Journal of Asian Economics 35 (2014) 65–76

Contents lists available at ScienceDirect

Journal of Asian Economics

Human capital, FTAs and foreign direct investment flows into ASEAN[☆]

Shandre M. Thangavelu [a,*], Dionisius Narjoko [b,1]

[a] Institute of International Trade, University of Adelaide, Australia
[b] Economic Research Institute for ASEAN and East Asia, Indonesia

ARTICLE INFO

Article history:
Received 4 November 2013
Received in revised form 2 November 2014
Accepted 3 November 2014
Available online 8 November 2014

JEL classification:
F21
F66
F63

Keywords:
Bilateral FDI
Free trade agreements
Human capital

ABSTRACT

In this paper, we examine the impact of foreign direct investment flows into ASEAN in a gravity model using the bilateral FDI data from 2000 to 2009. In particular, we study the key factors that determine the FDI flows into the region including human capital development and whether membership of a bilateral or regional trade agreement has a differential impact on FDI flows using an extended gravity model. The empirical results indicate that free trade agreements do have positive impact on FDI inflows. However, the returns on FDI inflows depend on the domestic absorptive capacity of the economy and region. It is imperative for ASEAN to align its infrastructure, human capital and technologies to provide MNCs with the necessary linkages to the global network and also to move the domestic industries seamlessly up the global production value-chain. The paper highlights that this is crucial for deeper ASEAN integration and for sustainable growth in the region.

1. Introduction

Since the Asian financial crisis, the share of FDI to World FDI to the South-East Asian region is declining (Thangavelu, Yong, & Chongvilaivan, 2009). As opposed to short-term capital flows that have turned negative during the financial crisis, foreign direct investment (FDI) flows into these crisis-affected countries in 1997 remained at a level similar to that observed just before the crisis in 1996 (UNCTAD, 1998).

At the outset of the Asian crisis, FDI flows into the region remained fairly stable given that FDI is primarily driven by different considerations from short-term capital. FDI involves not only financial capital, but also encompasses technological, organizational and intellectual capital. It is largely motivated by strategic economic interests such as access to markets and resources, and it is also subjected to asset creation and efficiency considerations. Further, as huge sunk costs are typically involved in the form of investments in infrastructure and human capital development, FDI is normally less mobile and footloose compared to short-term capital.

But notwithstanding this, multinational activities are not immune to economic crises, particularly since such crises could induce changes in the investment fundamentals of a region or a particular economy in the medium to longer term. According

☆ We would like to thank Yoshifumi Fukunaga, A. Chongvilaivan, Fukunari Kimura, and Shujiro Urata for their valuable comments on the earlier draft.
* Corresponding author.
E-mail addresses: Shandre.Thangavleu@Adelaide.edu.au (S.M. Thangavelu), dion.narjoko@eria.org (D. Narjoko).
[1] Sentral Senayan II, 6th Floor Jalan Asia Afrika No. 8, Gelora Bung Karno, Senayan, Jakarta Pusat 10270, Indonesia.

http://dx.doi.org/10.1016/j.asieco.2014.11.002
1049-0078/

to figures from the United Nations Conference on Trade and Development (UNCTAD), in the year following the onset of the crisis (i.e., in 1998), FDI into the developing Asia and Pacific region fell by US$38 million (UNCTAD, 1998).

Over the years, many South-East Asian countries have in fact relied heavily on multinational corporations (MNCs) to maintain their competitiveness and economic growth in the global economy. This paper examines the inflow of FDI into the key South-East Asian countries of Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam, as well as selected East Asian economies after the crisis. It is pertinent to study these trends given that FDI has the potential to bring about direct and indirect benefits to the domestic economies of the host countries.

Firstly, FDI directly results in an injection of capital, new technologies, marketing techniques and management skills into the domestic economy, thus potentially raising its competitiveness and output growth. Secondly, FDI could potentially create positive externalities by raising the productivity levels of domestic firms. Specifically, the production activities of multinational corporations could have a significant impact on the operational structure of domestic industries through (a) greater competition, (b) diffusion of new ideas and technologies, and (c) transfers of important managerial skills and marketing networks; and thus creating various productive spillovers[2] onto the domestic industries (e.g. Blomström & Kokko 1997).

