

# Factors Influencing ASEAN FDI and the Policy Implications

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## I. Introduction

ASEAN is an important economic partner for the Republic of Korea in terms of bilateral and regional relations. ASEAN is currently the second-largest foreign direct investment (FDI) destination and second-largest trading partner for Korea.

In the 2000s, ASEAN FDI showed a firm and steady rising trend, except for the global financial crisis period of 2008-2009. Between 2004 and 2014, ASEAN's share in the world FDI stock increased from 3.5% to 6.8%, and the region's share in FDI flow has increased from an average 5.0% in 2004-2006 to an average 8.6% in 2013-2015.

Looking into the performances of each ASEAN member states in terms of FDI stocks, Singapore maintained a high share of 58% in ASEAN FDI stock during the period of 2004 - 2015, and Indonesia witnessed a significant increase from 4% to 13%.

The top investor of ASEAN is Japan, which placed first in terms of ASEAN FDI flows in 2013 to 2015, reporting a share of 15.4% in total ASEAN FDI flows, followed by Singa-

pore (11.6%), the United States (9.5%), Netherlands (6.3%), and China (5.8%). We classified ASEAN countries into three country groups according to GDP per capita and compared the main five investors. In the case of the high income group, namely Singapore, Malaysia, and Thailand, a large source of FDI came from developed countries. In the case of the ASEAN low-income group, namely Cambodia, Myanmar, and Lao PDR, investment from emerging countries such as China, South Korea, Thailand and Vietnam was more significant.

In light of the above, this study examines the characteristics of ASEAN FDI and doing business conditions by income level, and conducts an empirical analysis of the determinants of ASEAN FDI to draw policy implications for further economic cooperation between Korea and ASEAN.

## II. Main Study Results

First, we analyzed the characteristics of ASEAN FDI based on the knowledge-capital model from Markusen and Maskus (2001) and

eclectic theory from Dunning (1993), and concluded that most ASEAN FDI in all income groups is of the vertical type. Only FDI in Singapore showed a market-seeking, horizontal FDI pattern among the ASEAN high-income group. In Malaysia and Thailand, Japanese manufacturing firms continued their business operations while Korean manufacturing firms focused their investment in Vietnam. The ASEAN low-income group of Cambodia, Lao PDR, and Myanmar received investment mainly in the light manufacturing industries, serving as a complementary production base for Thailand, Indonesia, and Vietnam, which are experiencing sharply rising labor costs. Meanwhile, ASEAN's characteristics of a vertical FDI is slowly becoming visible together with the market-seeking FDI in high-income ASEAN countries such as Indonesia, Malaysia and Thailand, which have a relatively large population and economic scale. For instance, the share of the services industry in ASEAN FDI, which has a higher probability of being a market seeking FDI type, rose from an average of 58.5% in 2004~2006 to an average of 64.7% in 2013-2015.

The business environment differed markedly between ASEAN member states. The business conditions in Singapore, Malaysia, Indonesia and Thailand, member states which accounts for the majority of ASEAN FDI, tend to offer a more favorable business environment compared to other member states. Among the indices, areas of enforcing contracts, bond recovery rate and trade period showed a high correlation coefficient with the FDI. In particular, the business conditions of ASEAN member states showed a distinct positive linear relationship with the FDI, indicating that better business conditions may result in further FDI inflow.

This study conducted an empirical analysis to

determine factors influencing the FDI inflow of 10 ASEAN countries between 2003 and 2014, utilizing a covariance structure analysis. The results of the primary component analysis show that Factor 1 which uses four variables involving the “starting a business: time,” “time to import,” “time to export,” and “resolving insolvency: recovery rate” and Factor 2 which includes four variables of “enforcing contract: time,” “starting a business: procedures,” “trade openness,” and “exports of goods and services” are the determining factors affecting extra-regional FDI inflows. Among the variables in Factor 1, time to import (-0.99) and time to export (-0.95) were the most significant factors affecting extra-regional FDI. Among the variables in Factor 2, enforcing contract: time (-0.98) was the most significant factor affecting extra-regional FDI, followed by exports of goods and services (0.87) and trade openness (0.77). However, both Factor 1 and Factor 2 were statistically insignificant in the case of intra-regional FDI inflows. This implies that factors related to trade liberalization affects extra-regional FDI more significantly.

