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ROUNDTABLE ESSAY

FDI in the ASEAN States: The Engine that Roared

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EXECUTIVE SUMMARY

This essay examines how Southeast Asia's economic fortunes are at risk as the climate for trade and investment sours.

MAIN ARGUMENT

FDI is the engine that has propelled economic growth in Southeast Asia over the last few decades. The region, grouped together as ASEAN, has astutely used foreign investment and know-how to upgrade technology and skills and to transition from a low-cost manufacturing model to high-value goods and services. This openness to trade and investment has transformed the region's economic fortunes, with front-runners such as Singapore, Vietnam, Malaysia, Cambodia, and Thailand at the vanguard of global manufacturing in fields as diverse as electronics, automobiles, pharmaceuticals, and textiles. ASEAN's success as a manufacturing hub would not have been possible without both an openness to trade and the presence of regional supply chains that favorably position Southeast Asia as an essential supplier of raw materials and key components for final assembly in China. But this defining economic model is confronting headwinds that could upend its continued success. The region's policymakers face a difficult set of challenges as they navigate an increasingly disruptive external and internal landscape.

POLICY IMPLICATIONS

- ASEAN is at the epicenter of growing trade and geopolitical tensions between the U.S. and China, which raises the threat of decoupling and supply chain reconfiguration and potentially places the region in a difficult position of having to take sides.
- Deglobalization and reshoring also pose a risk to manufacturing and investment, which ASEAN states depend on. Protectionist policies are resurging in Europe and the U.S., and the Covid-19 pandemic highlights the fragility of just-in-time supply chain management, encouraging instead a just-in-case approach. This will test the region's ability to sustain its high pace of economic growth to meet rising public aspirations and concerns about stalling social mobility.
- Southeast Asia is already facing climate-related devastation due to rising ground temperatures and sea levels. The region is challenged to adjust its economic model to build a more sustainable future.

The Association of Southeast Asian Nations (ASEAN) has always been about making things work to attract foreign investment. Whether delivering contract manufacturing in toys and fashion for Hong Kong traders like Li & Fung or e-commerce for venture capital, the 54-year-old bloc uses its diversity in levels of economic development, technological sophistication, and wage structure as a major strategic economic advantage.[1] Embracing its own variations, ASEAN has single-mindedly focused on economic and financial integration as its *sine qua non* and achieved one of the world's greatest economic success stories as a result, eclipsed in recent years only by China. "The ASEAN Economic Community (AEC) is one of the more successful economic groupings in the world, and a prime example of how a united ASEAN is much larger than a sum of its parts," stated Singaporean prime minister Lee Hsien Loong in 2018.[2]

A major point in proof of ASEAN's success has been its ability to attract and retain FDI to the region. At the same time, however, it is becoming more difficult for ASEAN to navigate the uncertainties spilling into the investment environment from three areas often outside its control: geopolitics and decoupling, deglobalization, and climate change. This essay examines both the tailwind trends behind ASEAN's success in becoming a leading region for FDI and the headwinds that threaten to slow its ascent.

TRANSFORMING THE REGION: FDI AND FTAS

Southeast Asia has become the "world's most important FDI region."[3] The evidence is incontrovertible: a key measure, FDI over GDP, increased from 20.6% in 1995 to close to 70.0% in 2015. In dollar terms, FDI increased from a modest $21.8 billion in 2000 to an impressive $160.0 billion in 2019.[4] This growth has been the economic engine that has propelled growth and prosperity in ASEAN over the last few decades. Its openness to trade and investment

1 ASEAN is an atypical grouping. Not fully integrated like the European Union (and consequently less cantankerous), the bloc includes some of the richest nations in Asia (Singapore and Brunei), some of the poorest (Cambodia, Laos, and Myanmar), and several middle-income nations in between. It also has a significantly larger population than the EU, with 675 million people versus 447 million, and a combined GDP of $2.8 trillion, which places the bloc in the top tier of the world's largest economies.

2 Lee Hsien Loong (remarks at the opening ceremony of the 50th ASEAN Economic Ministers' Meeting, Singapore, August 29, 2018).

3 Suteera Sitong, "The ASEAN Economic Integration and Foreign Direct Investment: A Case Study of Japan's FDI on the Automotive Industry," Policy Research Institute, Ministry of Finance (Japan), 2017.

