CHAPTER 1

INTRODUCTION

Foreign Direct Investment (FDI) is accepted as a significant player in developing an economy. FDI brings about technologies, know-how, employment, export sales, etc. to the host country economy. The growth of international production system reflects the response of multinational enterprises to diligently adapt themselves to the changing global economic environment, technology creation, political liberalization, etc.

Multinational Enterprises (MNEs) will provide more competitiveness to the market unless it is a new emerging industry or comes by merging and acquisitions (M&A). Those are benefits a country may gain from FDI. Thus, many studies are conducted to describe the requirements, patterns, process, impacts, and appropriated government policies toward FDI.

Hence, many countries have changed their policies and regulations toward FDI. Some are to support FDI, provide more liquidity for international investment, and to make the regulation fairer. However, few changes are less favorable to FDI. The study from UNCTAD, shown in table 1, reports that there are numbers of regulatory changes, concerning FDI. Numbers of changes are to more favorable to FDI. Meanwhile, the changes that are less favorable to FDI have been decreasing significantly since 1998. In 2000, 147 regulations have been changed to be more favorable. National barriers for

MNEs accession to a domestic market during the recent years have dropped as well.

Besides, trade liberalization among countries also encourages firms to invest aboard and acquire advantages that the host countries enjoy by participating in free trade agreements. The freer of the international trade stimulates the investment flows to grasp new emerging markets. Japanese firms, for example, have been expanding their thousands of affiliates to other countries. Thai firms are also in the process of going out. China is attracting thousands of MNEs from hundreds countries to invest as it entries WTO. (UNCTAD, 2002)

During these recent years, any trade agreements have been initiated, negotiated, and implemented. The agreements are established in all regions, and continent. Examples of agreements that have been made in these recent years are shown in table 2. From the table, ones shall see that many types of agreements have been made among countries during the years, in every region. Many of them are made to support their international investment activities. These shall also reaffirm that countries are aware of the importance role of international investment activities on their economies.

Table 1: National Regulatory Changes, 1991-2000

Items	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Number of countries that introduces Changes in their investment regimes	35	43	57	49	64	65	76	60	63	69
Number of regulatory changes of which:	82	79	102	110	112	114	151	145	140	150
More favorable to FDI[a]	80	79	101	108	106	98	135	138	131	147
Less favorable to FDI[b]	2	-	1	2	6	16	16	9	9	3

Source: UNCTAD

[a] Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives

[b] Including changes aimed at increasing control as well as reducing incentives

Table 2: Examples of Agreement Made to Support FDI

Title	Year	Setting
Agreement between the European Communities and the Government of the US. On the Application Of Positive Comity Principles in the Enforcement.	1998	European Communities and the U.S.
Protocol III: Industrial Policy Framework Agreement on the ASEAN Investment Area	1998	ASEAN
Trade and Investment Cooperation Arrangement between Canada and Mercosu	1998	Canada and Mercosu
OECD Council Recommendation Concerning Action against Hard Core Cartels	1998	OECD
OECD Principles of Corporate Governance Trans-border Data	1999	OECD

Title	Year	Setting
The Treaty Establishing the East African Community	1999	East African Community
Agreement between the Government the United States of America and the Government of Australia On Mutual Antitrust Enforcement Assistance	1999	Australia and of the United States
short-term Measures to Enhance ASEAN Investment Climate	1999	ASEAN
Revised OECD Declaration on International Investment and Multilateral Enterprises (including the Revised Binding/ Guidelines for Multinational Enterprises and commentaries	2000	OECD

Source: UNCTAD

Table 3 and table 4 show the pattern of investment inflows and outflows among country groupings in the world during 1989-1998. It is obviously seen that, most of FDI flowed into Triads, which consists of the United States, European Union, and Japan. Triads share the largest part of investment flows, both inward and outward, comparing to other country groupings. These countries, and country grouping, are developed countries with high level of capital, technology, proprietary assets, and skilled labors. Excluding Traids, Asia and Pacific shared the highest proportion of FDI inflows, which accounted about 22% to the world investment inflows. The region is also accepted as a growth center of the world. During the last decades, East Asian countries had experienced rapid growth, partly induced by FDI. (Sueo, 1995) However, the proportion dropped dramatically in 1998 as the Asian Crisis. Most of investment flowed back to developed countries.

Among Asia and Pacific nations, East Asia shared the highest proportion of the flows. During 1989-1994, the region shared approximately 17.54 percent of the total world's investment inflow value. The share increased to 22.23 percent in 1995 and 23.23 percent in 1996. However, the value of the flows, comparing to the world's, dropped to 20.61 in 1997 and 12.42 percent in 1998 as a result of the region financial and economic crisis.

