

**Regional Integration, Signaling, and Foreign Direct Investment: The Case of
ASEAN**

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Abstract

Beginning in the 1950s, developing countries invested substantial resources in regional economic integration. Despite seemingly little prospects and meager results, these efforts continue and even intensify today. Considering the widespread skepticism regarding the benefits of regional integration arrangements (RIAs), this enthusiasm is puzzling. This paper offers an answer to this apparent discretion. In it, I argue that developing countries form RIAs not necessarily to boost intra-regional trade but rather to attract foreign capital from extra-regional private investors and public donors. In particular, governments of developing countries institutionalize their economic relations to signal that they are reliable and peaceful states. In doing so, they reduce the political risk associated with investment in their economies. This argument suggests that – by providing information under conditions of uncertainty – international institutions can promote cooperation not only among their members, but also between members and non-members. I demonstrate the empirical plausibility of my argument with the case the Association of Southeast Asian Nations (ASEAN). I first argue that conventional explanations for the formation of this organization in 1967 are unconvincing. I then make the case for the theoretical framework offered here. I show that Indonesia was a primary driving force behind ASEAN and that Indonesian policymakers believed that joining this RIA will reverse its aggressive and irresponsible image in the international community. A more positive and peaceful image, they believed, will result in increasing foreign capital and financial, which were indispensable for the development of the Indonesian economy. Evidence from other ASEAN countries and data on the inflow of foreign capital into the ASEAN region offers further support to my theoretical framework.

Economic regionalism is one of most notable manifestations of efforts to institutionalize international cooperation among developing countries in the last fifty years or so. Following the pioneering initiative of the European Economic Community (EEC), several regional integration arrangements (RIAs) were formed in Latin America, Sub-Saharan Africa, and Asia. Examples are the Central American Common Market (CACM) and the Economic and Customs Union of the Central African States (UDEAC). After some setbacks in the 1970s and early 1980s, regional integration among developing countries was resumed in full steam in the 1990s with the deepening of existing RIAs – like the Economic Community of West African States (ECOWAS) and the Andean Community – and the formation of new RIAs – MERCOSUR and the Arab Maghreb Union, for example. Today, most less developed countries (LDCs) are members of at least one RIA and some states belong to three and even four RIAs.

This enthusiasm for regional integration remains a puzzle. Both scholars and practitioners tend to assume that the primary goal of regional integration is to promote international trade among member-states. This was the main logic of the European integration, which served (and still serves) as a model for many RIAs in the developing world. Theoretically, most economists (and to a lesser extent political scientists) examine trade flows to evaluate the effectiveness of RIAs. From this perspective, the conventional wisdom is that regional integration among LDCs generated only few benefits. A variety of studies demonstrated that, for the most part, RIAs in the developing world failed to boost intra-regional trade. As two prominent economists conclude, “as far as South-South

integration is concerned, there is no future in it” (de Melo and Panagariya 1993, 20).¹

Why, then, policymakers in developing countries disregard such gloomy assessments and continue to invest physical, human, and political capital in these arrangements?

In this paper, I offer an answer to this apparent discretion by providing a new interpretation for the role of RIAs in the developing world. I argue that an important motivation behind these arrangements is to attract foreign capital from the economically developed countries (EDCs) rather than to increase regional commerce. Foreign capital (either private or public) is an important source of economic development. The flow of such capital into developing countries is contingent, however, upon the perceived stability of particular regions and the political orientation of governments in these regions. I argue, then, that LDCs join RIAs in order to project a responsible and peaceful image to the rest of the world. Such image, in turn, is instrumental in attracting valuable capital and conducive for economic development.

This theoretical framework contributes to the broader research agenda that endeavors to understand *how* international institutions matter (Martin and Simmons 1998). In particular, it highlights the role of such institutions as vehicles of valuable information in an uncertain world. While the notion that international institutions mitigate informational asymmetries is not new, extant literature emphasizes their usefulness in fostering cooperation (or reducing conflict) *among* their own members.² My argument sheds light on the largely overlooked possibility that international institutions provide

¹ For similar assessments see de la Torre and Kelly (1992); Frankel (1997); Langhammer and Hiemenz (1990); OECD (1993).

² The literature on this issue is voluminous. For some seminal studies, see Keohane (1984); Martin (1992); Fearon (1994); Abbot and Snidal (1998).

valuable information to non-members and in so doing advance the interests of their members.³

To demonstrate the plausibility of my argument, I examine the creation of the Association of Southeast Asian Nations (ASEAN). Specifically, I show that Indonesia was the main force behind the formation of ASEAN in 1967. The foremost reason for the Indonesian enthusiasm for ASEAN was its determination to project an image of a trustworthy state and a friendly neighbor. Projecting such image, Indonesian policymakers believed, was a key in their attempts to attract foreign capital and financial aid from the West in the path to economic development.

The next section develops a theoretical framework that links regional integration, political risk, and foreign capital. The third section examines conventional explanations for the formation of ASEAN and cast doubt on their validity. The fourth section provides a detailed account of Indonesia's motives in promoting regional cooperation through ASEAN. The fifth section examines other ASEAN members as well as trends in actual flows of capital into the ASEAN countries. The final section concludes.

The Argument

This section develops a detailed theoretical framework that links regional integration to the flow of foreign capital into developing countries. It begins with the observations that, by and large, LDCs have been striving to attract much-needed foreign capital into their economies. While developing countries were oftentimes ambivalent about such capital, it proved essential for their economic development. In the last several

³ For exceptions, see Morrow (1994); Simmons (2000); Bütte and Milner (2005).

decades, then, they were dependent on different combinations of public and private capital from EDCs.⁴

At the same time, developing countries have faced significant hurdles in obtaining this essential capital. Private investors are worried about a variety of investment risks that may decrease their return on this investment. When considering investment in developing countries, investors are especially concerned with political risks.⁵ One important source of political risk that impedes the flow foreign capital from the developed to the developing world is international and domestic instability. Foreign investors often worry that civil wars, coups, insurrections, and international conflicts will lead to political instability, the disruption of the orderly economic process in the host country, and thus smaller profit (Baker, 1999:13). In addition, such events may put host governments under political and economic pressure, which may result in nationalization and expropriation of foreign assets in order to alleviate short-term difficulties (Schneider and Frey 1985, 166). Thus, developing countries that hope to attract foreign capital have to convince potential investors that they are unlikely to experience inter-state or domestic violent conflict.

