CHAPTER 1

INTRODUCTION

There is a growing recognition of the importance of foreign direct investment (FDI) in the development process. Developing countries everywhere are not only becoming more receptive to FDI but many are actively seeking ways to increase inflows. Several considerations underlie this trend. The first is the increasing preference for investment in equity form over commercial bank borrowing. The latter has proved to be unpredictable and inflexible in it's servicing obligations. Foreign investment, on the other hand provides not only an initial capital inflow which assists the balance of payments of the host country, but the subsequent outflow of profits is determined by the performance of the investment. Secondly, FDI is an important means of obtaining not only capital but also technology, scarce management and skills, and improved marketing know-how and outlets for non-traditional exports.

This changing trend towards emphasizing FDI as the source of economic growth is nowhere more evident than in Association of Southeast Asian Nations (ASEAN). The economies of ASEAN have enjoyed robust economic growth rates in the past two decades. A conducive external environment, an outward-looking development strategy which emphasizes the role foreign trade and FDI and political, social and economic stability have contributed to economic buoyancy, high levels of investment and employment generation, rising productivity and skill development, and sharply improved export performance in manufactures. At the same time, the buoyant economies have acted as a magnet to attract further inward investment flows. Thus, FDI acts as both cause and effect in economic growth and facilitates economic upgrading.

In the 1980s the ASEAN region had become one of the most attractive investment locations in the developing world and attracted a large amount of FDI. Furthermore, foreign direct investment (FDI) has proved to be resilient during the financial crisis. In ASEAN countries, such investment was remarkably stable during the global financial crisis of 1997-98. In sharp contrast, other forms of private capital flows - portfolio equity and debt flows, and particularly short-term flows - were subject to large reversals during the same period (Dadush, Dasgupta, and Ratha, 2000; and Lipsey, 2001). The resilience of FDI during financial crises was also evident during the Mexican crisis of 1994-95 and the Latin American debt crisis of the 1980s.

This resilience could lead many countries to favor FDI over other forms of capital flows, furthering a trend that has been in evidence for many years. Is the preference for FDI over other forms of capital inflows justified? This study sheds some light on this issue by carrying out graphical and empirical work on FDI's impact on growth and savings of each of the 5 selected ASEAN countries between the years 1970-2000.

1.1 Objectives of the Study

Countries of the Association of Southeast Asian Nations (ASEAN) have succeeded in accelerating economic growth through FDI influence. FDI is the powerful dynamo of ASEAN's development, creating trade and employment. Hence, there has been a significant increase in the interest among economists concerning the role of FDI in the economic development of ASEAN.

The studies done on the impact of FDI in Southeast Asian region are very limited and are across a number of countries, using aggregate FDI inflow data. Since the developing countries in the region are not homogeneous in their capital inflow policies, it is important to determine the effects of FDI on a single economy.

This study is conducted in an attempt to examine and compare the impact of FDI on five selected ASEAN member countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand. The impact of inward FDI on host economy will vary between countries. The study is to analyze graphically and then to empirically evaluate the 'direct' effect of FDI on the economic growth and domestic savings of each of these selected countries for the period between 1970-2000.

FDI may contribute significantly to growth and development in some circumstances, but may also have insignificant or even negative effects on the local economy in others. The role of foreign capital in economic growth is controversial. Neither the theoretical arguments nor empirical evidence is clear-cut or conclusive. In the early 1960s a group of economists had argued that cut or conclusive. In the early 1960s a group of economists had argued that foreign capital inflows invariably had a favorable effect on economic efficiency and growth. In the early 1970s the assumptions and findings of this group were challenged by the "displacement theorists" who argued that foreign capital could be immiserizing. Recent developments and experiences in ASEAN countries have warranted a further consideration of this issue. First, the recent accumulation of external debt in these countries is emerging as a potential constraint on economic development. Second, the rapid increase of intraregional investment in Asia in recent years has renewed interest on the contribution of foreign capital to economic growth.

This study will also survey the trends and patterns of FDI in ASEAN during 1970-2000. It would also be useful to examine the role of FDI in bridging the savings-investment gap in the ASEAN countries.