In terms of investment outflows, the pattern is similar to the inflows. Triads has been a single major player during the period. The investment outflows of the group accounted for more than 70 percent of the world's total investment outflows. Beside Triads, Asia and pacific, particularly for East Asia, took the second share, which was approximately 11-12 percent during

1989-1996. After the crisis in 1997, the share of investment outflows from the region dropped dramatically to 4 percent.

Hence, it brings an interesting point to study how a country can attract the high volume of inward FDI and what determine the value of the flow to each country in the region so that policies can be made to attract FDI and stimulate country's growth.

Table 3: Regional Distribution of FDI Inflows and Outflows, 1989-1998 (Billions of dollars)

Region/Country	FDI Inflows 1989-1994 (Annual Average)	FDI Inflows 1995	FDI Inflows 1996	FDI Inflows 1997	FDI Inflows 1998	FDI Outflows 1989-1994 (Annual Average)	FDI Outflows 1995	FDI Outflows 1996	FDI Outflows 1997	FDI Outflows 1998
Developed Countries	137.1	203.5	219.7	271.4	483.2	203.2	305.8	332.9	396.9	672
Western Europe	79.8	117.2	114.9	137.6	273.4	114.2	179.6	204.3	242.4	475.2
European Union	76.6	113.5	109.6	127.6	261.1	105.2	159	183.2	220.4	454.3
Other Western Europe	3.1	3.7	5.2	9.9	12.3	9	14.6	21.1	22	22.1
Japan	1	-	0.2	3.2	3.3	29.6	22.5	23.4	26.1	24.2
United States	42.5	58.8	84.5	103.4	174.4	49	92.1	84.4	95.8	131
Developing Countries	59.6	113.3	152.5	187.4	188.4	24.9	49	57.6	65.7	37.7
Africa	4	4.7	5.6	7.2	7.7	0.9	0.5	0	1.7	0.9
Latin America/Caribbean	17.5	32.3	51.3	71.2	83.2	3.7	7.3	5.5	14.4	8
Asia and the Pacific	37.9	75.9	94.5	107.3	95.9	20.3	41.1	51.9	49.4	28.7
- Asia	37.7	75.3	94.4	107.2	95.6	20.3	41.1	51.9	49.4	28.6
West Asia	2.2	-	2.9	5.6	6.6	0.3	-1	2.3	-0.3	-1.7
Central Asia	0.4	1.7	2.1	3.2	3	-	0.3	0	0.2	0.3
East & South-East Asia	35.1	73.6	89.4	98.5	86	20	41.8	49.7	49.5	30
South Asia	0.8	2.9	3.7	4.9	3.5	-	0.1	0.3	0.1	0.1
- The Pacific	0.2	0.6	0.2	0.1	0.3	-	-	-	-	0.1
Developing Europe	0.2	0.5	1.1	1.7	1.6	-	-	0.1	0.2	0.1
Central-Eastern Europe	3.4	14.3	12.7	19.2	21	0.1	0.5	1	3.4	2.1
World	200.1	331.1	384.9	477.9	692.5	228.3	355.3	391.6	466	711.9

Source: UNCTAD

Table 4: Regional Distribution of FDI Inflows and Outflows, 1989-1998 (Percent to the world)

(Percentage)

Region/Country	FDI Inflows					FDI Outflows				
	1989-1994 (Annual Average)	1995	1996	1997	1998	1989-1994 (Annual Average)	1995	1996	1997	1998
Developed Countries	68.52	61.46	57.08	56.79	69.78	89.01	86.07	85.01	85.17	94.40
Western Europe	39.88	35.40	29.85	28.79	39.48	50.02	50.55	52.17	52.02	66.75
European Union	38.28	34.28	28.47	26.70	37.70	46.08	44.75	46.78	47.30	63.82
Other Western Europe	1.55	1.12	1.35	2.07	1.78	3.94	4.11	5.39	4.72	3.10
Japan	0.50	0.00	0.05	0.67	0.48	12.97	6.33	5.98	5.60	3.40
United States	21.24	17.76	21.95	21.64	25.18	21.46	25.92	21.55	20.56	18.40
Triads	60.02	52.04	50.48	49.01	63.36	80.51	77.01	74.31	73.45	85.62
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Developing Countries	29.79	34.22	39.62	39.21	27.21	10.91	13.79	14.71	14.10	5.30
Africa	2.00	1.42	1.45	1.51	1.11	0.39	0.14	0.00	0.36	0.13
Latin America/Caribbean	8.75	9.76	13.33	14.90	12.01	1.62	2.05	1.40	3.09	1.12
Asia and the Pacific	18.94	22.92	24.55	22.45	13.85	8.89	11.57	13.25	10.60	4.03
- Asia	18.84	22.74	24.53	22.43	13.81	8.89	11.57	13.25	10.60	4.02
West Asia	1.10	0.00	0.75	1.17	0.95	0.13	-0.28	0.59	-0.06	-0.24
Central Asia	0.20	0.51	0.55	0.67	0.43	0.00	0.08	0.00	0.04	0.04
East/South-East	17.54	22.23	23.23	20.61	12.42	8.76	11.76	12.69	10.62	4.21
South Asia	0.40	0.88	0.96	1.03	0.51	0.00	0.03	0.08	0.02	0.01
- The Pacific	0.10	0.18	0.05	0.02	0.04	0.00	0.00	0.00	0.00	0.01
Developing Europe	0.10	0.15	0.29	0.36	0.23	0.00	0.00	0.03	0.04	0.01
Central-Eastern Europe	1.70	4.32	3.30	4.02	3.03	0.04	0.14	0.26	0.73	0.29
	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
World	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: UNCTAD 2002