Another type of political risk pertains to domestic economic orientation and the policies that follow from such orientation. Private investors consider risky socialist and protectionist ideologies, which generally promote policies of heavy state intervention, import-substitution, and other restrictions on economic activity. Host governments may also discriminate against foreign investors through unfavorable treatment of their

⁴ Private capital refers to foreign direct investment (FDI), portfolio investment, and bank loans. Public capital refers to loans from international financial institutions and official financial aid.

⁵ See, for example, Nigh (1986, 99). Political risks refer to uncertainties that emanate from a wide range of contingencies that are external to the production process and other economic factors (Sobel 1999, 33-34).

businesses or confiscation of their assets without due compensation. Governments of the EDCs have also been reluctant to grant loans or financial aid to developing countries that adopted economic policies that undermined the free operation of markets. The conditions attached to loans from the International Monetary Fund and the World Bank is but one obvious example of this reality. Notwithstanding the discontent of many in the developing world of this conditionality, LDCs still needed to convince potential donors that they are willing to adopt market-oriented policies.

What regional integration has to do with this? I contend that by joining an RIA, LDCs can convince potential investors and donors that they are responsible and trustworthy. The logic of formal signaling games is useful in developing this argument. Signaling games deal with strategic interaction under conditions of incomplete information. In it, the preferences, or 'type', of one player is not known to the other player. The two relevant players in my analysis are foreign investors and donors, on the one hand, and developing countries on the other. Political risk reflects the notion that the former is uncertain about the type of the latter. As I elaborate below, developing countries can be either 'peaceful' or 'conflictual' (with respect to political stability), or either 'anti-market' or 'pro-market' oriented (with respect to economic orientation). Developing countries can take costly action in order to convince foreign investors and donors that they are of one type and not the other. In what follows I explain how RIAs can be such useful signal, first in the context of violent conflict and second in the context of economic orientation.

As pointed out above, foreign investors face a great deal of uncertainty regarding their investment in LDCs. As a result of the processes of decolonization and nation-

building, domestic and international conflicts ran rampant in many developing countries in the immediate periods that followed independence and decolonization. Later on, however, some states were able to reverse this misfortune and stabilize. Regions that inhabited states that experienced such change became politically stable and turned into the so called ‘zones of peace’ (Kacowicz 1998). Such regions benefited from substantial reduction of domestic and inter-state conflicts. In light of the past hostilities, however, states in these safer regions found it difficult to convince extra-regional investors that this newly-obtained political stability is sustainable. In other words, foreign investors were still uncertain about the ‘type’ of these states, which can be either ‘conflictual’ to ‘peaceful.’ From this perspective, states that had a conflictual past but a peaceful present and future have a strong incentive to use costly signals, which will allow them to solve the problem of asymmetric information.⁶

Forming an RIA in such ‘zones of peace’ can help alleviate the problem of information asymmetry and signal a benign political environment.⁷ RIAs reflect institutionalized cooperation between states on a variety of issues. It is a long-term arrangement, which its formation involves the investment of physical, human, and political capital, all quite scarce in developing countries. RIAs also require that their member forgo at least some national autonomy and sovereignty (Haftel and Thompson 2006; Keohane 1989; Choi and Caporaso 2002, 483). Such costs are especially prominent for governments in the developing world, where sovereignty and statehood are not taken for granted. Moreover, that RIAs are commonly regional in scope is particularly useful in this regard. Neighboring states interact more often on more issues and thus are more

⁶ Also see Kydd (2001, 811).

⁷ For a similar argument regarding the role of security alliances, see Morrow (1994).

likely to disagree. Indeed, current research shows that contiguous states are indeed fight each other more than other states. In addition, domestic conflicts generally involve a high risk of spillover to other states in the region, and it is the region that suffers the consequences of such conflict most immediately and most intensely. Thus, even states that are not involved directly in any particular conflict have an interest in containing it. That is why a regional arrangement can be a good signal of regional peaceful intentions (as opposed to broader multilateral arrangements or narrower bilateral ones). In sum, joining an RIA can serve as a costly signal of peaceful intentions, which in turn can reduce the perceived political risk that investors associate with conflict and war.

A similar argument can be made with respect to the economic orientation of LDCs. In the 1950s and the 1960s, neo-Marxist and other Structuralist ideologies were very popular in the developing world. Many states adopted policies that followed from these theories, which recommended heavy involvement of the state in the economy, economic protectionism, restriction on the operation of Multinational Corporations (MNCs), and the like. These policies created an unfavorable economic environment for foreign investment and financial aid from EDCs. Because of this legacy, governments of developing countries that decided to substitute an inward-looking economic orientation with a market-oriented orientation, found it difficult to convince foreign investors and donors that they are committed to long-term economic reforms and free-market policies. As Dani Rodrik (1989b, 757) explains, “[particularly for developing countries] private sectors decision-makers may not be able to tell how serious the government really is about the reform process. In other words, they may be in the dark about the true

objectives of the government in power, or may ‘confuse’ it with an alternative government whose objectives differ.”⁸

Thus, states that have an ‘anti-market’ past reputation but are now ‘pro-market’ have to use costly signals to reinforce their new, market-oriented policies and to separate themselves from other types of states. That is, they have to take some extreme measures to demonstrate the credibility and irreversibility of their economic reforms (Rodrik 1989a, 11-12). Such measures can signal the commitment of the government to their stated objective and reduce the risk of investment and foster the inflow of private capital and financial aid.

