# Chapter 2

# Model and Practices of Foreign Direct Investment in Asia

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## Abstract

Foreign direct investment (FDI) is when a company or entity based in one country makes an investment in another company or entity based in a different country, and by which the foreign investor will have control over the company purchased. Companies, rather than governments normally carry out the process.

This study focuses on the Model and Practices of Foreign Direct Investment in Asian countries, and specifically Laos and Myanmar. The data provided analyses the effects of all Asian countries and pays particular attention to Laos and Myanmar. The paper provides a balanced view highlighting the positive effect such as the development of economies and societies and also the negative effect such as the imbalance of the distribution of investment.

One of the major drivers behind investment in Asian countries is multinational companies (MNE's), they are looking to take advantage of the many benefits such as the low cost of labor and a wide array of natural resources. Seeking investment from Multinational companies by host countries is deemed a top priority, as many believe this will increase their economic stability and help to reduce the development gap between nations.

The results indicate that foreign direct investment (FDI) plays a large part in the development of emerging economies, such as many southeast Asian countries, but is not the a sole factor. A major emphasis is placed on building a stronger

relationship with the rest of Asia as a whole in a hope of developing economic, social and trade partnerships. The unreliable social, governmental and economic situation in many Asian countries was found to be a limitation to FDI. Having an appropriate strategy to implement FDI in Asian countries would allow foreign investors to offset for the revealed barriers of FDI.

**Keywords:** Foreign Direct Investment/ Development/ Economy/ Asia

## Introduction

Foreign Direct Investment (FDI) is deemed to be a vital tool for developing economies; various countries in Asia including Laos and Myanmar have recognized this fact. FDI provides many opportunities for the host country, including the opportunity to reduce the development gap between nations, having the capital to finance projects that without FDI could not move forward and proving an essential link between small and medium sized companies and multinational companies which in turn provides many business opportunities.

The benefits of foreign direct investment are vast, but what also should be taken into consideration are the unexpected additional costs that may arise from it. The right form and mix of FDI must be sought, so the benefits outweigh the costs for the host country.

Laos and Myanmar are still emerging economies both countries have a lot to offer such as their locations, vast natural resources, and cheap labor costs. These advantages need to be taken advantage of as a way to attract more FDI; other consideration should be given to incentives for investors into the countries and promotions. An increase in foreign direct investment can increase the countries economical growth, strength, and stability, in turn raising the employment level, tax receipts and ultimately the living standards of its citizens.

## Objective

The aim of this study is to focus on three main points:

1) To investigate the current trends of foreign direct investment in Asian countries.

2) To find out how to attract more FDI through assessing the advantages and practices in Asian countries.

3) To assess the FDI relationship with Lao, Myanmar, and other Asian countries.

## Literature Review

The amount of foreign direct investment (FDI) has been increasing year on year for many decades, but since the early 1980's the rate of investment increased phenomenally, this is a result of government's increasing efforts to attract it after seeing the results.

Most developing countries depend heavily on official sources of external financing such as grants and concessionary loans, which are often referred to as Official Development Assistance (ODA). ODA, which includes debt relief as one of its vital components, is especially important for many of the poorest countries burdened by heavy debt service payments. However, in light of decreasing net ODA disbursements (ODA including debt relief) from donor countries in the recent years, it has become essential to consider other types of private sources of external financing that could help these developing countries realize their development goals (Gopalan & Rajan, 2010). Since the establishment of the Bretton Woods Institutions and the United Nations, official development assistance (ODA) has grown steadily and played a lead role as a source of external capital for economic growth and development of less developed countries around the world (Amerasinghe & Espejo, 2006).

FDI is considered a vital source of private external finance for developing countries. It is different from the many other types of external private flows in that it is motivated largely by the investors' long-term prospects of making large profits from production activities that they control. Foreign bank lending and portfolio investment, in contrast, are invested in activities, which are often motivated by short-term profit considerations. These investments can be influenced by a number of factors (e.g. Interest rates), and they are prone to herd behavior. What determines the selectivity of foreign direct investment (FDI), and has it changed in recent years? In particular, how are countries in Asia dealing with this source of external financing?

