



Economic Research Institute for ASEAN and East Asia

# Policy Brief

## Is Promoting Foreign Direct Investment Worthwhile? Learning from the East Asian Experience

1. Economic and FDI Performance in East Asia and Latin America
2. Determinants of the East Asian Production Networks
3. Policy Remarks

By Dionisius Narjoko<sup>1</sup>

*East Asia presents a new model of industrialization that aggressively utilizes the dynamics of multinational corporations (MNCs). The model puts networks of production into practice, and such networks improve domestic capability and contribution to national output. Promoting foreign direct investment (FDI) is therefore warranted to ensure the sustainability of the production-network model. For this reason, FDI should always be promoted even when demand is less supportive, such as at this moment during the current global economic crisis.*

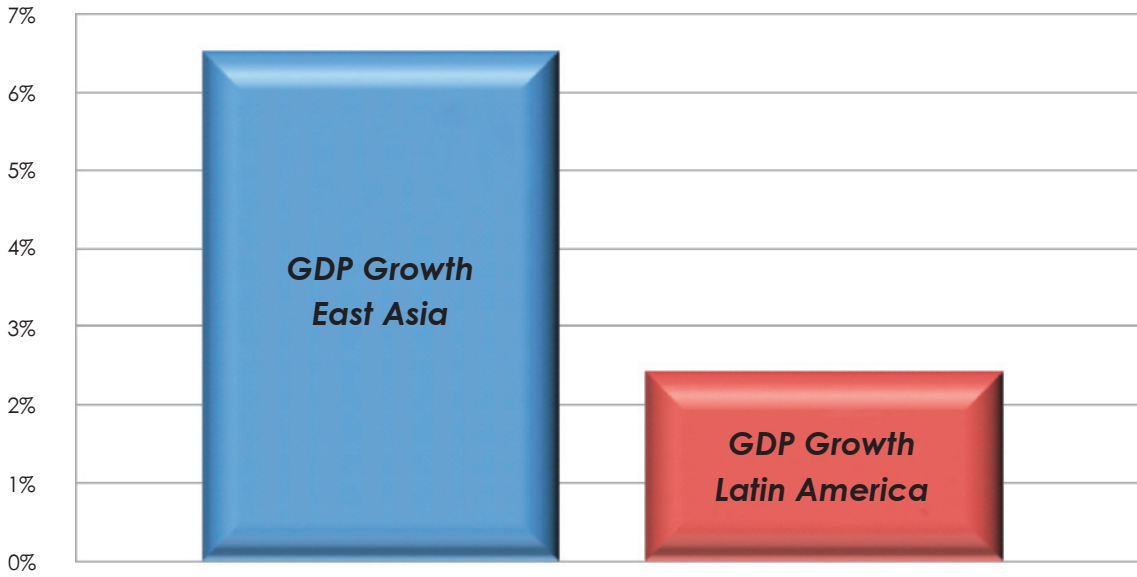
### 1. Economic and FDI Performance in East Asia and Latin America

East Asia and Latin America are dynamic regions that share some similarities in terms of the strategies to promote economic development. The regions adopted an inward-looking and import substitution basis for industrialization during the 1980s facilitated by high trade barriers, the involvement of strong state-owned enterprises, and subsidies. Since the 1990s, both regions have shifted away from an import-substitution regime and adopted a more market-driven and export promotion-based approach.

The economic performance of the two regions, however, has been very different over the past three decades. Gross Domestic Product (GDP) has expanded much faster in East Asia than in Latin America. GDP in East Asia grew annually at the rate of 6.5% over these decades, in contrast to only 2.4% per annum in Latin America (Figure 1). Given the much lower East Asian income per-capita in the early 1980s, the faster East Asian GDP growth significantly narrowed the income-gap between the two regions by the mid 2000s. The average GDP per-capita in East Asia has increased by about 2.5 times over this period, while in Latin America it only increased by about 20% (Figure 2).