States can take various measures to signal that they have mended their ways. Domestically, they can implement economic and political reforms as well as delegate decision-making power to independent agencies like central banks (Maxfield 1997; Sobel 1999). RIAs can serve as costly signals as well. To the extent that RIAs promote market-oriented policies – like free movement of goods, services, and capital – joining such an arrangement demonstrates a long-term commitment to such policies. Unlike domestic reforms, joining an RIA creates international legal obligations that may be very difficult and costly to renege on (Büthe and Milner 2005, 9-10). As pointed out above, forming and maintaining RIAs also require substantial wherewithal that is especially scarce in developing countries (Fernandez 1997, 16). Thus, joining an open RIA can serve as a

⁸ See also Fernandez (1997, 16).

costly signal of free-market orientation, which in turn promotes foreign investment and financial assistance.⁹

In sum, institutionalized cooperation through economic regionalism can serve as a costly signal of political stability and pro-market economic orientation of developing countries. This signal, in turn, should reduce the political risk perceived by foreign investors and donors and increase the flow of FDI and financial aid into countries that formed an RIA. This argument has several observable implications. First, to the extent that this logic was really an important consideration for developing countries, one should find that policymakers in such countries actually rationalized the formation of RIAs in this way. Second, one should expect that higher levels of uncertainty should require more costly signals. That is, the higher the initial level of conflict or anti-market orientation, the more difficult it is for a state to convince others that it has changed its ways and the more it will be willing to invest in regional integration. Finally, to extent that foreign investors and donors receive the signal and incorporate it into their policies, one should expect that forming an RIA will result in an increase of FDI and financial aid inflows. Again, the greater the initial political risk, the greater the expected change. In the following sections I evaluate these observable implications in the context of ASEAN and the role of Indonesia in forming this RIA.

⁹ Not all RIAs in the developing world are open, in the sense that they promote economic liberalization. Some RIAs that were formed in the 1960s and 1970s, the Andean Pact for example, were designed to promote inward-oriented policies. My argument does not apply to such RIAs. Most contemporary RIAs can be classified as open, however.

Case Study: The Formation of ASEAN

In this section I examine the formation of ASEAN in light of the theoretical framework thus far presented. Since this framework is rather novel, this case study serves as a plausibility probe and is not meant to prove or disprove the argument. In what follows, I discuss extant explanations for the formation of ASEAN. I conclude that none of these accounts is satisfactory. I then consider my own argument. Finally, I examine the role of other ASEAN member-states and some trends in the flow of real economic indicators.

Existing Explanations

ASEAN was formed in the summer of 1967 between Indonesia, Malaysia, the Philippines, Singapore, and Thailand. What prompted these five Southeast Asian states to form this organization? The ASEAN Declaration – the agreement on which the organization was founded – emphasizes cooperation on social, cultural, and especially economic issues.¹⁰ There are good reasons to doubt that these were the primary objectives of ASEAN during its early years. Like in other developing regions, policy-makers were very skeptical of the benefits of lower intra-regional barriers to trade.¹¹ The economies of the member-states had little to offer to each others. Indeed, the first preferential trade agreement was signed only nine years later, in 1976. It seems that the emphasis on functional and economic cooperation emanated from the inability of the

¹⁰ Even this emphasis was quite ambiguous and did not offer clear measures to obtain these very general goals. See articles 1 to 5 of the Declaration and Frost (1990, 4-5).

¹¹ Gordon (1966, 150) writes that “The disappointing efforts to increase regional trade, by ECAFE [Economic Commission for Asia and the Far East] and others, have confirmed the suspicions of some who believe that all regionalism is impractical. This appears to be particularly true of political leaders, but many economic advisors are also beginning to lower their estimates of the role that trade alone can play in achieving cooperation.”

founders to agree on other common objectives. As Roger Irvine (1982, 14) observes, “considering the fact that the ambitions of ASEAN members in the field of economic cooperation were initially very modest, the key factor behind the emphasis on economic co-operation was that co-operation in this field, and even more so in the social and cultural fields, was relatively uncontroversial.”

A second popular explanation focuses on the anti-communist disposition of the ASEAN member-states. According to this line of argument, ASEAN was a security alliance in economic disguise. The main objective of ASEAN was, so the story goes, to contain communist powers in the region, particularly China and North Vietnam.¹² As one prominent scholar argues, “the involvement in ASEAN can hardly be understood without reference to the members’ strong concern about security...and it is communism and China that loom largest (Jorgensen-Dahl 1982, 73). This was especially pressing due to the British decision to scale back its military presence in the region and the American growing difficulties in Vietnam. According to this view, then, ASEAN was, first and foremost, a security organization that attempted to restrain communist expansion in the region. As Rüländ (2003, 58) contends, “It was thus no accident that ASEAN was formed at the height of the Vietnam War in 1967. The grouping was in the first place a creature of the Cold War and initially served an anti-communist cause.”¹³

There is little evidence to support the contention that ASEAN was formed as a collective anti-communist instrument. To begin with, the organization included no agreement on military cooperation or any other measures that pertained to international

¹² To some extent, this argument was popularized by China, the Soviet Union, and other Communist countries in order to undermine ASEAN’s legitimacy in the developing world.

¹³ See also Antolik (1990, 16).

security (Irvine 1982, 15-16). Even if it were to have such provisions, the military power of all the ASEAN members as a whole was still much weaker than those of China or the Viet-Kong (Gordon 1969, 110). In addition, both the Tet offensive – that was the first prominent sign of American troubles in Vietnam – and the British decision to imminently withdraw its military forces east of the Suez took place after the formation of ASEAN.¹⁴ As such, they cannot account for its formation and initial objectives. Thus, despite the undeniable anti-communist sentiment of its member-states, it is very difficult to see how ASEAN could promote an international anti-communist agenda.

A related, more plausible, argument points to the role of ASEAN in decreasing domestic instability, with a particular reference to communist insurgency. These concerns should be understood, some observers argue, in the context of mounting communist influence elsewhere in East Asia (Antolik 1990, 16; Gordon 1969, 109-110). In this view, ASEAN espousal of the non-interference principle intended to sanctify national borders, to prevent from one state to meddle in another state's domestic struggle, and to avert spill over of domestic disputes (Acharya 2001, 59-60; Collins 2003, 128-30; Huxley 1993, 4; Leifer 1989). Unlike the explanations thus far discusses, the early history of ASEAN seems to provide reasonable empirical support to this argument. It is apparent that ASEAN did provide some assurances against domestic violence, mainly through the principle of non-interference.