4 ASEAN Secretariat, *ASEAN Key Figures 2020* (Jakarta: ASEAN Secretariat, 2020) ~ https://www.aseanstats.org/wp-content/uploads/2020/11/ASEAN_Key_Figures_2020.pdf.

has transformed the region's economic fortunes, with front-runners such as Singapore, Vietnam, Malaysia, Cambodia, and Thailand at the vanguard of global manufacturing of electronics, automobiles, pharmaceuticals, and textiles. There are, however, also laggards in the region, such as Indonesia, whose resource-rich economy has been buffeted by a virulent strain of nationalism that has hampered FDI flows, and the Philippines, which has eschewed FDI in manufacturing to focus on services. There has additionally been a dramatic change in sources of foreign capital as well, with traditional investors such as the United States, Europe, Japan, and South Korea being disrupted by China, which has transformed itself from merely a destination for FDI into a reliable source of capital for ASEAN.

It is FDI that created the foundation for Singapore's transformation from a third-world country to a first-world one in the 1970s and 1980s, followed in short order by Malaysia, Thailand, Indonesia, and Vietnam in subsequent decades. Even low-income countries in the region such as Cambodia and Myanmar have made a virtue out of FDI by becoming some of the world's largest garment exporters.

ASEAN's economic success and ability to attract FDI have been built on successive free trade agreements (FTAs), beginning in 1992 with the ASEAN Free Trade Area, followed by bilateral and regional FTAs with states in the wider region. The cornerstone of this approach is ASEAN's bilateral FTAs with its so-called dialogue partners—China, Japan, South Korea, India, Australia, and New Zealand. These FTAs, which provide duty-free access to many goods originating from the subregion, have given the grouping the political muscle to forge more ambitious broader regional agreements. While several ASEAN members (Singapore, Brunei, Malaysia, and Vietnam) are part of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the apogee of ASEAN ambitions is the Regional Comprehensive Economic Partnership (RCEP), which was signed last year. Described as a triumph of ASEAN's "middle-power diplomacy," the RCEP brings ASEAN together with its +3 partners, China, Japan, and South Korea, as well as Australia and New Zealand, in a regional FTA that Brookings researchers estimate could add $209 billion annually to world incomes and $500 billion to world trade by 2030.[5]

Many commentators have quibbled about the shortcomings of the RCEP. To some, it is regarded as a China-centered FTA that delivers little by way

5 Peter A. Petri and Michael Plummer, "RCEP: A New Trade Agreement That Will Shape Global Economics and Politics," Brookings Institution, November 16, 2020.

of additional economic impact and is primarily aimed at challenging U.S. primacy as an economic and political power in the region. The RCEP has also been criticized for not including provisions for so-called 21st-century principles in trade agreements. Yet the effects of the partnership "are impressive even though the agreement is not as rigorous as the CPTPP," the Brookings researchers noted. "It incentivizes supply chains across the region but also caters to political sensitivities. Its intellectual property rules add little…and the agreement says nothing at all about labor, the environment, or state-owned enterprises—all key chapters in the CPTPP." They observed, however, that "ASEAN-centered trade agreements tend to improve over time."[6]

AN ECOSYSTEM FOR FOREIGN INVESTMENT

By establishing itself as an indispensable partner for FTAs, ASEAN in effect has created an ecosystem for foreign investors to access the region with certainty about market access and predictable regulations. Members of the group have also been astute in the way they have attracted foreign investment in technology-intensive sectors, even though many ASEAN members initially lacked the industrial base or relevant infrastructure. For example, Singapore still accounts for a significant share of FDI into the ASEAN region, with researchers positing that the city-state serves as an important channel of technology and knowledge transfer to the wider grouping.[7] "Singapore set up industrial estates and clusters in association with both FDI and innovation-friendly domestic policies such as in the field of biotechnology.… FDI can be a key to innovation creation because it is a major channel of technology spillovers into ASEAN member states from other developed countries."[8]

Regional supply chains, with China as the final assembly point, have also served as a transmission mechanism for the region to upgrade its technological know-how. An official paper published by the ASEAN Secretariat in October 2020 noted that the increasing level of connectivity between the group and its +3 partners drove favorable economic outcomes.[9] The report observed that "connectivity serves as a platform for production networks to settle and

6 Petri and Plummer, "RCEP."

7 This point is drawn from Patrick Ziegenhain, "ASEAN 2025: Towards Increased Foreign Direct Investment in Southeast Asia?" *AEGIS* 4, no. 1 (2020).

8 Ibid.

9 "Joint Study on 10 + 3 Cooperation for Improvement of Supply Chain Connectivity (SCC)," ASEAN Secretariat, November 2020.

helps connect local companies within the [ASEAN +3] region with global value chains, thus allowing resources to be allocated efficiently and keeping the products affordable for consumers." Two major trends highlighted by the study include:

- The share of intermediate goods trade in total trade by the ASEAN +3 countries is considerably high, indicating a close involvement in supply chains throughout the region.
- Imported inputs—another measure of interdependence—coming from the +3 countries amounted to slightly more than 40% of the total ASEAN member inputs in 2015, with input from China accounting for about half of this.