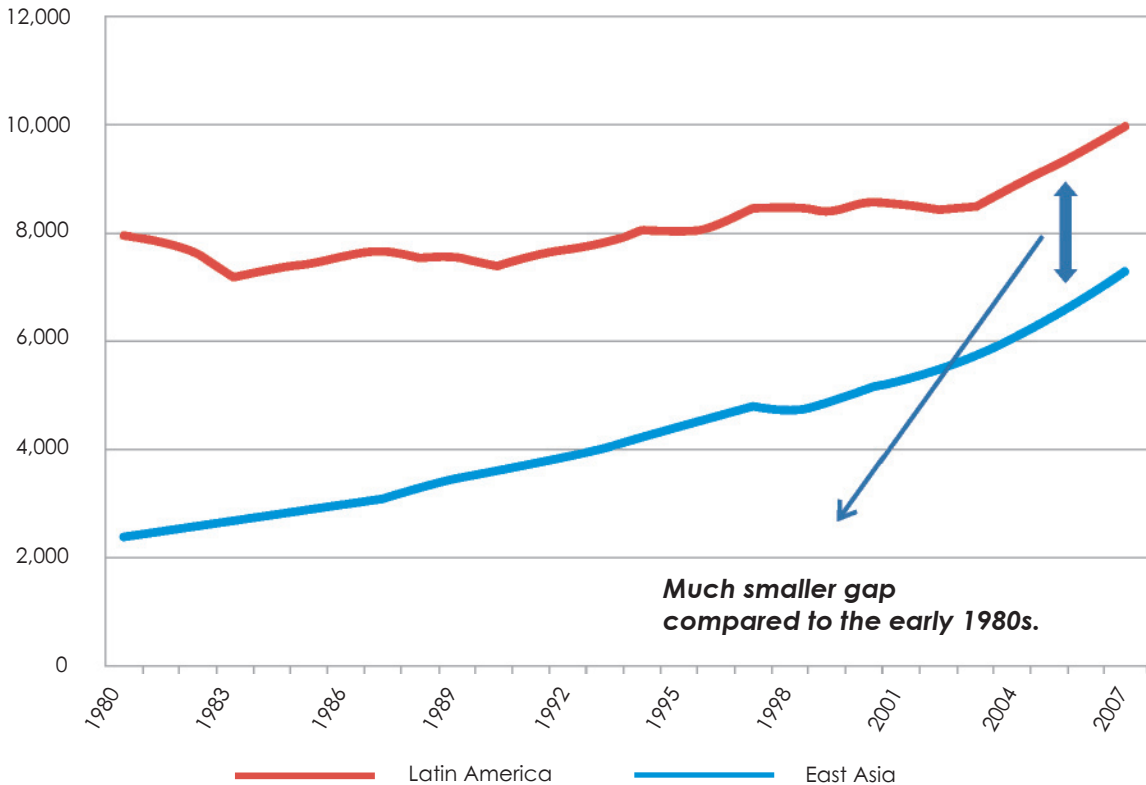
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**Figure 1. Annual Average Real GDP Growth in East Asia and Latin America, 1980-2007**



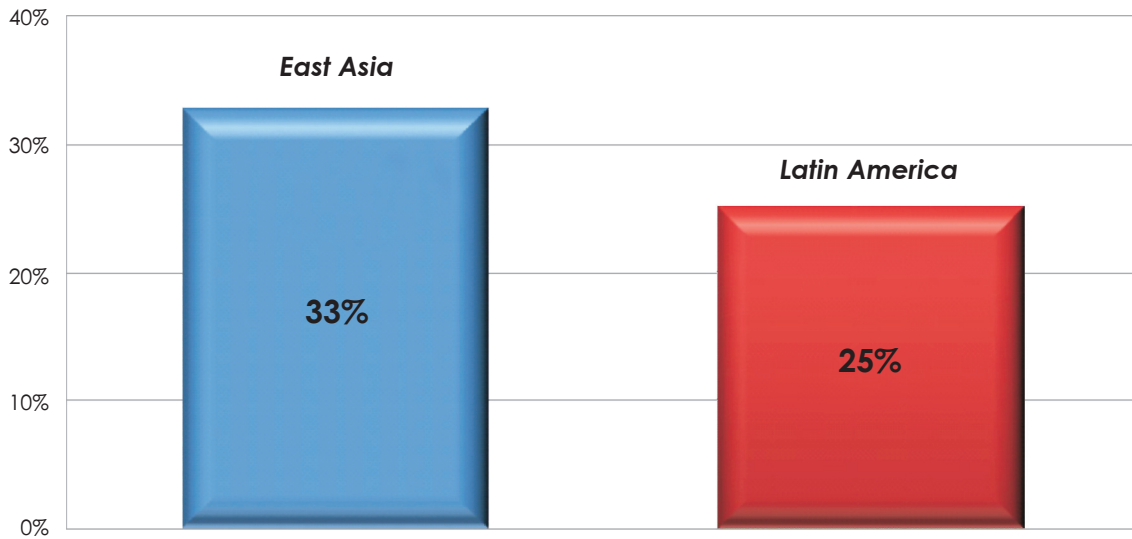
Source: The figures are computed based on the GDP (constant 2000 USD) data, taken from the World Development Indicator 2009. They are weighted averages of the individual country data, using country's population as the weight .