This study is initiated to revisit the determinant of inward FDI in East Asian region, both in cross line view and dynamic view. Some parts of the study are adapted from various accepted papers, while the rest are self-initiated. However, several minor attractive characteristics that affect inward FDI shall be descriptively analyzed in order to provide better understanding on the issue among the nations. However, it is necessary to reaffirm that the study is conducted by the following objectives and scope.

Objectives of the Study

The main objective of the study is to investigate the determinants of the inward Foreign Direct Investment inflows among East Asian nations. The determinants are grouped to verify three hypothesis, which are market-size hypothesis, cost-efficiency hypothesis and export-oriented hypothesis.

In Addition, the study analyzes the relation between economic factors and the value of inward FDI by employing both qualitative and descriptive analysis.

Scope of the Study

In this paper, the scope of study is limited inside the East Asian nations according to the cross-sectional data available from UNCTAD. The samples consist of 8 host nations respected to 9 home nations. Hence, for econometric procedure, there are 65 observations altogether. Names of the host nations are listed as follow;

China	Hong Kong, Province of China
Indonesia	Korea, Republic of
Malaysia	Philippines
Thailand	Vietnam

Names of the home nations are listed below;

China	Hong Kong, Province of China
Indonesia	Japan
Korea, Republic of	Malaysia
Philippines	Singapore
Thailand	

The sample countries are selected as its performance in international investment community. Vietnam, which attracts more and more FDI, is selected to be a sample for host countries, for instance. Similarly, Japan is selected as a sample of the home nations as it plays a major role of FDI sources in the region.

The time horizontal for the study is the year 1996 for the econometric model as it is the most updated, reliable, and available. Moreover, the year 1996, FDI flows rose very high before being hit by the economic crisis. The data is also fully updated by reliable source, UNCTAD.

However, for descriptive analysis, the data of 1991-2000 is employed to show the most recent dynamic picture of the flow. During the time, economic factors in the sample countries have been changed according to economic recession and recovery, so the study can investigate how the changes determine inward FDI to the countries.

The study is, nevertheless, limited in a macro view, which means it is scoped in national statistics and data. Those determinants of FDI in micro level; such as R&D, Sales, business connection, tax exemption- is assumed to be insignificantly different among the target countries.

Definition

Foreign Direct Investment, FDI, is defined, according to UNCTAD, as an investment involving a long term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (foreign direct investment enterprises or affiliate enterprise or foreign affiliate). (UNCTAD, 2002)

Flows of FDI refer capital provided (either directly or through other related enterprises) by a foreign direct investor to a foreign direct investment enterprise), or capital received from and foreign direct investment enterprise by a foreign direct investor.

Organization of the Study

Throughout the study of Inward FDI Determinants in East Asia, after the introduction part in Chapter One, the study describes two important theories and previous studies on the topic in Chapter two. The theories, which are used as a fundamental background for the study, are The Eclectic Model and the Gravity Model. Besides the models, some of involved literatures are presented for readers' references.

In chapter three, the study presents all about the econometric procedures used for the study. Within the chapter, the study's methodology, concerning sampling and assumptions, is described. Also, at the end of the chapter, the result of the econometric study is presented and interpreted.

After the econometric procedures in chapter three, profile of each sample is described country by country in chapter four. By the chapter, national profile, countries' economic environment, and their investment climate are illustrated. Also, relationships between key economic factors of the sampled countries and their performance as a recipient of inward FDI, during 1991-2000, are investigated and descriptively analyzed. The major analysis is made by the means of correlation coefficient analysis, which would show a movement relationship between two sets of data. Nevertheless, the coefficients would not report any cause and effect relationship.

At last, in chapter five, the study concludes the results and findings, reported in chapter three and chapter four. Some comments and suggestions for policy implementation and further studies are also presented in this last chapter.