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NEWSLETTER

Welcome to the East Asian Bureau of Economic Research (EABER). EABER aims to be the premier East Asian economics research forum and provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER facilitates the creation of high-level analysis and forward thinking on issues of importance to the East Asian economy.

Analysis

Southeast Asia's Post-Crisis FDI Performance

Prof. Shandre Thangavelu*

The severe recession following the East Asian financial crisis began in Thailand in July 1997 and adversely affected output, currencies, stock markets and other asset prices across most of the region, except in China and Vietnam. The crisis also saw a drastic decline in private external capital flows. The decline in net private foreign bank lending and portfolio equity investment and capital flight affected the regional markets most seriously and sent the Southeast Asian economy into a tailspin.

The crisis changed international perceptions of East Asia's growth experience.

Yet long-term capital flows of foreign direct investment (FDI) into East Asia, more influenced by long term structural factors, were not much lower in 1997 than they were in the pre-crisis year of 1996. However, in the medium to long-term there could be changes to the investment strategies of multinational corporations, if investment fundamentals in the region change significantly. Has the Asian crisis affected the inducement to invest in the ASEAN economies?

It has been a decade since the crisis, and Southeast Asian countries are emerging stronger and more resilient to external shocks with output growth converging to pre-crisis rates. Real growth in the first half of this decade has been slightly more than 4 per cent annually compared with 6.7 per cent in the first half of the 1990s. The recovery in output growth has been spurred by big lifts in the share of exports in GDP for almost all Southeast Asian economies. In most economies the share of exports to GDP has more than doubled.

Despite the strong recovery of output growth, Southeast Asian countries are also experiencing rising unemployment and budget deficits. In the half decade since the crisis, the unemployment rate in all the Southeast Asian economies increased two-fold over the half decade to 2005. The unemployment rate in 1999-2005 was more than 6 per cent in Indonesia, Philippines and Hong Kong and nearly 4 per cent in Korea, Singapore and Taiwan.

A major policy concern is the weakness of investment, especially FDI, and what can be done to improve the investment climate.

The role of FDI has always been crucial for the growth of Southeast Asian countries. Southeast Asian countries rely heavily on multinational corporations to maintain their competitiveness and economic growth in the global economy. FDI has been effectively used to augment domestic capital and drive their industrial strategies. Also, FDI has been a key factor driving export growth in Southeast Asia and in particular the growth of the electronic sector.

Despite the strong recovery in output growth, FDI flows to the region have not recovered to pre-crisis levels and in fact, are showing a declining trend. The Asian crisis has had a drastic impact on the flow of FDI into Southeast

Paper of the Month

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Asian countries and Indonesia seems to have experienced a significant decline in its FDI inflows. FDI inflows into the Southeast Asian region declined from around US$34 billion in 1997 to nearly US$20 billion in 2003. The share of Southeast Asian FDI flows in total world FDI declined from 7.7 per cent in 1992-1997 to only 2.9 per cent in 1999-2005, which is close to the share of 2.2 per cent for the African region.

More generally, the share of FDI to GDP and capital formation to GDP in most Southeast Asian economies except Vietnam continues to show a declining trend. This development is also in marked contrast with China.

FDI accounted for 7.7 per cent of Southeast Asian GDP in the first half of the 1990s but less than 3 per cent of GDP in the first half of this decade. Foreign investment in China has doubled from US$33 billion to over US$60 billion in the same period. Although the decline in FDI has been most notable in Indonesia, it has gone down in manufacturing throughout the region. While FDI is down from traditional sources such as the United States, Japan and Europe, a positive development is that intra-ASEAN FDI has been growing.

Clearly, the integration of the ASEAN market is an important factor in increasing the attractiveness of Southeast Asia as a destination for FDI. The integration of intra-regional production networks and the interest in market scale require it. Intra-ASEAN FDI could play an important role here.

The sustainability and acceleration of Southeast Asian growth seems likely to require higher rates of FDI inflow, since foreign investment is closely linked to export growth and international competitiveness. FDI continues to be important to building technological capabilities not only directly through the operations of multinational firms but through the positive spill-over on domestic firms. Domestic infrastructure and local firms have to be aligned to provide effective linkages to global production networks and allow progress seamlessly up the value-chain through the activities of multinational corporations. Their ability to align with these global activities depends not only on the strategies of private firms, but also requires growing government investment in upgrading physical infrastructure and education to develop the necessary human capital.

One question is whether the recent FDI experience in Southeast Asia is significantly a result of the growth of competition from China. There is one sense in which that is obviously the case. China's growth and the rapid pace of its market reform has provided a congenial location for FDI seeking lower cost and skilled labour, a more positive policy environment and growing market opportunities.

The crucial issue for Southeast Asian governments is what is the right response to investment competition from China?

Multinational corporations continue to seek competitive and diversified locations for their production activities in East Asia. To capture a larger share of the opportunities that foreign investors create, a priority for Southeast Asian governments is to regain the momentum of national and regional regulatory and institutional reform that is the foundation of a strong investment environment.

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