**Figure 2. GDP per Capita in East Asia and Latin America, 1980-2007**



Source: The figures are computed based on the GDP per-capita (PPP, 2005 international USD) data, taken from the World Development Indicator 2009. They are weighted averages of the individual country data, using country's population as the weight .

**Figure 3. Annual Average Export Shares of MNC Affiliates in Selected East Asian and Latin American countries, 1999-2001**



Source: The figures are computed based on data from the UNCTAD (2002), UNCTAD (2008) for the Vietnamese data, and Ramstetter and Sjöholm (2006) for the Indonesian and Thai data.

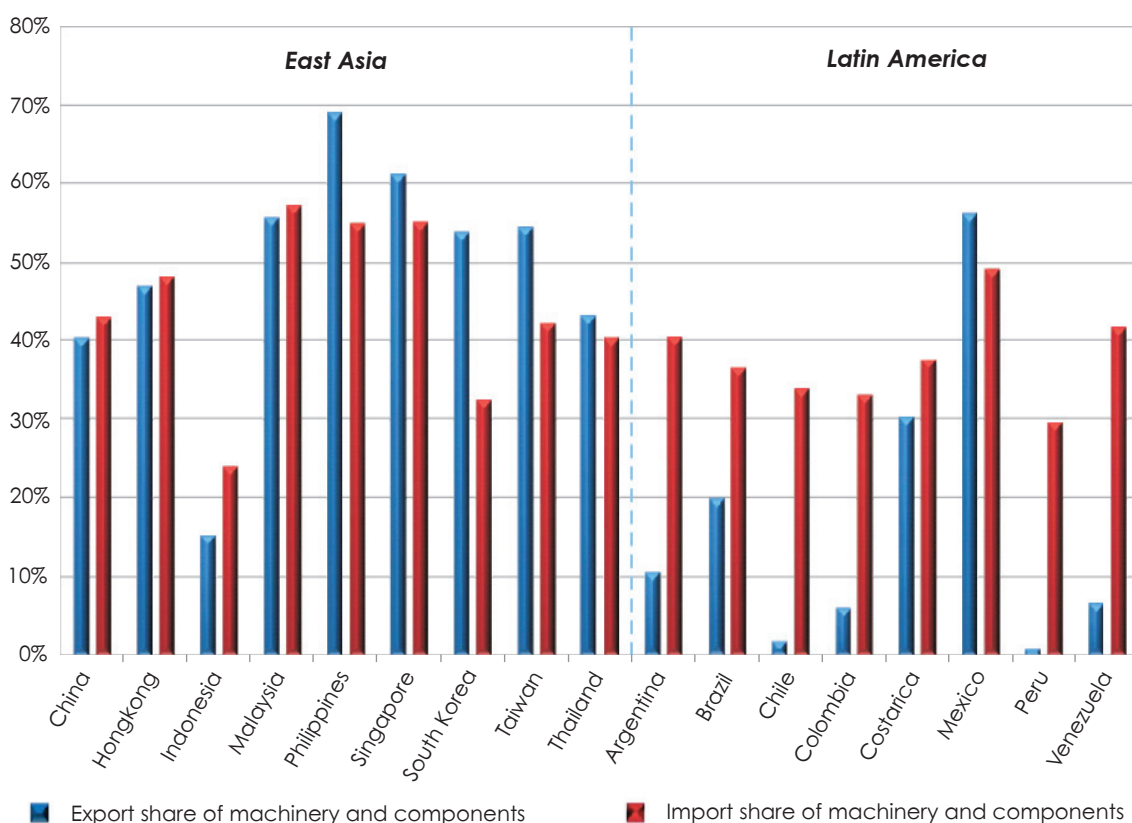
FDI is one of the key elements of economic development in both regions. Reflecting the overall economic growth performance, FDI seems to have performed much better in East Asia than in Latin America. This is indicated broadly by Figure 3, which shows the higher level of export creation by the affiliates of MNCs in East Asia.