¹⁴ The Tet Offensive began in late January 1968. The initial British announcement regarding the withdrawal of its forces, made in July 1967, stated that the withdrawal will occur in the middle of the 1970s. It was only in early 1968 that it declared the speeding up of the withdrawal that was now expected to be completed in 1971 (Irvine 1982, 23). Even if one considers the timing of the initial British announcement, the negotiations regarding ASEAN were well under way at that time.

Nonetheless, this explanation cannot account for the timing of ASEAN's formation. In 1966-67 the threat from communist insurgency was rather mild. In Indonesia communist forces were defeated and eliminated by Suharto's New Order (see below).¹⁵ Other ASEAN states did not face substantial increase in communist or separatist threats during these years (that is, they faced similar threats in the late 1950s and the early 1960s, so why not forming an ASEAN-like organization then?).¹⁶ It was only in the early 1970s that the threat from communist and separatist movement dramatically increased. Similarly, there was no clear sign that communism elsewhere in the region was expanding its influence. China devoted most of its energy to the inward-looking Cultural Revolution (1966-69), and, as pointed out above, the potential triumph of communist Vietnam was not known during these years. The possibility that communist China or Vietnam will either inspire or support local communist opposition loomed large only later, during the 1970s. Thus, again, this explanation cannot account for the formation of ASEAN.

An Alternative Interpretation

In order to understand the formation of ASEAN and its timing, we need to examine the special role of Indonesia and its relationship with other member-states, particularly Malaysia. The reasons for focusing on Indonesia are twofold. First, Indonesia was (and still is) the largest and most powerful state among the members of ASEAN. As such, any viable regional organization had to have Indonesia as a member – something that is more difficult to say on other ASEAN members (Gordon 1969, 109-110). As one

¹⁵ Elimination took place in both configurative and literal senses. Some estimate that the Indonesian military killed about 400,000 people that were suspected Communists.

¹⁶ Gordon (1969, 154) estimates that the number of insurgents in 1967 did not exceed two-thousands in each of the ASEAN countries.

Malaysian officials said: “It all comes down to this. You can imagine Asean without Philippines, and even without Thailand – though of course the region would be very different. But you cannot imagine Asean without Malaysia and Indonesia.”¹⁷ It was obvious to the other members that in order to promote regional cooperation and to gain international recognition they needed to create a regional organization that includes Indonesia (Gordon 1969, 109). Second, and related, three other states formed an RIA as early as 1961, named the Association of Southeast Asia (ASA), with very similar objectives to those of ASEAN.¹⁸ That the other members already participated in an RIA indicates that we need to pay special attention to Indonesian motivation in order to explain the timing of ASEAN formation (Jorgensen-Dahl 1982, 13).¹⁹

Indonesian attitude towards regional cooperation should be understood in the context of its broader political orientation and its relationship with its neighboring states. From this perspective, Indonesian domestic and foreign policy went through a dramatic transformation in 1965-66. During the so-called Guided Democracy period (1959-1965) – under Sukarno’s leadership – Indonesia adopted a neutralist stance and developed close relationship with the Soviet Union and China on the expense of its ties with the West (Anwar1994, 21). During these years, Jakarta’s position with respect to regional cooperation was derived from this broader political outlook. In particular, Indonesia rejected an invitation to join ASA and dismissed it as pro-Western and anti-Chinese (Jorgensen-Dahl 1982, 17-18).

¹⁷ Cited in Antolik (1990, 18). Considering that a Malaysian official made this statement, the role of this country may be exaggerated.

¹⁸ The three members are Malaysia (then Malaya), the Philippines, and Thailand. ASA was largely subsumed by ASEAN.

¹⁹ Singapore, the fifth member, received independence only in 1965.

The most notable expression of Sukarno's foreign policy course was the confrontation against Malaysia (*Konfrontasi*). Indonesia was very hostile to the formation of the Malaysian Federation. It viewed it as a British neo-colonial plan to maintain its military presence and political domination in the region (Anwar 1994, 25). After several unsuccessful attempts to get Indonesia's blessings, Malaysia was formed in September 1963.²⁰ At this point, Sukarno launched the *Crush Malaysia* campaign that lasted for some three years. This campaign included anti-British propaganda, economic sanctions, and military attacks against Malaysian and British targets. This confrontation was by far the most severe conflict between any of the future members of ASEAN.²¹ Notably, Indonesia initiated this conflict in the face of widespread international support to the newly established Malaysian Federation. From this perspective, many in the international community believed that the real reason for the Confrontation was Sukarno's trouble at home and his attempt to rally the fragmented Indonesian nation around the flag. Indonesian foreign policy was perceived, then, as aggressive, radical, and irresponsible. As one observer sums it up, "Indonesia's international credibility became tarnished" (Anwar 1994, 27).

The Indonesian efforts proved unsuccessful and counter-productive. Instead of breaking Malaysia apart, the Indonesian campaign actually unified the new federation. It also resulted in deteriorating economic conditions and, as pointed out above, international isolation of Indonesia (Anwar 1994, 27-28). In 1964 the United Nation Security Council passed a resolution condemning Indonesia's use of force against Malaysia. This was a

²⁰ The Philippines also objected to the formation of Federation. One attempt to alleviate Indonesian and Philippino objection included a three-state organization named Maphilindo (Malaysia-Philippines-Indonesia). This organization collapsed as soon as Malaysia was formed. On this issue see, e.g., Fifield (1979); Solidum (1974).

²¹ It resulted in about 700 battle deaths, most of them on the Indonesian side. See Lyon (1969, 188).

serious blow to Indonesia's prestige. In the same year Indonesia lost financial support from the U.S., the International Monetary Fund, and the World Bank, which conditioned this aid on the cessation of the anti-Malaysian campaign (Anwar 1994, 37; Gordon 1966, 75-76). Sukarno was not deterred by these sanctions. In an early 1964 speech he stated that "If there is any country which says: We give you aid but you must stop your confrontation against Malaysia, I will say: 'Go to hell with your aid.'"²² Moreover, as a protest of these economic sanctions and the appointment of Malaysia to the Security Council, Indonesia pulled out of the U.N. and its affiliated agencies, like the IMF and the World Bank (Anwar 1994, 37).²³ In sum, the Indonesian aggressive foreign policy resulted in an international isolation, unfavorable environment for profitable economic activity, and the suspension of financial and developmental aid.

