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FOREIGN DIRECT INVESTMENT IN ASIA
HOW TO MAXIMISE ITS BENEFITS?
VIEWS OF A CIVIL SOCIETY ORGANISATION

Executive Summary

Ongoing research by CUTS confirms the lack of homogeneity in FDI inflows into Asia with South East Asia (including China) receiving the bulk of inflows and registering the highest growth rates. In contrast, countries in West and Central Asia have received little interest and South Asia, too, would not have figured had it not been for India.

The impact of FDI on emerging Asian economies has been varied. In certain countries, FDI has crowded out domestic investment and only 22 out of 107 countries in one survey could show a positive effect on domestic investment. The impact on job creation is also similarly mixed. Perceptions of the value of FDI are mixed.

Reactions to the incentives for attracting FDI inflows are varied. There seems no consistency in the appeal of different measures and an intangible feeling of being "welcomed" by a host country seems to be more important than conventional wisdom would dictate.

It is considered vital for each country to determine its own national priorities and channel FDI in the manner best suited to achievement of these priorities.

Introduction

Global foreign direct investment (FDI) flows have grown at an average annual rate of 20 percent over 1991-95 and at 32 percent during 1996-99. Flows increased from US$ 159 billion in 1991 to US$865 billion in 1999, a massive jump of 444 percent. Most FDI flows however take place between developed countries. The share of developing countries rose sharply during the early 1990s from 26 percent in 1991 to about 40 percent in 1994 but it declined to about 24 percent in 1999.

Even within the group of developing countries only a few large developing countries (e.g. China, Brazil) have been receiving most of the FDI. Though many developing countries have taken measures to attract higher FDI, most of them have been largely unsuccessful in this regard.

Asian developing countries or emerging Asia have received more than half of all FDI inflows to developing countries. In 1993 their share in global FDI shot up to 70 percent but subsequently with Latin American countries increasing their share in the global FDI, emerging Asia's share reduced[1].

This paper briefly looks at FDI trends in Emerging Asia, compares FDI with other forms of capital flows and investigates the expected impact of and hindrances to FDI. It also looks at civil society perceptions of FDI and measures to maximise benefits from FDI.

The Latest Trend in Asia

FDI flows in 1990s into Emerging Asia varied greatly from region to region. Inflows into developing Asia reached a record level of US$143 billion in 2000, which was a 44 percent increase over 1999[2]. Primarily an unprecedented FDI boom in Hong Kong, China drove Asian FDI flows in 2000. Hong Kong, China received a record inflow of US$62 billion[3] and Mainland China received FDI flows of about US$41 billion in this year.

In 2001, Mainland China regained its position as the largest FDI recipient pushing Hong Kong, China into the second spot. India (in South Asia), Kazhakstan (Central Asia), Singapore (South East Asia) and Turkey (West Asia) were leading FDI recipients in their respective sub regions in 2001.

[1] Foreign Direct Investment, Regional Economic Integration and Industrial Restructuring in Asia: Trends, Patterns and Prospects, Nagesh Kumar, RIS

[2] UNCTAD World Investment Report 2001

[3] UNCTAD World Investment Report 2002

Table 1: FDI Inflows by Host Region in Asia (millions of dollars)								
	Region	Annual Average of 1990-95	1996	1997	1998	1999	2000	2001
1	Asia	47,321	93,331	105,828	96,109	102,779	133,707	102,066
2	West Asia	2,096	2,898	5,645	6,705	324	688	4,133
3	Central Asia	662	2,590	3,844	3,152	2,466	1,895	3,569
4	South, East and South-East Asia	44,564	87,843	96,338	86,252	99,990	131,123	94,365
Percentage of FDI Flows Received by Different Regions								
5	Asia	100.00	100.00	100.00	100.00	100.00	100.00	100.00
6	West Asia	4.43	3.11	5.33	6.98	0.32	0.51	4.05
7	Central Asia	1.40	2.78	3.63	3.28	2.40	1.42	3.50
8	South, East and South-East Asia	94.17	94.12	91.03	89.74	97.29	98.07	92.45
Source: World Investment Report 2002								

Table 1 shows that the region South, East and South East Asia has received the highest FDI inflows between 1990-2001 (above 90 percent). Within this region, South Asia received the lowest FDI in this period (see table 2). In 2001, the region received FDI inflows of about US$4 billion, which was a 32 percent increase over 2000, of which US$3.4 billion went to India, a 47 percent increase over the previous year. FDI flows into both Central and West Asia have increased from 1990-1995 to 2001 but with wide fluctuations. FDI inflows into Asia as a whole increased by 2.15 times in 2001 over 1990-95.