The message is consistent with micro-level observation. A study using Venezuelan manufacturing plants, for example, gives no evidence of 'technology spillovers' from MNCs to local firms – or the transfer of technology from MNCs to domestic firms (Aitken and Harrison 1999).<sup>2</sup> A different story exists for countries in East Asia. Unlike the Venezuelan case, technology spillovers seem to have occurred in some sectors of Indonesian and Thai manufacturing (Ramstetter and Sjöholm 2006). In fact,

some other studies of Southeast Asian manufacturing firms point to the ability of foreign ownership in lowering the adverse impact of the 1997/98 economic crisis (see, for example Narjoko and Hill (2007) for the case of Indonesian manufacturing).

The positive FDI impact in East Asia varies across industries and countries. As an example, Blalock and Gertler (2008) found a pattern of MNC linkages with downstream industries in Indonesian manufacturing though Kohpaiboon (2009) did not find so for Thai manufacturing. Despite these variations, the most obvious difference in FDI performance between the two regions is captured by the different role of FDI. The different role leads to different outcomes, and here the key message is very clear; FDI flows in East Asia, and particularly those flowing into the Southeast Asian

**Figure 4. Annual Average Shares of Machinery and Components Trade in Selected Countries, 2000-07**



Source: Global Trade Atlas.

countries, facilitate the formation of the East Asian production networks. This is completely in contrast with what happened in Latin America, or even in the other part of the world, where there has not been a strong formation of such networks.

As the rapid growth of trade in parts and components within East Asia becomes evident, one can infer that FDI in this region indeed contributes positively to domestic economy. This is implied by Figure 4, which at the same time suggests active reciprocal transactions in machinery and components within East Asia, much more than those within Latin America (Kimura and Ando 2005). The size of the parts-and-component trade is not the only indication. There is now evidence that local firms are more

deeply integrated into the networks. A recent survey conducted by the Japan External Trade Organization (JETRO) reveals a relatively high contribution of local companies in supplying inputs for Japanese affiliates operating in major ASEAN countries. This contribution is about half of the total purchases from all suppliers in the host-countries (JETRO 2008).

## 2. Determinants of the East Asian Production Networks

It is important to explain why FDI performance differs so much between the two regions, and central to the interest is why FDI in East Asia was so successful in facilitating the formation of the region's production networks.

The first explanation is the existence of policies that encourage FDI. This seems to have been the main reason for the differences between the Latin American and East Asian experience. FDI into Latin America has been concentrated mostly in regulated or protected sectors. Therefore, it tends to seek for market expansion in the host countries. Given the protective nature of the sectors, it is natural to expect that much of this FDI extracts economic rents arising from the sectors' protection, leading to suboptimal resource allocation and small welfare-enhancing impact. Indeed, this seems to be what happened when there was only a sluggish manufacturing growth in some Latin American countries during the 1990s (Zhang 2007).

Unlike the Latin American experience, Southeast Asian countries have substantially reduced trade barriers since the early 1990s. These were not only limited to tariff reductions but also covered other measures, such as the removal of non-tariff barriers and the improvement of trade facilitation. Complemented by similar measures that ease investment restrictions, trade liberalization allowed MNCs to establish some of their production blocks throughout these countries, which in turn put forward an opportunity for the formation of production networks. The 1990s trade and investment liberalization marks the start-point of proliferation of the production networks; FDI in the region was transformed from import substitution to the export promotion or network-enhancing type of FDI. This is very clear for the pattern in China and

Thailand, for example (see Figure 5).