Of course, the vibrancy of regional supply chains in Asia is in equal measure due to the primary source of demand for finished products originating from Europe and the United States, which remain among the largest providers of FDI into ASEAN. Apple's iPhone exemplifies the strength of the U.S. company's deep presence in supply chains and contract manufacturers across the region. An analysis by Damien Ma shows the heavy concentration of Apple's suppliers in East Asia, with China, Japan, South Korea, and Taiwan serving as focal points for key iPhone components:

> Not only did Apple concentrate more suppliers in China from 2017–2019, it also increased its overall supplier presence in East Asia, from 83.6% to 86.5%.... [T]o the extent there is some diversification from China, the shifts have been largely intra-Asia among Asian suppliers. Some Japanese and even Chinese firms have relocated to Southeast Asia.[10]

This case illustrates how the ASEAN region has benefited in terms of fresh FDI and technology spillover from production work in East Asia, especially China. There is a virtuous circle in U.S. and European multinationals tasking East Asian contract manufacturers to assemble components for final assembly in China, for example, and for the finished product to be shipped back to consumers in the United States, Europe, and the rest of the world. Contract manufacturers, such as Taiwanese tycoon Terry Gou's Foxconn, are indispensable Apple suppliers and major investors in production facilities across ASEAN. At the other end of the manufacturing spectrum, in low-wage, labor-intensive sectors, Hong Kong–based Li & Fung serves as

10 Damien Ma, "How Apple Exemplifies the Resilience of East Asian Supply Chains," MacroPolo, June 2, 2020.

a key intermediary for global fashion, toy, and furniture brands by sourcing products from factories across Asia, including ASEAN.

While contract manufacturing is a global phenomenon, it has been perfected in Asia through the emergence of companies like Foxconn and Li & Fung that serve as intermediaries for global firms and are major investors themselves in businesses and production facilities. Their presence has made it possible for ASEAN to excel in both high-value markets such as electronics and low-wage sectors such as textiles. ASEAN is also at the vanguard of the mobility and e-commerce revolution, which has created a new generation of tech-savvy entrepreneurs. The rise of start-ups like Indonesia's GoTo (a result of the recently merged ride-hailing company Gojek and e-commerce firm Tokopedia) and Singapore's wide-ranging services firm Grab was fueled by investments from China's tech majors Alibaba and Tencent and Japan's SoftBank. Venture capital flows into the region have remained buoyant with an estimated $8.2 billion in 2020 alone.[11] These are primarily flowing into technology-intensive sectors such as e-commerce, mobility, and financial technology, although the pandemic will cause an increase in health technology investing. It is an open question, though, whether these flows will continue apace as China places ever greater restrictions on the operations of its tech majors, which could reduce investment flows in the future.

China has also played a visible role in investing in ASEAN's infrastructure via its Belt and Road Initiative (BRI). The Asia-Pacific Research Exchange estimates that Chinese BRI investments in ASEAN are concentrated in Indonesia, Malaysia, the Philippines, and Vietnam.[12] However, these BRI projects have not been immune from recipient country concerns about their lack of transparency and the overburdening of projects with high levels of debt, as has become evident in parts of South Asia and Africa. In Malaysia, for example, former prime minister Mahathir Mohamad sought to renegotiate terms with Beijing during his tenure over a controversial train project. Following a one-year delay, the project was resumed after the two countries mutually agreed to cut project costs to around $11 billion.[13]

These concerns notwithstanding, ASEAN's diversity in levels of economic development, technological sophistication, and wage structure is a major

11 Cento Ventures, "Southeast Asia Tech Investment—FY 2020," March 26, 2021 ~ https://www.cento.vc/southeast-asia-tech-investment-report-full-year-2020.

12 Albert Park, Angela Tritto, and Dini Sejko, "The Belt and Road Initiative in ASEAN," HKUST Institute for Emerging Market Studies, ARX Series, December 31, 2020.