Empirical evidence on the impact of FDI on economic performance has been extensively documented in the literature.[3] A number of explanations on the mechanism through which FDI brings about economic growth in host countries have been widely discussed. One such explanation is that FDI creates positive externalities by raising the productivity levels of domestic firms. This may come about via the transfer of skills and technology from MNCs to locally owned firms (e.g. Markusen, 1997). This argument is plausible given that MNCs in developing countries are highly concentrated in high-tech industries. Local firms can thus benefit from technology transfer via forward and backward linkages with the MNCs, and the subsequent improvement in their productivity will contribute to economic growth.

Besides such spillover effects, FDI may also lead to structural changes in the economy. More specifically, the establishment of MNCs may trigger changes in market structures and competitiveness, thereby improving resource allocation as well as overall welfare (Kokko, 1996). This hypothesis may be valid especially in highly regulated industries in which inefficiency emanates from entry barriers.

However, while several studies find positive association between FDI and output growth (e.g. Kneller & Pisu, 2010; Ramstetter, 2006), others find that FDI may negatively affect productivity (e.g. Harrison & Aitken, 1999). Using establishment-level data, Kokko (1996) among others, find strong linkages between MNC investments and the productivity improvement of local firms. In contrast, Harrison and Aitken (1999) using Venezuela data show that the productivity of local firms did not improve with the presence of foreign firms, and conclude that positive linkages hold only for firms with relatively high foreign ownership.

At the macro level, the existing literature also yields inconclusive results. Studies by De Mello (1999), Nair-Reichert and Weinhold (2001) highlight the positive impact of FDI on the output growth of host countries. For instance, Nair-Reichert and Weinhold (2001) find that FDI on average has a significant positive impact on growth though the relationship is highly heterogeneous across countries. On the other hand, the opposite conclusion prevails in a number of studies, such as Kawai (1994) and Djankov and Hoekman (1999), among others. The inconsistent empirical evidence may result from differences in the measurements of economic performance and growth (see Buckley et al., 2002).

It is also interesting to observe that the dramatic rise in FDI flows was accompanied by an increase in the number and intensity of regional trade agreements (RTAs)[4] since the 1990s, many of which include provisions for investments. The plethora of trade liberalization agreements overlapping at the unilateral, bilateral, regional and multilateral levels gave rise to what Bhagwati (1995) terms the ‘spaghetti bowl’ phenomenon. Baldwin (2006) proposes a process of multilateralizing regionalism in which preferential trading arrangements (PTAs) are extended to additional partners,[5] through juggernaut and domino effects. With the juggernaut effect, political economy considerations intensify trade opening. With the domino effect, countries participate in more open trading arrangements so as to avoid being left behind. Blomström and Kokko (1997) argue that by joining RTAs, trade and investment will be promoted in the short run while the extended market size, stronger competition, more efficient resource allocation and other positive externalities will enhance economic development of participating countries in the long run.

Countries in the Asia-Pacific region deserve special attention for two reasons. First, FDI has played an instrumental role in the economic growth of developing countries in the Asia-Pacific region over time – from the ‘flying-geese model of dynamic comparative advantage’ in Association of South-East Asian Nations (ASEAN) beginning in the 1970s to the rise of the economic powerhouses of China and India today. Second, the Asia-Pacific region has been the focus of bilateral trade negotiations, including with major economies like the United States, Japan and China.

FTAs could also provide other less tangible benefits (see Thangavelu, Findlay and Lim, 2014). The signing of FTAs not only signifies economic cooperation between nations, but also cooperation on the political and institutional fronts. Chia (2010)

[2] See Blomström and Kokko (1997) on the survey of multinational corporations and productive spillovers. Productive spillovers occur when multinational corporations are not able to internalize the benefits that are derived by the local firms through the multinational operations.

[3] See Caves (1996) for the comprehensive overviews.

[4] In this study, RTAs and regional integration agreements (RIAs) are used interchangeably as trade agreements often comprise commitments to domestic reformatory measures that promote trade and investment for the participating countries. Specifically, trade agreements may be seen as the formal means to the end of integrating trade and investment flows.

[5] The extension of PTAs to additional partners may occur via the inclusion of new members in existing agreements or the creation of new arrangements including new members.