessments, World Bank*

**For fast growing economies, potential benefits from relaxing the skill constraints are large.** Relaxing the skills constraints can provide large benefits. In the case of

Malaysia, it could raise the sales of most industries by an average of 11 percent.

**Fostering a country's innovative capacity can boost returns on investment.** An alternative way to increase returns is to encourage innovation. There are three key ingredients that drive a nation's innovative capacity: ideas, clusters and networking, and national innovation systems. In Malaysia, while firms are technologically active in terms of adopting and adapting new technologies, they are weak in technology creation and innovation. Indeed, few firms report activities to facilitate innovation. Only 20 percent of manufacturing firms and 12 percent of services firms report any R&D activity. Only 11 percent of manufacturing firms file patents or copyright materials. An alternative way to boost innovation is to encourage competition. High competitive pressure on firms' benefits consumers helps drive productivity improvements, and can increase the likelihood of innovation. The WDR 2005 estimates the change in the likelihood of innovating at more than 50 percent. Given the complementarities between skills and technology, further improving the quality of the educational output in EAP countries could help reducing skills shortage and, to a large extent, weak innovative capacity.

## IV. Conclusions

This paper asks what governments in the EAP region can do to accelerate private investment growth. Results of the investment climate assessments conducted in the region suggest that in Indonesia and Philippines, policy-related risks seem to be the most binding constraint to investment. Upholding property rights, reducing the regulatory burden, keeping the commitment to the current rules of the game and reducing macroeconomic instability would help. In countries such as Philippines and Cambodia, the high cost of doing business stemming from poor governance and corruption, and poor physical and financial infrastructure appear to be holding back investment. Revamping investment growth would require curbing corruption, ensuring a reliable supply of power, and better access to finance. In Malaysia and, to a certain extent, in China, skills shortages appear to be a key impediment to higher *innovation and investment returns*. Further improving the quality of the educational output could be critical in boosting returns to investment and accelerating private investment recovery.

These results indicate that "investment climate" issues are diverse. Consequently, some prioritization is needed for each country. A quantitative survey is one instrument that can help sort out the priorities, but ultimately the quality of a public-private dialogue is crucial to this process, and must be followed up by a determined political commitment to reform that might cut across several different government

agencies. Coordinating this change process to ensure impact is a further challenge for governments across the region.

This Special Focus was prepared by Albert Zeufack, World Bank East Asia PREM, drawing on inputs from investment climate teams throughout the region, as well as from the World Bank World Development Report 2005 team.

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