Table 2: FDI Inflows in the sub-regions of South, East and South East Asia (millions of dollars)								
	Region	Annual Average of 1990-95	1996	1997	1998	1999	2000	2001
1	South Asia including Afghanistan	1,221	3,620	4,936	3,560	3,099	3,095	4,071
2	China	19,630	40,180	44,237	43,751	40,319	40,772	46,846
3	East and South-East Asia Excluding China	23,713	44,043	47,165	38,941	56,572	87,256	43,448
4	Total	44,564	87,843	96,338	86,252	99,990	13,1123	94,365
Percentage FDI Inflows in the sub-regions of South, East and South East Asia								
5	South Asia Including Afghanistan	2.74	4.12	5.12	4.13	3.10	2.36	4.31
6	China	44.05	45.74	45.92	50.72	40.32	31.09	49.64
7	East and South-East Asia excluding China	53.21	50.14	48.96	45.15	56.58	66.55	46.04
8	South, East and South East Asia	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Source: World Investment Report 2002								

Asia's Potential in Attracting FDI

The World Investment Report 2002 reports that the prospect for Asia to attract high FDI is very bright in next two-three years. It is important to note that apart from East and South East Asia, other regions do not receive FDI commensurate with their potential. The potential of a country could be measured by comparing it with economies with similar economic structure. It could be also be done by comparing the interest of investors in the country and the actual flow of FDI.

South Asia receives FDI much below its potential even though it has a large market. West Asia received less than 0.6 percent of world FDI flows in 2001, which is about one-tenth of its share in the world GDP[4]. The distribution of FDI in this region is uneven, Turkey receiving the highest FDI. Countries of the region are capable of attracting FDI in export-oriented units producing low to medium technology goods and market-seeking FDI. Central Asia has the potential of attracting greater FDI in resource based activities, e.g. copper and zinc, and oil and gas extraction[5].

A survey conducted by Multilateral Investment Guarantee Agency (MIGA) on 147 multinational companies found that among the leading investment destinations of these companies China figures in the second place with the USA in the first place. The other emerging Asian countries, which figure in the list of 23 countries, are Singapore (13th), Thailand (17th), India (18th) and Malaysia (22nd)[6].

How Do We Measure the Impact of FDI on the Economy?

The impact of FDI is examined by using different parameters such as capital formation, backward linkages, employment, technology transfer, market access and knowledge spillovers.

Box: Impact of FDI on Domestic Investment

A study carried out by Research and Information System for the non-aligned and other developing countries (RIS), India found that evidence of the effect of FDI on domestic investments is mixed. The study was conducted taking a sample of 98 countries covering the 1980-98 period. The results for Asian countries is summarised below:

1. In India, Fiji, Papua New Guinea, Philippines and Singapore FDI crowded out domestic investment.

2. In Pakistan, China, Indonesia, Malaysia and Turkey FDI flow has not had any effect on domestic investment.

3. In Bangladesh, Korea, Nepal, Sri Lanka and Thailand, FDI has had a positive effect on FDI by crowding in domestic investment.

4. Of the 107 countries surveyed, FDI has had a positive effect on domestic investment in 22 countries.

Source: FDI, Externalities and Economic Growth in Developing Countries, Nagesh Kumar and Jaya Prakash Pradhan, RIS, (2002).

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[4] UNCTAD World Investment Report 2002

[5] UNCTAD World Investment Report 2002

[6] Foreign Direct Investment Survey, A Study Conducted by the Multilateral Investment Guarantee Agency with the Assistance of Deloitte & Touche LLP

Often the impact of FDI is ambiguous. Consider the issue of FDI and capital formation. FDI often crowds out domestic investment i.e. displaces or reduces it. FDI might also stimulate domestic investment by creating an investment environment favourable to it and, transferring technologies and management techniques. The relationship between FDI and domestic investment depends on, among other things, the quality of FDI, domestic regulatory environment and the time horizon studied. In the long run, if there are sequential investments to the initial one, FDI tends to have a favourable impact on domestic investment by stimulating it. The total effect is a sum of the component effects and quite difficult to predict. The empirical evidence on this is mixed (see Box).

Similarly, the evidence on whether FDI leads to an increase in employment is mixed. Overall, foreign investors seem to have created jobs. According to UNCTAD (1999), foreign affiliates of TNCs have generated direct employment for about 19 million people in developing countries in 1998[7]. TNCs also generate indirect employment through enterprises, which are suppliers, subcontractors or service providers to them. Indirect employment created by foreign affiliates is between one to two times greater than direct employment created. The quality of employment however varies widely especially in terms of wages and benefits, and safety and health matters.