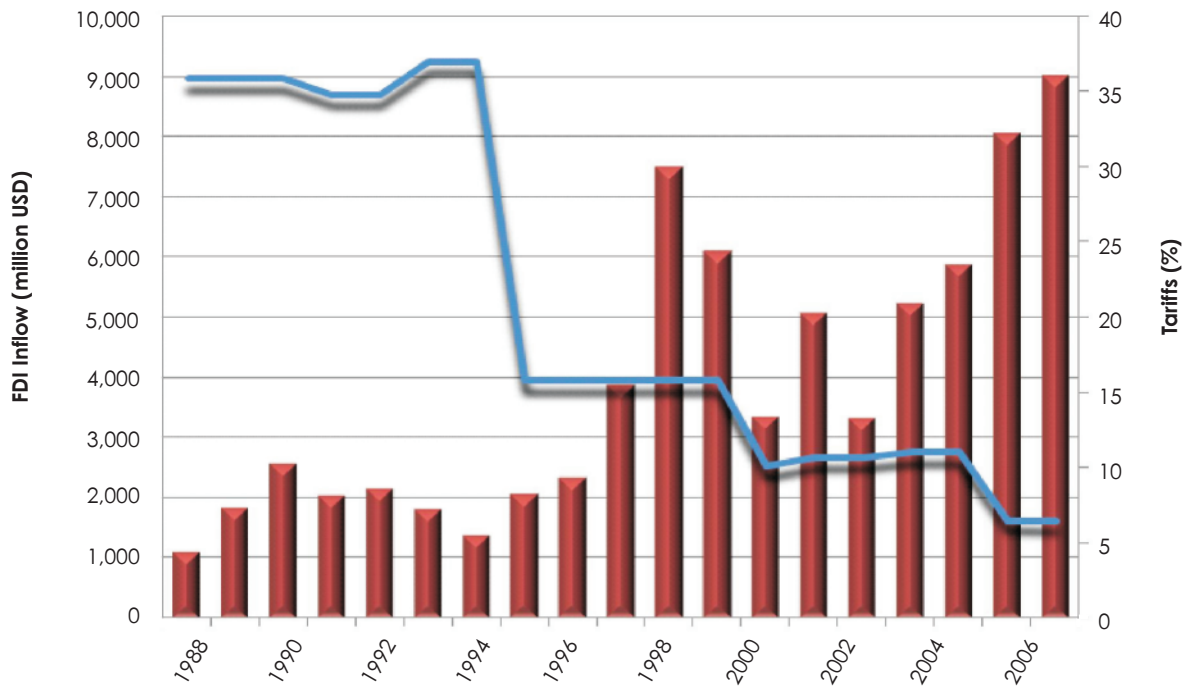
Other determinants are also important, particularly geographical proximity, rapid development of information and transport technology, and abundant stock of labor. Unlike the FDI-policy determinant, all these determinants tend to be region-specific. They allow the separation of production blocks to be economically feasible, arising from lowered transaction costs and low labor costs. These variables pave the way for greater network-enhancing FDI by increasing the potential rate of return of such FDI.

The determinants above comprise a macro-level explanation. The other explanation is microeconomic in nature, namely that the positive impact of FDI is facilitated by 'technology spillover'. In general, advanced technology embodied in the assets of MNCs benefits the economy – including drawing domestic companies into production networks – by improving the productivity of production inputs. In the Southeast Asian context, this is particularly true for improvement in labor productivity, and much of the empirical evidence for Southeast Asian countries lends support for this explanation.