The *Konfrontasi* ended in 1965 after dramatic changes in Indonesia. A failed coup attempt gave rise to a massive campaign of the army against the Indonesian communist party (PKI) and the removal of Sukarno, who was allied with the PKI, from office. The then Major-General, Suharto, became the new Indonesian leader. Suharto and his colleagues were determined to reverse Sukarno's destructive foreign policy. They gradually terminated hostile activities against Malaysia and initiated a process of rapprochement. Domestically, the Suharto government resumed an emphasis on economic growth and development. For this purpose, Suharto appointed several civilian professionals for key economic and diplomatic roles (Anwar 1994, 34-35). Appointing the experienced and well-respected diplomat, Adam Malik, for the position of Foreign Minister is of particular significance here. Suharto and his newly appointed officials were

²² Cited in Gordon (1966, 76).

²³ See also Table 2 below.

determined to restore economic links to the West. They strongly believed that rescheduling their debt, attracting foreign aid and FDI, and gaining access to foreign markets is key to economic recovery and development (Anwar 1994, 38-39; Malik 1968).

The Suharto government faced a serious problem of credibility, however. As described above, Indonesia was perceived as an aggressive and irresponsible state both by its immediate neighbors, the wider international community, and potential donors and investors. As Malik himself explains (1968, 301), “In our foreign relations, I regret to say, policy-makers of the past regime destroyed much good will or at the least did not respond adequately to evidence of it. The task of the Indonesian Government now is to regain the confidence of some of the nations which have experienced mistreatment by our predecessors.” In the language of my theoretical framework, outside observers were uncertain about the real nature (or type) of Indonesia and were not convinced that the new regime is genuinely committed to its stated policies. Even if the government was seen as committed for political and economic stability, it was not clear that it possesses the means to achieve these ends (Anwar 1994, 38). Thus, simply implementing the appropriate policies was not good enough. In order to convince its neighbors and potential investors that it is truly different, the Indonesian government had to go out of its way. In other words, it had to take some costly extra-measures that can signal the Indonesian commitment to its stated objectives and policies.

Suharto and his advisors understood this problem well and looked for ways to project a credible image. Domestically, they implemented economic reforms very rapidly. As Rodrik (1989a, 12) observes, “radical action can be used to signal the commitment of policy maker to reform... [This] tactic was displayed in the Indonesian

liberalization of 1966, when all quantitative import restrictions were lifted practically over night. The benefit of quick action, once again, was perceived to reside in its value as a signal to the private sector and foreign creditors.’’²⁴ Considering the great deal of uncertainty regarding Indonesia’s political and economic orientation, Suharto had to complement these domestic measures with international ones. Again, ending the confrontation and recognizing Malaysia and Singapore was not enough. Indonesian officials believed that its neighbors as well as potential creditors and investors wanted assurances that it truly mended its ways. Forming a regional organization meant to do just that.

That is why the Indonesian government, led by Adam Malik, vigorously promoted the ASEAN project. For them, ASEAN would signal a break from their recent past. It will, first, demonstrate to its neighbors that Indonesia is now committed to international cooperation rather than conflict. As Leifer (1989, 2) explains: “the most immediate and practical common security goal of the founding governments was to expand and institutionalise the process of reconciliation which had paved the way for a political settlement to Indonesia’s coercive challenge to the legitimacy of Malaysia between 1963 and 1966” (also Antolik 1991, 155). That is, ASEAN was instrumental in maintaining the peace and in reassuring Indonesian neighbors of its peaceful intentions.²⁵ It, moreover, served a signal of Indonesian peaceful intentions regarding its neighbors. As an Indonesian top official explains: “the New Order had to come up with something colossal in its regional policy to erase the memory of confrontation. It was not enough for Indonesia just to end confrontation, which was only the beginning of a more positively

²⁴ In his *Foreign Affairs* article, Malik (1968, 296-298) trumpets the Indonesian efforts on this issue and the high costs associated with these reforms for the Indonesian economy and population.

²⁵ On the role of ASEAN in mitigating intra-regional conflict, see (Haftel 2004).

activist policy towards the region: Indonesia needed to provide further proof that it was really committed to a good neighbor policy. In such circumstance, Indonesia had to show equal enthusiasm for regional co-operation as the ASA members, otherwise its sincerity towards neighboring would be open to doubt.”²⁶

Second, ASEAN will help convincing extra-regional observers that Indonesia is now committed to responsible and development-oriented economic policies as well as to regional peace and peaceful resolution of inter-state disputes. In Malik’s own words, “I am making it my mission as A Minister of Foreign Affairs to regain what good will we may have lost, not by promises but by proving Indonesia a reliable partner in political as well in business matters. In this context we are working toward establishment of regional cooperation in Southeast Asia.” Projecting this image, in turn, will reassure potential donors and investors that the political risk associated with their investments is low. Anwar’s (1994, 45-46) description of this logic is worth quoting in full:²⁷

“The New Order leaders saw several benefits in Indonesia actively participating in regional co-operation immediately in the wake of confrontation. Uppermost in their minds was the urgent need to restore Indonesia’s credibility both in the region and in the wider international community, especially in the West... Indonesia... had to refurbish its image abroad and convince the West that the new government was really worth supporting. Participation in regional co-operation was, therefore also intended by the New Order leaders to convince the Western countries that their assistance to Indonesia would not be wasted. Indonesia’s involvement in a regional association was intended to show that the country would no longer be a source of conflict in the region and a threat to neighboring countries. Regional co-operation could be seen as further proof that the Indonesian Government would devote its energies and resources to internal development rather than to the pursuit of an adventurous foreign policy. Finally, Indonesian participation in a regional association also emphasized the fact that the government had abandoned the NEFOS and OLDEFOS [New Emerging Forces versus the Old Established Forces, or the Non-Alignment] ideology, since the country was now willing to cooperate with states that the Indonesian leaders had formerly accused of being neo-colonies. In short, participation in a regional association, on top of its anti-communist credentials, could be expected to make Indonesia bask in the West’s favor, thus making the United States and it’s allies willing to undertake a large-scale economic rescue operation for Indonesia.”