UNCTAD Trade and Development Report 2002 highlights the example of foreign funded enterprises (FFEs) in China. In the last few years, China has seen a rise in the number of FFEs, which are mainly owned by East Asian investors. The share of their processed exports in total exports was over 55 percent in 2000. Their contribution to job creation is however modest. In 1996, their share in total Chinese exports accounted for about 9 percent of GDP but their share in the total labour force was less than 0.8 percent. These are generally small and medium sized enterprises using capital intensive technologies, export oriented and involved in the last stages of processing and assembly operations.

Measures of other parameters give out similar mixed results. The impact of FDI on economic growth and development is the sum of all these effects.

FDI and Other Forms of Capital Flows

FDI is usually sought to augment the shortfall in domestic investment. Economic development requires a certain level of investment and developing countries often lack domestic resources to achieve the required level. Some developing countries may have the requisite domestic capital but seek external capital for transfer of technologies and management techniques to achieve national technological development.

International capital flows are more volatile by nature than the domestic ones. Compared to other forms of international capital flows such as portfolio investment, FDI tends to be less volatile. Therefore it would seem prudent for developing countries to depend on FDI as a source of external finance.

During the Asian financial crisis of 1997 there was a sharp decrease in private external capital flows to emerging East- and South East Asia. Net private foreign bank lending and portfolio equity investment turned negative in 1997 for the countries most affected by the crisis: Indonesia, Republic of Korea, Malaysia, Philippines and Thailand. Their FDI flows however remained positive and continued to add to

[7] Employment, UNCTAD Series on Issues in International Investment Agreements

existing stock. In fact at the height of crisis in 1997, total FDI inflows to the five most affected countries remained at a level similar to that of 1996[8].

Though it is more stable than other forms of capital, FDI is usually more volatile than domestic capital. In addition, there could be other problems associated with FDI such as adverse balance of payments due to repatriation of profits by foreign investors. Benefits of FDI can be best maximised if FDI inflows to a country grow in harmony with domestic investment.

What does Civil Society Believe?

In the past few years, civil society organisations (CSOs) have played an important role in national and international economic development. CSOs have been doing research and advocacy work and working closely with governments of developing countries on investment issues. They have identified problems such as corruption, regulatory failure and inappropriate policies, which adversely affect FDI flows and have also addressed the issue of the impact of FDI on development.

Given the controversial role of FDI, the civil society perceptions of FDI often play an important role in a country's policy-making process. CUTS has been conducting a civil society survey on perceptions of FDI in seven developing countries and transition economies as part of its "Investment for Development"[9] project. The preliminary results of the ongoing survey are as follows.

Civil society in all the project countries[10] with the exception of India thinks that FDI has contributed to the national economic development of the country. Civil society in India has grave reservations about the historic role of FDI in the national development, whereas Bangladeshi civil society thinks FDI has played a more positive role in the long term (10 years) than in the short term (2 to 5 years).

Civil society believe that FDI brings in valuable new management techniques and technologies, that it is a reliable source of foreign capital and, that it increases access to world markets and competitiveness of the host economy. Civil society, however, is not sure whether FDI increases domestic investment and exports, reduces imports and profit opportunities for domestic companies, or of the environmental impact of FDI.

Civil society also believes that to increase FDI flows to their countries, the following policies and strategies should be strengthened: environmental, labour, competition and sectoral policies, intellectual property rights (IPR), support to local businesses to upgrade technology and developing countries' access to finance.

Despite reservations of some respondents about the historical role of FDI the civil society generally is in favour of FDI. A clearer picture will emerge when the civil society surveys are completed by January 2003.

[8] UNCTAD World Investment Report 2002

[9] www.cuts.org/ifd-indx.htm

[10] Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia

Factors Which Might Hinder FDI

Factors, which could hinder FDI flows to Asia are, depression in the world economy, negative perceptions of the countries of the region, poor infrastructure, poor profitability due to a low rate of return or high costs, political instability and rigid labour regulations.

The importance of these factors varies from region to region. For example, the poor FDI flow to West Asia partly reflects political instability and risk, whereas poor FDI flows into South Asia particularly after the September 11 terrorist attacks reflect poor perceptions among foreign investors of the stability of the region's investment environment[11].

Sometimes it is difficult to pinpoint such factors. Angola is a case in point. This southern African country is at present torn by a civil war and has reportedly has a very corrupt regime but attracts the highest FDI in the continent. Brazil, despite the shaken confidence of foreign investors in the region following the Argentine economic crisis, attracted the second highest FDI among developing countries in 2001.