Government reformation in many Asian countries would reduce the amount of excessive bureaucratic regulation and antiquated rigid conformity to formal rules, which hinder or prevent action or decision-making. The Asian governments should consider emulating the strategic approach taken by other nations to make their economies more conducive to business. According to the Dhaka Tribune (2016), "corruption, red-tape, and counter-productive foreign exchange regulations have to be eliminated to build the business-friendly environment the country needs to sustain growth".

"When the trend in the international financial scene veered toward openness and deregulation through the 1970s and 1980s, few foresaw how explosive private capital growth would become" (Amerasinghe & Modesto, 2006). Tempted by the prospect of higher returns on investment, private capital rushed toward emerging economies in the 1990s and became a far-reaching economic development trigger of the late twentieth century.

The World Bank (1997) states "sixty-six years since the establishment of the Bretton Woods Institutions, private capital now accounts for about sixty percent of total capital going to developing economies." Since the start of the 1990s, private capital flows, particularly foreign direct investment, have grown rapidly while ODA has more or less remained stagnant. Among the three types of private capital (FDI, portfolio equity, and private debt), FDI is largely motivated by long-term prospects of making a profit from production activities in developing countries.

From an economic perspective, external assistance is assumed to facilitate and accelerate the process of development by generating additional domestic savings as a result of the higher growth rates that it is presumed to induce. With the trend in openness and deregulation throughout the 1970s and 1980s, private capital was rushing towards emerging economies in the 1990s, and today is an important source of development finance.

## Methodology

The methodology employed in this research comprised of books, journals, and newspapers. Also used were online sources, i.e. web-based information postings.

## Results

Amerasinghe & Modesto (2006), state that most developing countries grapple with a savings gap. Domestic savings are low, which means that government financing is not enough to spur economic development. As shown in table one, in 2009, the least developed countries (LDCs) in the world had a gross domestic savings rate of only 14.6% of gross domestic products (GDP), whereas the world average was at 19.1%. Some countries in Asia continue to enjoy surplus savings. China and Lao PDR (peoples democratic republic of) have gross domestic savings of 52.0 and

51.4%, respectively, while countries such as Cambodia and the Philippines still have low savings, at 18.3 and 15.5%, respectively.

| *(As a Percentage of GDP)* 2002 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| Bangladesh | 18.4 | 17.6 | 18.7 | 18.1 | 18.4 | 17.5 | 15.8 | 17.2 |
| Combodia | 9.3 | 10.1 | 8.9 | 9.8 | 13.1 | 13.6 | 16.4 | 18.3 |
| China | 40.4 | 43.4 | 45.8 | 47.6 | 50.7 | 50.5 | 51.8 | 52.0 |
| Hong Kong | 31.1 | 31.2 | 30.7 | 33.0 | 33.1 | 31.8 | 30.7 | 28.8 |
| India | 24.2 | 25.5 | 31.1 | 31.9 | 32.6 | 34.1 | 29.1 | 32.0 |
| Indonesia | 27.7 | 32.9 | 28.7 | 29.2 | 30.8 | 29.0 | 28.9 | 33.8 |
| Lao PDR | 19.3 | 21.1 | 16.4 | 13.4 | 28.9 | 38.3 | 47.5 | 51.4 |
| Malaysia | 42.0 | 42.5 | 43.4 | 42.8 | 43.1 | 42.1 | 42.3 | 36.0 |
| Philippines | 15.5 | 15.4 | 16.1 | 15.9 | 16.2 | 17.2 | 16.8 | 15.5 |
| Singapore | 41.2 | 44.0 | 47.4 | 49.4 | 50.8 | 53.3 | 51.1 | 50.0 |
| Thailand | 30.5 | 31.8 | 31.6 | 30.3 | 31.8 | 34.8 | 31.7 | 31.8 |
| Vietnam | 28.0 | 27.1 | 27.9 | 31.4 | 31.7 | 28.2 | 24.5 | 27.8 |

**Table 1: Gross Domestic Savings in Asia**

Source: FDI Statistics, accessed November 2011

The year 2007 saw a financial crisis hit a large part of the world; Asia was not spared the pain of this financial problem. At the start of Asia's financial crisis, the current account balance of all developing countries was negative at US $83.7 billion. As the crisis dragged on, private creditors became reluctant to lend, and portfolio equity flow veered away from these developing countries in Asia. These economies then found respite in increased aid, grants and loans from the international financial institutions (World Bank, Asian Development Bank, and the International Monetary Fund, 2007), and the steady flow of workers' remittances in the late 90s. A consequence of this is developing countries turn to official flows at times of crisis when it becomes risky for foreign investors to bring in private capital.