²⁶ The official is Supradjo Rustam, who negotiated with Malaysia the end of the Confrontation and then served in the Suharto government. Cited in Anwar (1994, 45).

²⁷ Several other area experts make similar observations. See, for example, Leifer (1989, 49-51, 153-154); Irvine (1982, 12).

Thus, in 1966 and 1967, Adam Malik and other Indonesian top diplomats toured several Southeast Asian capitals in an attempt to convince their counterparts to join a regional organization. In particular, they had to convince Malaysia – that remained suspicious of Indonesia’s intentions – to join the new organization (Gordon 1969, 112-114; Jorgensen-Dhal 1982, 31-33). Only after a face-to-face meeting between Malik and the Malaysian leader, Tunku Abdul-Rahman, in May 1967, Malaysia agreed to support the Indonesian initiative (Jorgensen-Dhal 1982, 34). It was persuaded that this proposed regional organization will tame the hegemonic aspirations of Indonesia and will promote regional peace and stability (Fifield, 1979, 9). Malaysia’s acceptance paved the way to the Bangkok Declaration that ushered ASEAN in August 1967.

In sum, then, erratic and aggressive Indonesian foreign policy that was accompanied with violence and instability resulted in high levels of uncertainty regarding the potential benefits of doing business in Indonesia. That is, the political risk attached to foreign investment was very high. A new Indonesian government wanted to abandon its predecessor’s antagonistic policies and to renew the stream of private and public investment into the Indonesian economy. In order to convince potential investors and donors that it is committed to domestic stability and regional peace it formed a regional organization that espoused these very objectives. In other words, the costs (economic as well as political) associated with formation of ASEAN serves as a credible signal of Indonesian peaceful intentions and pro-market orientation. It allowed Indonesia to project a responsible and amicable image and to restore the confidence of foreign investors in its economy and foreign governments in the seriousness of its government regarding economic reforms.

Further Evidence and Considerations

While Indonesia best illustrates my theoretical framework, we can apply it on other ASEAN members as well. Malaysia, in particular, greatly suffered from Indonesia's hostility against it. Even though it did not initiate the Confrontation, the ongoing violence increased the political risk associated with foreign investment in Indonesia. As pointed out above, Malaysia agreed to join Indonesia in ASEAN exactly because it believed it will contain Indonesia and promote regional peace. This regional stability, in turn, will allow Malaysia to attract foreign capital. As the former Malaysian Deputy Prime Minister said in retrospect (Hitam 1987, 11), "because of the respect ASEAN has earned, the confidence it has built, and the stability it has helped to ensure, the ASEAN area has become a magnet for foreign investment."

Singapore was similarly vulnerable to high levels of political risk. In 1967 it was independent for only two years after a trying break-up from Malaysia. As part of Malaysia until 1965, it was also involved in the Confrontation and its aftermath (Leifer 1989, 39). From this perspective, Singapore viewed ASEAN as an instrument of regional peace that will promote its independence and its economic prosperity (Fifield, 1979, 9). This view is reflected in the words of Singapore's Foreign Minister, S. Dhanabalan, who said: "in my view the biggest contribution of ASEAN toward economic development has been the way we have presented to the rest of the world a picture of ASEAN co-operation and neighbourliness ... this has created an image of ASEAN as an area of stability ... we depend very much on foreign investments and foreign markets ... supposing ... countries in the regions would pursue their quarrels ... investors ... would get the impression that

this part of the world was not safe for them to invest. I don't think we should take ASEAN's good relations with its members for granted."²⁸

The examples of Malaysia and Singapore remind us that while we should expect high political risk in all developing countries (relative to EDCs) we should also find variation in the levels of political risk among developing countries. That is, states that were more violent-prone or had more anti-market orientation and reversed these policies faced higher level of uncertainty regarding their "true" nature. They thus had to take additional measures (or to incur additional costs) to reduce investment risk. This logic also suggests that the effectiveness of signaling should vary with the level of uncertainty. In the context of regional integration, we can expect that joining an RIA will have greater impact on the members that were perceived to have higher political risk. The evidence thus far presented indicates that we can locate the five ASEAN members on a continuum of uncertainty. On the one extreme is Indonesia, which, as described in details above, was perceived to have very high political risk. In the middle, Malaysia and Singapore were still exposed to political risk, but not as much as Indonesia. In the other extreme, Thailand and the Philippines experienced relative stability and were not involved the Confrontation. They also had long-lasting economic and political ties to the West. As such, they were the least vulnerable to political risk.

My theoretical framework expects, all else equal, positive relations between the level of uncertainty and the level of political risk and negative relations between the level of uncertainty and the level of financial flows into these countries. Unfortunately, data on political risk for the ASEAN countries in the 1960s is not readily available. Some data on

²⁸ An interview with the Bangkok Post, quoted in Indorf (1984, 62). Spaces are in the original.

FDI and financial aid is available, however. I therefore examine some trends in these flows. For FDI, I collected information on FDI of American firms in the ASEAN countries.²⁹ Considering the dominant role of U.S. firms in the global economy during these years, this should be a reasonable approximation of the more general trend. Figure 1 presents the net U.S. investment in the five ASEAN countries from 1966 to 1973.³⁰

The trends reported in Figure 1 are consistent with my expectations. The increase in the inflow of FDI into Indonesia is striking. In only a small number of years it moved from an outflow of 28 million dollars to an inflow of almost 200 million dollars. As Figure 1 makes clear, this increase overshadows changes in the rest of the ASEAN countries. While attributing this entire dramatic shift to the transformation of Indonesian foreign policy and the formation of ASEAN may be premature, one is hard-pressed to think of changes in the economic conditions that may have contributed to upsurge of FDI.³¹ At a minimum, it seems reasonable to attribute at least some of this increase to the more favorable political climate and the role that ASEAN played in conveying this climate to foreign investors.