Again, openness of a FDI regime or the political regime in a country does not indicate whether FDI will flow into a country. A country such as China has received much more FDI than India with a more liberal FDI regime.

Measures to Maximise Benefits from FDI

It is as important for countries to take measures to maximise benefits from FDI so as to attract higher FDI. Benefits from FDI could be maximised if efforts are concentrated on attracting long term productive FDI. Short-term profit making FDI may destabilise developing countries and certain types of FDI such as resource seeking FDI in mining activities, may not add any productive value to the economy. The quality of FDI is important in this regard. The quality of FDI could be measured by the extent of localisation of investors' product, their contribution to the development of modern industries and extent of export-orientation and, research and development activity of companies[12].

To attract quality FDI, a developing country must ensure that a sound investment climate is in place. A sound investment climate requires a sound macroeconomic environment, appropriate institutions and basic infrastructure[13]. If these conditions are not properly in place, the cost of transacting business usually increases and thus profitability reduces.

Macroeconomic environment: A sound macroeconomic environment is said to be "necessary but not sufficient" to provide a stable and secure investment environment. Developing countries should ensure sound monetary policies, strong fiscal accounts and stable exchange rates to this end. Sound monetary policies will keep inflation under control. Strong fiscal accounts will provide funds for counter cyclical spending, building of safety nets, redistribution of incomes and provision of public goods such as infrastructure services. Stable exchange rates are required as large fluctuations in exchange rates can undermine investment incentives.

Appropriate institutions: Often developing countries lack proper institutions to set up and maintain an effective investment environment. It is important to have institutions to maintain strong property rights and

[11] UNCTAD World Investment Report 2002

[12] Globalisation and the Quality of Foreign Direct Investment, Nagesh Kumar

[13] World Bank World Development Report 2003

the rule of law, to enforce contracts, and a regulatory structure which would prevent corruption and enforce rules.

The problem with a large number of emerging economies is that while they have proper FDI policies, their implementation is poor. Again for large federal countries such as India, there could be a gap between the policy and regulatory structures of the federal and provincial governments. It is important that the countries fill such gaps in their FDI regime by strengthening their existing institutions or setting up appropriate ones. It is often felt that if a government lacks the ability to regulate effectively, it should have a small regulatory set-up with minimal regulation[14].

Basic infrastructure: Inadequate availability of basic infrastructure such as power and water supply, roads and bridges, transport and communications deters foreign investors from entering a country. The responsibility to provide adequate infrastructure usually lies with the government in developing countries. In recent years, due to the inability of the government in providing adequate infrastructure, domestic and foreign investors are being invited to the sector. However, the very factors, which deter private investors in other sectors, deter those in the infrastructure sector.

Social infrastructure such as literacy and education is important as it determines the quality and availability of labour.

The East Asian FDI boom before 1997 showed that accrual of benefits of FDI largely depends on factors such as per capita income and growth and the availability of appropriate infrastructure and labour, rather than on a liberal trade and investment regime and incentives.

The East Asian experience also shows that there is a need for selectivity and a strategic approach in attracting FDI in line with national development priorities, and socio-economic and technological development. South Korea, for example, did not receive a high FDI during the Asian boom before 1997 but it used its investment strategically to achieve technological development. China, Malaysia and Singapore received higher FDI than South Korea. They too ensured that flows are in line with their national development priorities[15].

FDI is not a panacea for all economic evils plaguing a country. The quality of FDI is important. It is also important to devise national strategies so as to attract right kinds of FDI in right sectors. One important factor is the attitude of officials towards FDI. Though China does not have a very liberal FDI regime, it has a welcoming attitude towards FDI.

Summing Up

Emerging Asia has the potential of attracting a very high rate of FDI in the next few years provided certain external and internal conditions are fulfilled. However the region is not a homogenous one. The whole region can be divided into several sub-regions with distinct FDI characteristics. In terms of actual FDI flows, East- and South East Asian countries are the winners in Asia, though other sub-regions also hold good potential.

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[14] World Development Report 2003

[15] Foreign Direct Investment, Development and the New Global Economic Order: A Policy for the South, South Centre

It not easy to predict the right combination of factors which would encourage or discourage FDI inflows to a particular country but some measures to attract FDI are clearly critical. For equitable economic growth, developing countries should take proper steps to maximise the benefits from FDI.

Civil society has the potential to play an important role in FDI policymaking process of a developing country. It can carry out research on FDI and help to demystify it for the benefit of the public at large. Governments and civil society organisations of Emerging Asia should work together to achieve the goals of high economic growth and development in the region.

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