In spite of this, it can be seen that the share of FDI has increased over the decades, with reference from FDI statistics from November 2011 from the United Nations conference on trade and development. It now occupies around 60 percent of external financial flows. Remittances have also been an increasing source of capital - through bonds, business networks, financial products, and so on.

Data from the World Bank in 2011 shows that from US $59 billion in 2001, ODA for all developing countries has increased US $140 billion in 2009. Bilateral ODA still accounts for around 70 percent of total ODA to developing countries. Meanwhile, total official flows to Asia have increased threefold in 2009 since 2001. Half goes to South and Central Asia, while around a quarter goes to East Asia.

According to the OECD (2011), in 2009, Vietnam became the largest recipient of ODA, from various sources. As shown in Figure one, China has been investing in specific Vietnamese industries such as the heavy industry sector (iron and steel, timber, fertilizer, and mining), the energy sector (hydroelectricity and thermoelectricity), and infrastructure development (houses, railways, and telecommunications) (Van and Sam 2009). In these cases, Chinese ODA to Vietnam was ultimately concerned with prioritizing economic gains between the two countries, rather than addressing development and social problems such as poverty.

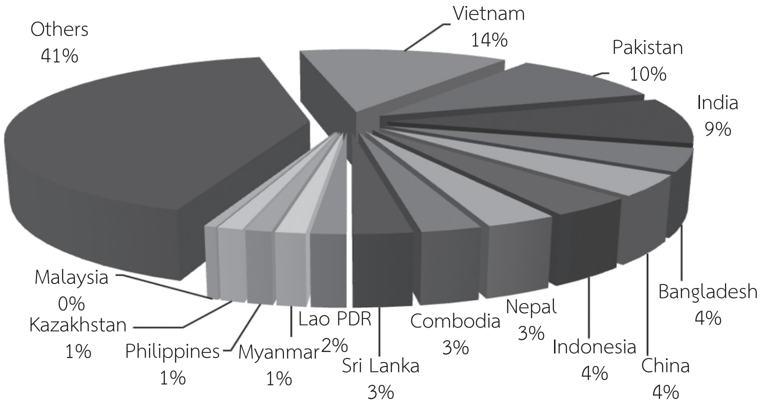


**Figure 1: Net ODA Percentage Breakdown in Asia, 2009**

Source: Development Database on Aid, accessed November 2011

Beginning in the 1980s, private capital has become the major source of external financing for developing countries. There are three forms of private capital: foreign direct investment (FDI), portfolio equity, and private debt. Private capital was mostly driven by the robust growth in FDI.

**Foreign direct investment–** Amerasinghe & Modesto (2006) state that:

1) "In the year 1990, net FDI flowing to developing countries stood at US $23.7 billion, but by 1996 FDI ballooned to US $128.6 billion, far outpacing any other type of private capital flow. The

surge in FDI was mostly due to the series of mergers and acquisitions (M&As) that were encouraged by the wave of privatization in the developing countries in the wake of the Asian financial crisis. Although FDI has been on a general rise since 2003, the current global financial crisis of 2008 has once again slowed down direct investment in the past two years. As a result of withdrawal and low investor confidence, in 2008, 2009, and 2010, the world experienced FDI outflows of US $196.8 billion, US $22.3 billion, and US $49.7 billion, respectively. In Asia in particular, the experience was not as severe, though net FDI flows decreased from US $133 billion in 2006 to only US $30 billion in 2008.