13 Joseph Sipalan, "China, Malaysia Restart Massive 'Belt and Road' Project after Hiccups," Reuters, July 24, 2019.

strategic advantage as a combination of souring geopolitics and rising wages drives investment southward from China. ASEAN wants to have its cake and eat it too by benefiting from foreign investor relocation away from China as well as by gaining access to Beijing's wallet and know-how in building quality infrastructure. The region is well-positioned for this because of varying levels of economic development (which makes it wage-competitive for foreign investors) and the simple fact that ASEAN is indispensable for economic outreach by China and other competing powers. This point was underscored by consulting firm BCG, which has stated that the region has a "golden opportunity to move up the manufacturing value chain" as geopolitics and rising costs force companies to rethink "where and how they make and source their goods."[14] The region comprises one of the world's largest, fastest-growing markets and has an extensive manufacturing base that spans light, heavy, and high-tech industries. If ASEAN can take advantage of these trends, BCG estimates that "by 2030 the region can generate up to $600 billion a year in additional manufacturing output, increase annual FDI in manufacturing by up to $22 billion, and create up to 140,000 new jobs a year."[15]

GEOPOLITICAL, ECONOMIC, AND ENVIRONMENTAL HEADWINDS AHEAD

These numbers are dazzling by any yardstick, but there is a problem with the rosy projections. The ASEAN region is hostage to turbulence in the global economy and geopolitics that it cannot completely control. Challenges include:

- Deteriorating relations between an incumbent and rising superpower—the United States and China—which will have a tangible impact on politics and economics in ASEAN and the wider region for the foreseeable future. There is a real risk of decoupling and the establishment of distinct spheres of U.S. and Chinese influence.
- The threat of deglobalization and reshoring, which jeopardizes ASEAN's economic model that is built on openness toward trade and investment.
- Finally, ASEAN is still a laggard in complying with environmental, social, and governance (ESG) standards as foreign investors step up

14 Michael Meyer et al., "How ASEAN Can Move Up the Manufacturing Value Chain," BCG, June 15, 2021.

15 Ibid.

> compliance as a result of pressure from regulators, investors, and NGOs. The region is also experiencing significant impacts from climate change due to a rise in ground temperatures and sea levels.

Geopolitics first. Singapore's foreign minister Vivian Balakrishnan was speaking for the rest of ASEAN when he told an audience in Washington, D.C., that the way competitive dynamics between the United States and China play out in trade, technology, and security will affect the region disproportionately: "Southeast Asia, which stands at the intersection of major power interests, is viewing the duet with great concern, maybe even grave concern. And one point is that for us in the middle, especially for smaller countries, we do not wish to be forced into making invidious choices."[16] On his first visit to Singapore as defense secretary, Lloyd Austin sought to reassure ASEAN partners that the United States is attempting to build a "constructive, stable relationship with China" and that, even in times of competition, Washington's enduring ties with Southeast Asia are bigger than geopolitics. He emphasized that "we are not asking countries in the region to choose between the United States and China. In fact, many of our partnerships in the region are older than the People's Republic of China itself."[17]

The worst-case scenario for ASEAN is decoupling, which would force countries into making choices that could splinter the wider region into distinct U.S. and Chinese spheres of influence, with separate channels for trade, investment, and technology flows and standards. It is no exaggeration to say that such decoupling would be an economic disaster for ASEAN, which has prided itself on its ability to host foreign investment regardless of political systems and ideology. For foreign investors, who treasure certainty and predictability when deciding to put money into a country, decoupling would also upend their business models, which are built on gaining market access to the world at large. Although decoupling concerns are tangible, to date there is little evidence that the region is splintering. Within ASEAN, there are countries such as Cambodia and Laos that are pro-China in their foreign policy approach, while Singapore and the Philippines are regarded as closer to the United States. Yet neither set of alignments has stopped Cambodia from becoming the preferred location for global fashion brands to source

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16 Vivian Balakrishnan, "Seeking Opportunities Amidst Disruption" (remarks at CSIS Banyan Tree Leadership Forum, Washington, D.C., May 15, 2019).

17 Lloyd J. Austin III, "The Imperative of Partnership" (Fullerton lecture, IISS-Asia, Singapore, July 27, 2021) ~ https://www.iiss.org/blogs/podcast/2021/07/40th-fullerton-lecture-us-secretary-of-defense-austin.

supplies or Chinese companies from targeting Singapore as the base for their regional ambitions.

The second risk for ASEAN stems from concerns over deglobalization, which originated from the populist backlash in the United States and Europe manifested in Donald Trump's victory in the 2016 presidential election and the United Kingdom's Brexit referendum. As one of the single-largest beneficiaries of globalization, trade, and investment, ASEAN stands to lose out the most if U.S. and European investors, under pressure from politicians and the public at home, reverse course and reshore some of their manufacturing facilities. For ASEAN, this would represent as great an economic shock as decoupling because of the region's dependence on FDI. Covid-19 has aggravated concerns that some level of reshoring is perhaps inevitable given the persistent shortages of medical supplies and equipment at the outset of the pandemic in 2020.