²⁹ To the best of my knowledge, data on aggregate FDI inflow for this period is not available.

³⁰ Net investment is the inflows minus outflows. Thus a negative number indicates that capital flight is greater than capital inflow.

³¹ Such potential changes could be the sudden discovery of valuable natural resources such as oil. I am not aware of such discoveries during these years. The imitation of the Newly Industrialized Countries could also attract foreign investment. The ASEAN countries did integrate into the global economy until the 1970s. Indonesia was the last to adopt such policies, and it did so in the middle 1980s.

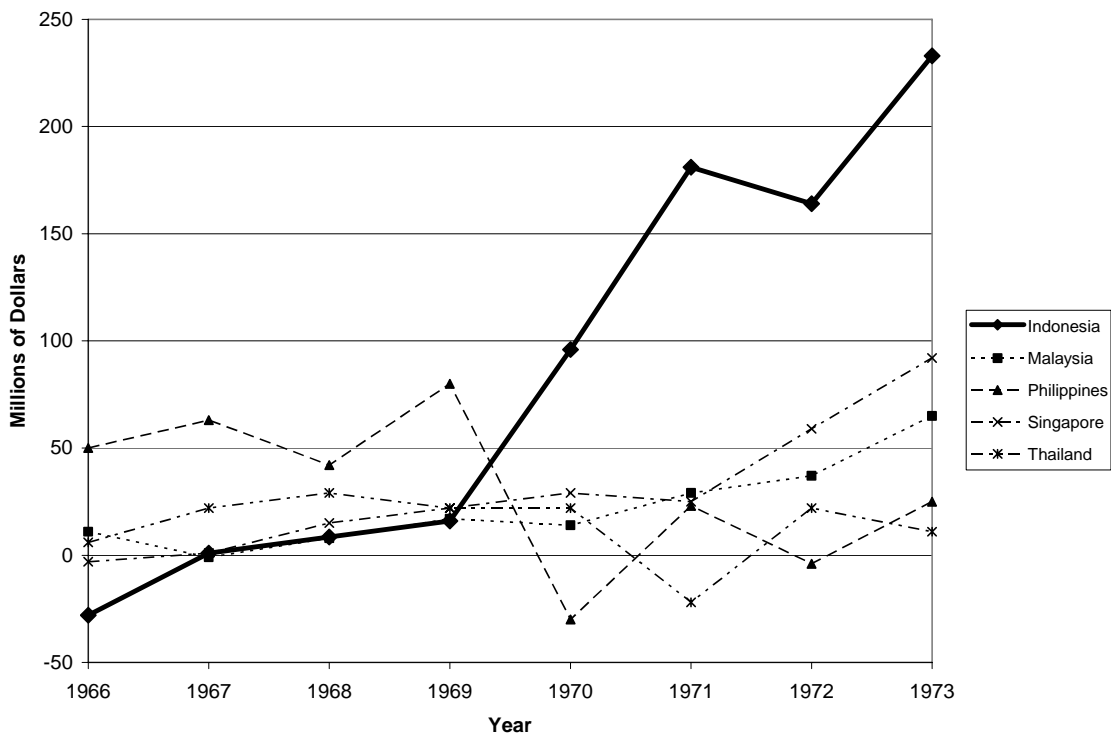


Figure 1: Net U.S. Investment in Five ASEAN Countries, 1966-1973³²

³² Data obtained from the U.S. Bureau of Economic Analysis' International Economic Accounts website at <http://www.bea.gov>. 1966 is the first year for which data is available. Data for Indonesia in 1968 is suppressed. The value for this year is average of the 1967 and 1969 values.

The other two countries that enjoyed an expansion of investment activity are Malaysia and Singapore. The flow of FDI into Malaysia increased from eleven million dollars in 1966 to thirty-seven million dollars in 1972. The equivalent figures for Singapore are an outflow of three million dollars in 1966 and an inflow of fifty-nine million dollars in 1972. These two countries experienced, then, a decent increase in foreign investment. This trend is consistent with the notion that because the initial political risk of these two economies was initially lower, the benefits from signaling a more stable and investment-friendly environment were more modest. Finally, there is no obvious change in the level of FDI flowed into Thailand and the Philippines over the examined time-period. This is, again, conforms to my expectations that when the climate for foreign investment is positive, stable, and relatively certain, costly signals will not make a great deal of difference.

I now turn to trends in financial aid. Figure 2 reports the amount of official development assistance and official aid in current U.S. dollars from 1962 to 1970. Similar to foreign investment, Indonesia experienced a massive infusion of financial aid following the change of government in Indonesia and the formation of ASEAN. It is also apparent that the financial aid decreased during the Confrontation years (1963-65). These changes demonstrate that aid from the economically developed countries, and the financial institutions controlled by these countries was sensitive to Indonesia's political orientation and to its stated and implemented foreign policy. In addition, it seems that the most notable increase in aid took place only in 1967, after Indonesia committed itself to regional peace and stability to ASEAN. While it is impossible to infer a direct causal link from this data, considering the perceived importance Indonesian policy-makers attributed

to ASEAN in this context (as discussed above), the role of the organization in reestablishing Indonesia's credibility in the eyes of potential donors seems likely.

In contrast to Figure 1, Figure 2 reports fairly small differences between the other ASEAN members. Foreign assistance to these countries is rather stable with some modest fluctuations over the years.³³ Thus, with the exception of Indonesia, it seems that official aid was not very sensitive to changes in political risk that emanate from violent conflict as such. Instead, it appears that donors pay greater attention to the intentions and actions of the assisted government rather than to the repercussions of other states' action for this government. Therefore, it seems, the international community punished Indonesia for its aggressive behavior during the confrontation and rewarded it for mending its ways and for espousing regional cooperation. Foreign donors did not, however, withhold financial assistance from Malaysia and Singapore, even though they were involved in a violent conflict – probably because these two countries were perceived as the victims in this conflict.

³³ One should not make much of the differences in absolute number between Indonesia and the other ASEAN members. Indonesia was both larger and poorer than its counterparts. As such, it is not surprising that it attracted a much larger level of financial aid.