The result of this study will provide some new information on the direct effect of FDI inflows to these five selected ASEAN countries. They also will provide some strong indicators of the problems to be faced and pitfalls to be avoided by developing countries embarking upon policies to promote FDI inflows. Better understanding of flows of FDI is helpful to assist not only the governments on the policies of FDI but also investing firms on decisions of entry modes abroad. By analyzing the overall differential impact on the five selected ASEAN countries, it will lead to several policy conclusions.

1.2 Methodology of the Study

The study on the impact of FDI on growth and savings rates is two fold. First, a descriptive study using line graphs is carried out on the relationship between FDI, growth and saving rates between the period 1970-2000. This is done to analyze the impact of the change in FDI/GDP ratio on the economic growth and saving rates of each of the 5 selected ASEAN countries in this study on a year-to-year basis. The differential impact of FDI is clearly seen in the graphs used to determine the relationship between FDI and growth and saving rates of each of the country in this study. The graphical analysis will also indicate the years that show positive and negative impact of FDI on the economic growth and saving rates during the period 1970-2000. This descriptive analysis will give an overall picture of the impact of FDI on growth and saving rates of each of the country in this study.

Secondly, to enhance the graphical analysis, an empirical study on the impact of FDI on growth and saving rates is conducted by using Ordinary Least Squares (OLS) method with time series data where FDI is used as an explanatory variable in the growth and savings equations. The empirical investigations into the consequences of FDI on the economic growth and domestic savings use single-equation models. To look at the effect of FDI on the economic growth rate and savings rate, foreign capital inflow (FCI) in the growth and savings equations is disaggregated into two components: foreign direct investment (FDI) and other foreign capital (OFC).

Foreign direct investment's (FDI's) and other foreign capital inflow's (OFC's) 'direct' effect on the economic growth rate and domestic savings are tested by inserting FDI and other foreign capital inflows (OFC) as an additional explanatory variable in the growth and savings equation. If the estimated parameters of the explanatory variables indicate the expected sign and the adjusted R^2 adequately explains the variation of the dependent variable, the estimated model can be used for the testing of hypothesis. The size, sign and the significance of the FDI variables indicate the strength and the direction of its effects on the economic growth rate and domestic savings rate.

The data series, which will be used to analyze the models, are also tested for stationarity. Any time series data should have been generated by a stochastic or random process and should be stationary for an estimation of a regression model to be meaningful. The Augmented Dickey-Fuller Unit Root Test will be used in this study.

The data used in the study will be mainly obtained from secondary sources which include ADB Asian Development Outlook, ADB Key Indicators of Developing Asian & Pacific Countries, IMF International Financial Statistics Yearbook, IMF Balance of Payments Yearbook, Economic Reports from UNCTAD, UN Yearbook of International Trade Statistics, UN Yearbook of National Accounts, World Bank World Economic Report, and other resources.

1.3 Organization of Chapters

A critical survey of the theoretical and empirical literature regarding the impact of foreign capital inflows on economic growth and domestic savings are presented in Chapter 2.

Chapter 3 introduces the methodology used in analyzing graphically and empirically the impact of FDI on economic and domestic savings, the two single equation model for growth and savings and the sources of data for the variables in the two models. In this study, graphical analysis is done to study the relationship between FDI, growth and savings rates of each of the 5 selected countries. Then, empirical analysis is carried out using the OLS method on the growth and savings equations to examine the impact of FDI on growth and savings of each of the 5 selected ASEAN countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand, for the period between 1970-2000. In this study, useful insights into the impact of FDI are gained by individual country study.

Chapter 4 begins with a brief analysis on the trend and pattern of FDI inflows into the 5 ASEAN countries. The results from the graphical analysis in terms of the relationship between the change in FDI/GDP ratio, growth rate and saving rate are presented in Chapter 4. To enhance the graphical analysis, the regression results from the two single-equation on growth and savings rates are also presented in this chapter. From the analysis on the results of the two single equations estimates, the impact of FDI on growth and savings rate are empirically examined. Finally, the last chapter summarizes major findings and their policy implications and suggests some direction for further research.