2) Portfolio equity – Amerasinghe & Modesto (2006) Also say that "historically, portfolio investments are more volatile compared to FDI, and they are more prone to react quickly to adverse changes in the economic climate relative to other forms of private capital. This susceptibility to changes in market sentiment accounts for the fluctuations in net portfolio flows toward the developing and transition economies in the past few years. For instance, before the Asian financial crisis struck, portfolio investments to developing countries were generally upward. After the Asian crisis, however, portfolio investments to developing countries in Asia dwindled. Furthermore, the recent global crisis also caused a decrease in portfolio investments. From US $154 billion in 2006, net portfolio equity in Asia decreased to negative US $121 billion in 2007 and US $99 billion in 2008, a manifestation of the volatility of these short-term investments".

3) Private debt – Amerasinghe & Modesto (2006) also state that more than any other form of private capital, private debt has suffered the most due to the financial crises that rocked the global financial markets in Asia, Latin America, and most recently, Europe and the United States. Banks and bondholders do not want to expose themselves in emerging economies. The series of financial crises has severely reduced developing countries' access to the international capital markets. In a similar pattern to portfolio equity, from US $176 billion in 2006, net flows to Asia dwindled to US $71 billion in 2008.

What are the forces driving private capital flows? First of all, the trend in both industrial and developing countries toward capital market liberalization and trade globalization encourages cross-border transactions.

The arrival of supporting infrastructure, for instance, telecommunications and information technology, and the international standards on banking supervision and accounting have made business processes more accessible and integrated. Furthermore, regulatory changes have made it possible for companies of developed countries to invest abroad, especially in perceived new, high-yield investment opportunities in emerging market economies.

In the past decade, private capital flows have greatly fluctuated as a result of financial crises. In 2008, as expected from volatile short-term investments, portfolio equity, and private debt took a huge dive, while FDI only decreased slightly.

Foreign direct investment is different from other types of external private flows in that it is motivated largely by the investors' long-term prospects of making profits from production activities that they control. On the other hand, foreign bank lending and portfolio equity are invested in activities, which are often motivated by short-term profit considerations. These considerations are influenced by a variety of factors (e.g. interest rates) that are prone to herd behavior. The success of attracting FDI by Asian economies has been markedly different. There are particular conditions or determinants, which make these countries attractive to a foreign investor.

While FDI represents an investment in production facilities, its significance for developing countries is much greater. Not only can FDI add to investable resources and capital formation, but perhaps more importantly, it is also a means of moving production technology, skills, innovative capacity, and organizational and managerial practices between locations, also accessing international marketing networks. The first to benefit are enterprises that are part of transnational systems (consisting of parent firms and affiliates) or that are directly linked to such systems via non-equity arrangements, but these assets may also be transferred to domestic firms and wider economies of host countries if the environment is conducive. The greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spill-over (indirect effects) from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competitiveness will spread (Mallampally & Sauvant, 1999).

Furthermore, domestic market-oriented FDI brings new products and services to market. It would also add to the exchequer through taxes, boost exports, and encourage competitiveness in local industries. Despite these opportunities, the large literature on the host economy impacts concludes that the benefits are uneven. In terms of poverty reduction, the development of infrastructure has positive impacts, on two levels (Van and Sam, 2009). First, the poor living in remote areas have access to transport services, which would enable them to go to work or participate in trading centers (e.g. markets). Second, the actual process of building the infrastructure creates a large volume of jobs for many people in the host country.

In relation to the type of investing countries, some studies find a distinction between FDI from developing countries versus FDI from so-called emerging countries (e.g. China, India) (Van der Lugt et al., 2011). FDI inflow from emerging countries assumes considerable importance for host developing countries. Because of greater familiarity with the technology and business practices of developing countries, emerging country foreign affiliates may be able to interact more effectively with domestic firms in host developing countries than the affiliates of transnational corporations (TNCs) from developing countries. As such, the impact of aspill-over from emerging country TNCs on economic growth and poverty reduction can be higher.

A large number of factors determine the inflow of FDI into a host country. These can broadly be classified as factors endogenous and exogenous to the host country. The national government of the host country has total control over the endogenous factors; the exogenous factors are beyond its control. Given the potential role FDI can play in accelerating growth and economic transformation, developing countries are strongly interested in attracting it. They are taking steps to improve the principal determinants influencing the locational choices of foreign direct investors. These determinants are given in Table 3. Developing countries have during the past two decades liberalized their national policies to establish a hospitable regulatory framework for FDI by relaxing rules regarding market entry and foreign ownership, improving the standards of treatment accorded to foreign firms and improving the functioning of markets (Mallampally & Sauvant, 1999). These core policies are imperative because FDI will simply not take place where it is excluded or strongly impeded. Changes in policies have an asymmetric effect on the location of FDI: changes in the direction of greater openness allow firms to establish themselves in a particular location but do not guarantee that they will do so. In contrast, changes in the direction of less openness (e.g., nationalization) will ensure a reduction in FDI.