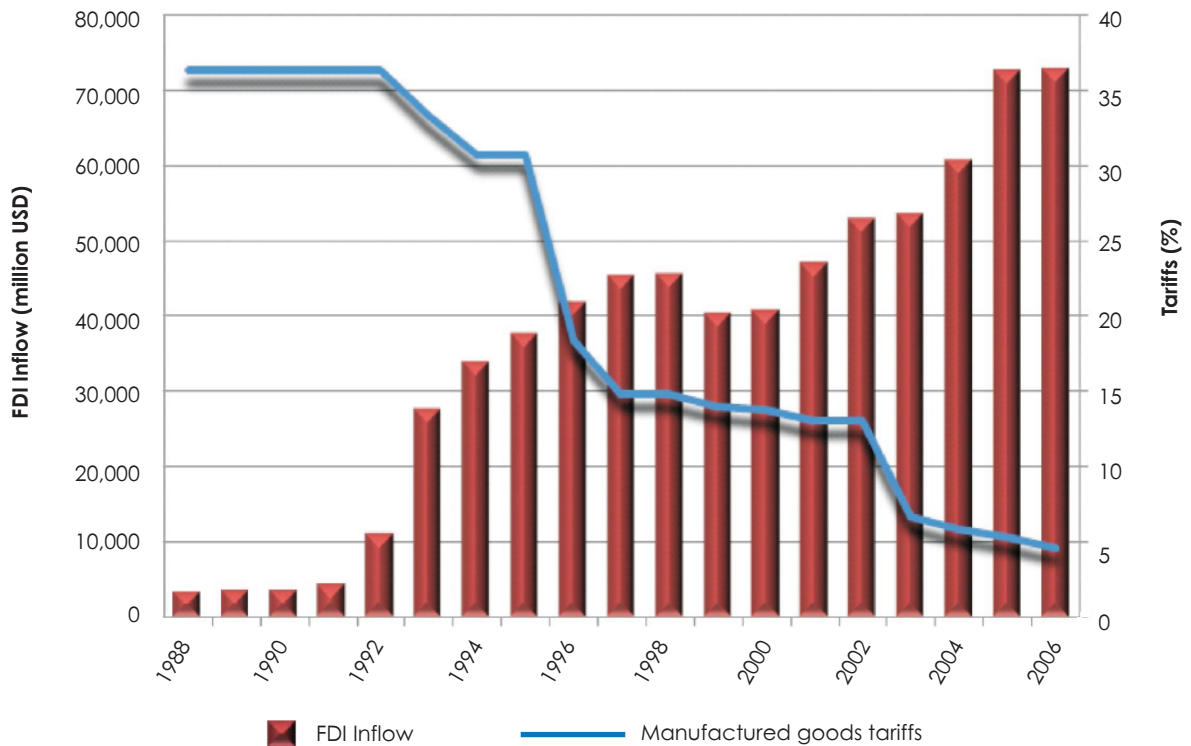
In practice, technology spillover occurs particularly when MNCs choose domestic firms as a source of procurement. Here, MNCs often actively engage in a process of transferring their technology to domestic firms, mainly to ensure that the goods supplied meet the strict requirement of the MNCs. In this situation, upstream-downstream

Figure 5. Declining Protection but Increasing FDI Inflows

## Thailand



## China



Source: Global Trade Atlas and FDI/TNC Database, UNCTAD.

transactions and personal communication are important factors that moderate the technology transfer (Machikita, et al. 2009).

### 3. Policy Remarks

There are a few remarks for policymaking that are worth considering, deriving from the discussion so far.

- *The benefits of FDI should be considered as being both long- and short-term.*

The argument for allowing a greater FDI flow into a country seems warranted. A greater extent of FDI means a higher chance of strengthening a country's position in the growing regional production networks. Besides this, and equally importantly, FDI puts in place a continuous learning mechanism which allows productivity improvement. Thus FDI does not only benefit a country in the short run, but also in the long run.

- *FDI should always be promoted even when the demand situation is not supportive.*

Because of this long-term perspective, one should not then take for granted the view that FDI inflow should be reduced because of FDI's suspected role in amplifying the current global economic crisis. Accepting this position would undermine the 'learning process' and jeopardize a country's global competitiveness in the long run.

- *Policies that stimulate technology spillover should also be promoted.*

The government should not only concentrate on how to invite a greater flow of FDI but also ensure the existence of technology spillovers. As explained, doing so maximizes the benefits from having FDI. One way to do it is to leave all micro decisions at the firm level – because, at the end, a decision to whether or not to benefit from FDI originates from firm – and let government develop policies that are able to 'stimulate' the spillover process. Observations from East Asia suggest that the important stimulating policies are those that improve a country's absorptive capability, which largely depends on the quality of human capital.

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1 The author is grateful for the comments and inputs provided by Fukunari Kimura.

2 Technology is broadly defined; it does not only refer to some types of advanced machinery, but also includes modern managerial systems.

#### **About the author**

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