### III. Korea-ASEAN Cooperation Opportunities to Enhance Investment

#### 1. Standardization of Rules of Origins through RCEP

The RCEP is a free trade agreement (FTA) between ASEAN member states and Korea, China, Japan, Australia, New Zealand and India, countries which have signed an FTA with ASEAN. RCEP member states account for 48% of the world population, 31% of world GDP and include China, ASEAN and India, countries which serve as global production

bases. The enhanced market access and improved business environment resulting from the RCEP negotiations will significantly contribute to Korea's production network.

Among the many issues at stake, harmonizing rules of origin (ROO) is one that is particularly expected to contribute to an increase in ASEAN FDI inflow. The 16 RCEP partner countries have already formed a complex bilateral FTA network. In addition to the ASEAN +1 FTAs, the Korea-Vietnam FTA, the Japan-India CEPA, and the India-Malaysia CECA are in effect. As each FTA has its own rules of origin, the different rules being applied have been pointed out as main obstacles to the utilization of FTA preference, which has the potential to enhance the efficiency of the East Asian production network. In this respect, the RCEP can contribute to the harmonization of the rules of origin and thus enable corporations to reduce the costs necessary to comply with the rules of origin. In addition to harmonization of the rules of origin, regulations related to the recognition of electronic certificates of origin and trade facilitation are closely related to the time to import and export, which this study found out to affect FDI inflows to ASEAN. An RCEP, which incorporates the aforementioned issues, is expected to facilitate further Korea-ASEAN FDI.

## 2. Institutional Support to Strengthen Korea-ASEAN Economic Cooperation: FTA and BIT

An investment treaty acts as an opportunity to upgrade institutional quality and transparency, thereby increasing the credibility of the signatory country and having a positive effect on its business environment. According to the study results, ASEAN member states which were evaluated as possessing higher institutional transparency, received more FDI. Thus, en-

hanced institutional transparency is an important factor when it comes to deepening economic relations between Korea and ASEAN. ASEAN member states' investment regulations in the manufacturing and services sectors studied in this report show the need for further improvement, with the exception of Singapore.

Starting with Malaysia in 1989, the Korean government has signed bilateral investment agreements with most ASEAN member states, except for Singapore and Myanmar, to increase the protection for Korean investors. In the 2000s, the Korean government concluded FTAs with ASEAN, Singapore and Vietnam to provide investors better market access and additional institutional support for further regional economic cooperation. The Korea-ASEAN Investment Agreement was concluded at a relatively high level when compared to other bilateral agreements with ASEAN member states. However, only Singapore, Vietnam, Thailand and Korea have ratified the agreement. In terms of a bilateral investment treaty (BIT), most BITs were signed in the 1990s except for Brunei and Vietnam. Previous literature indicates that investment treaties affect investors' investment decisions because of the conditions made by the investment treaties to the host country's stability, predictability and institutional transparency (UNCTAD 2004, Jeong et al. 2010). In this respect, Korea can suggest ASEAN countries, which are yet to ratify the Korea-ASEAN Investment Agreement, to consider a possible bilateral investment treaty.

In terms of FTAs, Korean government must make efforts to raise the utilization ratio of companies and discuss further liberalization needed by Korean companies via the Korea - ASEAN FTA Implementation Committee.

### 3. Promoting a Strategy of Focus to Enhance the ASEAN Business Environment

Most ASEAN countries had comparatively restrictive business environment, except for Singapore and Malaysia. The results of our analysis indicate that Factor 1<sup>1</sup> and Factor 2<sup>2</sup>, are the extra-regional FDI determinants for ASEAN. In parallel to the government's efforts to pursue an agreement, we propose for the government to provide consulting services to ASEAN members. In particular, we propose for the Korean government to provide consultation on factors which Korea has comparative advantages in, and those which our study show affect ASEAN FDI. According to the World Bank 2017 Doing Business Index, Korea ranked top in the areas of enforcing contracts and getting electricity. Korea also ranked near top in resolving insolvency (4th) and starting a business (11th), factors which our study showed have an effect on extra-regional FDI for ASEAN. In addition, the study results point toward a gap between the business conditions of the high-income groups and the low-income groups among ASEAN members.

From this point of view, Korea could focus its capacity building programs in areas where Korea has a relatively high investment ratio. Also, Korea should consider areas which it possesses a comparative advantage, i.e. electronic customs clearance system, when organizing capacity building projects and programs with ASEAN countries. **KIEP**

1 Factor 1 is consisted of time required to start a new business, import time, export time, and rate of businesses failing.

2 Factor 2 is consisted of contract procedures, business opening procedures, trade openness, and exports of goods and services