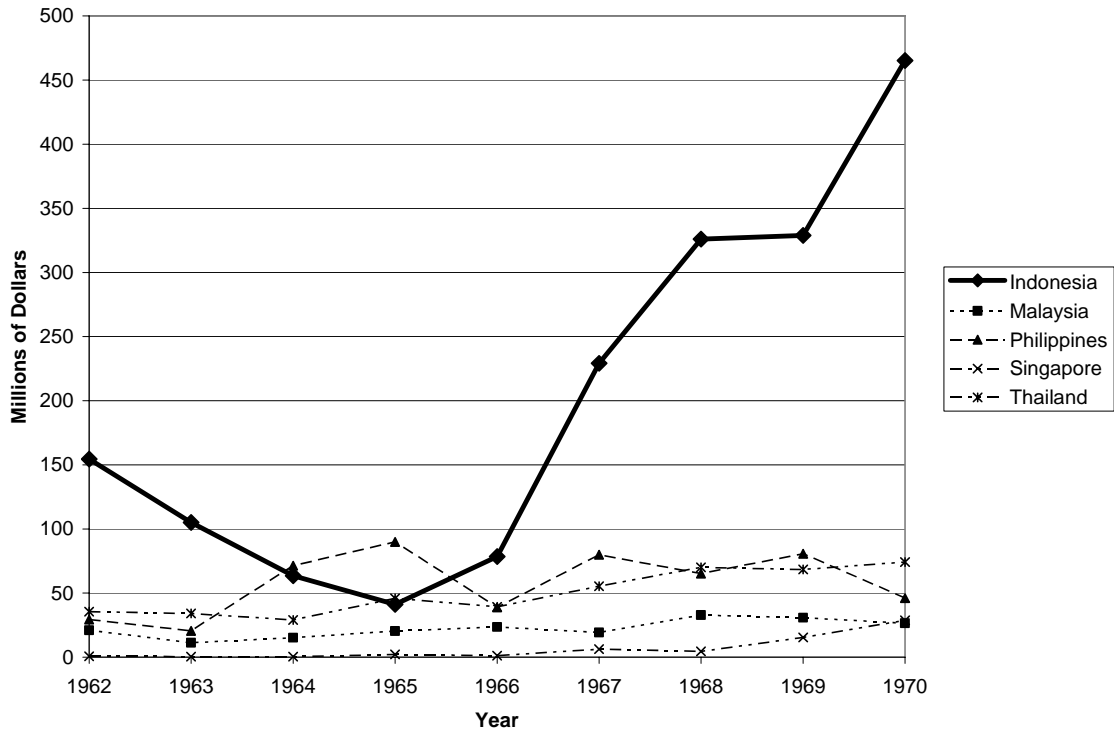


Figure 2: Official Development Assistance and Official Aid (Million of US\$) to Five ASEAN Countries, 1962-1970³⁴

³⁴ Data obtained from the World Development Indicators (World Bank 2002).

In sum, applying the logic of my argument on other ASEAN states (beyond Indonesia) and examining trends in FDI and financial aid, I find additional support for the theoretical framework. One should keep in mind, of course, that the economic data bears on my argument indirectly. That is, historical accounts indicate that the Indonesian government strongly believed that the formation of ASEAN will serve as a signal of responsibility and stability that will in turn attract foreign capital. I also showed that trends in the inflow of foreign capital into the ASEAN region *as if* the signal was received and affected decision-making of private investors and public donors. While I do not have direct evidence that this was indeed the case, considering the evidence thus far presented as a whole, the causal mechanism purported in this paper appears, at the very least, plausible.

Conclusion

The proliferation of RIAs among developing countries in recent decades seems at odds with the widely held belief that they are unlikely to provide benefits to their members. Why, this paper asks, LDCs continue to invest valuable resources in these organizations. It then points out the overlooked possibility that one important goal of economic regionalism in the developing world is to attract foreign investment and aid from the developed world. RIAs are instrumental in attracting foreign capital, I argue, because they serve as a costly signal of both regional peace and pro-market economic orientation. Historical analysis of the formation of ASEAN provides support for my argument.

From a theoretical perspective, this study highlights the role of international institutions as a solution to the problem of market failure. That is, it shows that by serving

as a credible signal to outside observers, such institutions allow developing countries, on the one hand, and potential investors and donors, on the other, to promote their interests and improve their well-being. This notion expands on the conventional neoliberal institutionalist arguments, which usually emphasize efficiency gains only for the members of the institutions. From this perspective, my paper indicates that this research program will benefit from broadening its horizons and consider the effect of international institutions on the relationship between member and non-members, which may include states and international organizations as well as private actors such as multinational corporations and other types of non-governmental organizations.

Empirically, the ASEAN case study provides ample evidence in support of my argument. While it was certainly not the only objective of its member-state, it seems that signaling a peaceful and market-friendly environment was an important consideration in the eyes of policymakers, at least initially. Nonetheless, skeptics may question the generalizability of my argument. Admittedly, some of the early experiments in regional integration, the Andean Pact for example, promoted anti-market policies, and others, like the East African Community, consisted of members that continued to confront each other. I would argue, however, that the more recent wave economic regionalism – dubbed the “new regionalism” – emphasizes market reforms, integration into the world economy, and regional peace and stability. In this respect, ASEAN probably represents one of the first episodes of open regionalism in the developing world. As such, its experience seems applicable to other developing regions.

As mentioned above, the evidence thus far collected indicates that the argument is empirically plausible. More research is needed to increase our confidence in its validity.

Several avenues of future research may shed further light on my theoretical framework. First, the theoretical framework is grounded in the logic of formal signaling games. Actually formalizing this argument will allow us to evaluate its logical consistency. It may also point to some of the conditions under which this argument applies. Second, more direct evidence on the actual assessment of foreign investors and donating bodies of the political risk associated with investment or aid in LDCs (rather than assuming them) would also corroborate the hypothesized causal mechanism. Finally, evidence from other RIAs in different regions will provide us a better indication regarding the generalizability of this theoretical framework.

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