The most important determinants of FDI are economic considerations, which come into full play once an enabling FDI policy framework is in place. They may be divided into three groups: those related to the availability of location-bound resources or assets, those related to the size of markets for goods and services, and those related to the cost advantages in production. Although many of the factors that attract investments to particular locations such as abundant natural resources, large host country markets, or low-cost, flexible labor remains important, their relative importance is changing as transnational corporations within the context of a globalizing and liberalizing world economy are increasingly pursuing new strategies to enhance their competitiveness (Sacks & Bajpai, 2000).

An important factor under the market-seeking determinant is political motivation (Rajan, 2008). Lower political risk is an important consideration in selecting host countries for FDI. For instance, political instability in Thailand in 2008 resulted in a huge drop in FDI inflow, with effects being felt in 2009. Previous or intended political ties may also play a role; for instance, former colonies are likely to be selected as destinations of FDI due to cultural ties and familiarity.

Under the efficiency-seeking determinant, there is another factor, which may play a role in selecting FDI flow to developing countries. One possible determinant of FDI would be the geographical distance between donor and recipient countries (Rajan, 2008). As in the case of international trade, a larger geographical distance stands out as an important determinant deterring bilateral FDI flow. Higher exports appear to stimulate the future FDI flow, as firms desire to increase regional integration. There is then a role for government policy to reduce transactional and informational distance and to somehow reduce trade and transport costs. While this factor can be considered "natural," exogenous, and cannot be shaped by policy, governments in Asian countries still need to focus greater attention on reducing communication and transaction costs and informational barriers that may hinder intra-regional FDI flow.

An analysis of the experiences of seven countries in Asia – China, India, Indonesia, Malaysia, Philippines, Singapore, and Thailand – was undertaken to glean lessons of experience which would provide a framework for countries aspiring to attract future FDI.

The growth competitive index (GCI) for Singapore is way ahead compared to other Asian countries, as it is very easy and quick to set up a business in this country. Singapore is followed by Malaysia then China. The cost of setting up a business in China is very low at 4.9 percent, which may explain the high inflow of FDI. Meanwhile, labor is an issue for countries such as Indonesia and the Philippines, where there are high redundancy costs, difficult hiring, and rigid employment requirements.

## Conclusions & Discussion

FDI is essential for the development of a country, especially in emerging economies. The experience of newly industrialized countries (NICs) shows that FDI has played a crucial role in their economic development. In the age of globalization with the cross-border flow of capital among nations, FDI is certainly a key solution to reduce development gaps among nations. The rapid growth of multinational corporations (MNCs) has become the huge driver in the process of FDI because they have become investment centers around the globe.

Asia has become one of the major investment centers of the world and a prime target for MNCs, this is due to their many major advantages in terms of cheaper labor cost and rich natural resources.It should also be taken into account that, increasing acknowledgment of the positive impact of FDI by the emerging countries in Asia leads to vigorous competition among themselves to secure FDIs in their countries.

In conclusion, most countries agree that FDI plays a key role in the economic development of a country. However, attracting FDI is not an easy and simple task. A number of barriers could hinder the inflow FDI into a particular developing country, especially for at least develop country (LDC). These barriers can lead to increased risks and costs to foreign investors that can outweigh the location specific advantages and resource endowments of LDCs.

Also, foreign investors expect to receive a high level of returns from the investment to compensate greater risks. Political and economic unreliability are the most important barriers to FDI. Hence, investors should have an appropriate strategy to implement FDI in the host country that they will invest and should be aware of the following barriers, which are:

- Administrative barriers
- Information asymmetries and imperfections
- Policies barriers
- Infrastructure shortcoming barriers
- Constraints of human, social and institutional capital

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