To date, such concerns are not yet backed up by hard data. Although the latest data from the UN Conference on Trade and Development does show a steep 25% contraction in FDI into ASEAN in 2020 to $136 billion, the slowdown in investment flows has been attributed to the pandemic, supply chain disruptions, and delayed investment plans.[18] One country, Thailand, recorded an actual decline because of a divestment—a local business group acquired the retail operations of the United Kingdom's Tesco for $10 billion. ASEAN policymakers are also fretting about the Biden administration's "Buy America" mandate to the federal government, which they fear may lead to significant reshoring and reduce inbound investment flows.

The third risk for ASEAN is from climate change. Many countries in the region are already at risk from climate distress, and ever-higher requirements are being imposed on multinational corporations by investors and regulators in terms of ESG standards. Countries on the front line of climate distress include Indonesia, which is host to rapidly dwindling rainforests in Borneo, and Vietnam, where rising sea levels have placed low-lying coastal areas at risk from flooding. ASEAN leaders have been parsimonious in outlining their nationally determined contributions (NDCs), climate change policies that they have committed to undertake under the 2015 Paris Agreement. Indonesia is certainly the worst offender because authorities there have failed to contain devastating forest fires in Borneo from annual slash-and-burn practices by corporate palm oil plantations. The region is also promiscuous in

18 "Investment Flows to Developing Asia Defy Covid-19, Grow by 4%," UN Conference on Trade and Development, June 21, 2021.

its use of coal as the primary feedstock for power generation—a trend that is evident in the broader Asian region. "Over 80% of global coal power capacity under construction is in this region," according to Kaveh Zahidi of the UN Economic and Social Commission for Asia and the Pacific. "Our region is still the one where the greatest new investments are being made in coal and clearly that is incompatible with the ambitions of Paris."[19]

The international aid community and foreign investors have some leverage with ASEAN policymakers in bringing about a change in behavior and attitudes toward ESG and climate compliance. Sustainable development has featured as a rhetorical priority in ASEAN ministerial communiques and pledges, but tangible progress has been slow. This issue is where ASEAN's official partners and foreign investors can make a difference. In the aftermath of the pandemic, the region will be eager to boost official and private investment flows. Multilateral institutions like the World Bank and Asian Development Bank can help the region "build back better" by rigorously enforcing higher environmental and social standards. The private sector is already under pressure to do the same. Global fashion and footwear brands, for example, have imposed rigorous social standards on their suppliers in Cambodia requiring them to improve working conditions and wages. International banks and asset managers operating in the region have also used the power of their purses to force borrowers and investee companies to comply and implement rigorous ESG standards. This shift is beginning to happen with mixed results. Many international banks have pulled out of lending to polluting sectors like palm oil and coal, for example. However, this divestment has not stopped local banks in Indonesia from doubling down on lending to these sectors instead, making the net climate impact still negative. Global consumer companies, which source palm oil as a key ingredient, have also committed to using sustainable practices. Yet international NGO Greenpeace is not impressed: "After tremendous consumer pressure worldwide, many of these companies committed to put an end to deforestation and exploitation in their palm oil supply chains by 2020. None of them are on track to meet this deadline."[20] Palm oil usage as a raw material and ingredient remains pervasive in the food and cosmetic sectors, and global efforts to label the end product as sustainable based on independent validation have been unsuccessful.

19 Trudy Harris, "Asia Undermining Efforts to Reduce Coal Dependence," SciDev.Net, September 8, 2019.

20 "Indonesian Forests and Palm Oil," Greenpeace.

CONCLUSION

In the end, ASEAN is too open and integrated with the global economy to ignore either the real threat from global climate change or the impact it will have on future economic prospects. More than ever, the region needs to sustain its high pace of economic growth to meet rising public aspirations and concerns about stalling social mobility. There will need to be increasing convergence between the NDCs, which must be scaled up in ambition, and foreign investor preconditions on ESG rules of the road. Unlike China and India—continent-sized economies with large domestic drivers of growth—most ASEAN states rely on FDI and trade to sustain their high pace of development. A more coherent approach toward sustainable development, higher ESG standards, and tangible action on climate change would make the region even more attractive for foreign and local investors. The centerpiece of this effort is the region's aspirations to build an ASEAN Economic Community by 2025, which will require significant reworking to deal with emerging challenges of environmental and social sustainability. After enjoying favorable economic tailwinds for several decades, Southeast Asia must demonstrate that it is able to navigate climate and geopolitical headwinds to retain bragging rights as one of the world's truly spectacular economic success stories. ◈