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ASEAN's Economic Development and the Role of International Cooperation : FDI for the Future: Human Capital, Innovation, and Competitiveness

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Executive Summary

The Policy Brief is based on the TIFO 25th Anniversary Symposium in ASEAN with the title **“FDI for the Future: Human Capital, Innovation, and Competitiveness”**, held on Monday, November 24, 2014 initiated by LPEM FEUI in partnership with Graduate School of Public Policy, The University of Tokyo.

A key message from the seminar was foreign direct investment (FDI) is an important agenda for the AEC, and several issues were flagged: (1) impediments to FDI to ASEAN countries; (2) connectivity between ASEAN countries and its external partners; (3) outward FDI.



Introduction

The Association of Southeast Asian Nations (ASEAN) has been an imperative element in Asia's ongoing socio-political and economic transformation. It remains an example for other regional groups of how carefully constructed cooperation can benefit all members, even if they are diverse in size, geography, culture, income level, and resource endowment. As we approach the target for the construction of an ASEAN Economic Community (AEC) by the end of 2015, a major challenge will be to build a longer-term strategy for the shared prosperity of ASEAN members, the wider Asian region, and the world in general.

As is widely acknowledged, continued foreign direct investment (FDI) inflows are an indispensable component for sustained development of economies aiming at technological and productivity advancement. FDI is regarded as potentially contributing to avoiding the middle-income trap by raising the productivity and international competitiveness of host country industries through positive spillovers of technology and organizational capability, and by linking local firms to international production networks and markets. FDI also can benefit innovation activity in the host country via a variety of spillover channels, and it is hoped that such activities can spur similar efforts in the domestic economy and add impetus to the nation's ascent of the development ladder. However, FDI inflows to ASEAN economies are characterized more by inflows from outside ASEAN than intra-ASEAN flows, \$90 billion as opposed to \$20 billion in 2012 (ASEAN Secretariat, ASEAN FDI Statistics 2014). This fact suggests the importance of cooperation beyond ASEAN while intra-ASEAN FDI has its own potential to be promoted.

In response to this challenge, ASEAN needs a well-defined strategy to secure FDI inflows with positive spillover effects. Equally important is the need to harmonize business practices among countries as

well as to make the most of human capital and so maximize gains when such positive spillover effects occur. ASEAN policymakers need to adopt deep structural reforms of their domestic economies and boost regional cooperation. If policymakers are unable to take bold action, ASEAN economies could lose their competitive edge and centrality in Asia's economic and institutional architecture.

This symposium examines the role of FDI in the context of ASEAN's economic development and the role of international cooperation. In particular, we shall deliberate how FDI relates to human capital, innovation, and competitiveness.

FDI in ASEAN

One of the main engines of rapid development in ASEAN has been the expansion of trade. ASEAN has developed production networks and supply chains through trade-promoting FDI in manufacturing sectors. Furthermore, intra-regional and intra-industry trade has expanded considerably. There are three types of manufacturing FDI: (1) FDI in resource-based manufacturing; (2) market-seeking (import-substituting) FDI; and (3) efficiency seeking (export-oriented) FDI. Over the past to decades, global production sharing has been the prime mover of efficiency seeking FDI. Increase in efficiency seeking FDI contributed to the growing importance of East Asia as a centre of global production sharing (Indonesia remains an outlier).

The Key Issues

• There are three issues highlighted a result of the symposium :

- **While main pillar of the AEC includes free flow of investment, there are several factors that could impede FDI.**

Although the emergence of AEC makes ASEAN countries more open to investment, there are several determinants that could hinder inward FDI. Firstly, investment climate is key determinant of the site section decisions of MNEs involved in global production sharing.



Investment climate is determined by five factors: (1) infrastructure and trade-related logistics; (2) political stability and policy certainty; (3) property right protection; and (4) liberalization of trade and investment policy regimes. Improving investment climate is a primary challenge for most of ASEAN countries.

Secondly, under global production sharing, firms in developed countries shift low-skill-intensive segments of the production process to developing countries. However, low-skill intensive activities in the developed country are more-skill intensive than the labour-intensive activities in the developing country. Human capital development is, therefore, a vital element in ASEAN countries endeavour to join production networks.

To attract more FDI, ASEAN countries could implement giving incentives for firms or countries to invest in their countries. The use of investment incentives is pervasive and growing global phenomenon. For instance, Thai government has long give incentives for FDI in form of tax incentives.

• **Integration between ASEAN countries as well as ASEAN Plus 3 countries should be managed.**

According to ASEAN FDI Database (2014), intra-ASEAN FDI Inflow reached \$21 billion in 2013 that contributed about 17% to the total inflows in the region. To support more intra-ASEAN investment, ASEAN Comprehensive Investment Agreement (ACIA) has been established with three actions:

1. Extend non-discriminatory treatments: national treatment and most favoured nations.
2. Reduce & eliminate restrictions to entry of investments.
3. Reduce & eliminate restrictive investment measures & other impediments including performance requirements.

ASEAN dialogue partners contributed significantly of the FDI Inflow, such as Japan, China, Korea. Total FDI from the Plus Three Countries into ASEAN remained on an upward trend, recording an increase of 1.7 per cent amounting US\$ 35 million in 2013 from US\$ 31 million in 2012. FDI flow from the Plus Three countries accounted for nearly 28.7 per cent of the total FDI flows into ASEAN in 2013. Manufacturing, Financial, and Real Estate Sector dominated ASEAN FDI inflow.

The East Asian economies are negotiating on mega regional FTAs such as the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP). RCEP is an ASEAN-centered FTA with its 6 dialogue partners (China, India, Japan, Korea, Australia, and New Zealand). Four ASEAN members join TPP negotiations, while six members do not. It is believed that mega FTAs has several benefits; (1) Narrow the development gap by integrating landlocked and/or low-income countries to large ones like Japan, China, and India. (2) Reduce noodle-bowl risks.

• **Start to look for outward FDI. But in the mean time, the main focus is still to make better condition to attract more inward FDI.**

Apart from inward FDI, ASEAN countries should start to give attention to expand outward FDI. Outward FDI to other ASEAN countries could deepen the integration between the regional. Some members have started to promote outward FDI such as Thailand and Malaysia. The latter shows that its outward FDI exceeds inward FDI.

Although it is important for ASEAN countries to start promoting outward FDI, inward FDI is still the main focus of investment simply because inward FDI especially in manufacturing is believed to have positive spillover effect and absorb high number of labour.



Key Recommendation

The following summarizes recommendations flagged by participants:

1. Improve investment climates, and focus on human development in ASEAN countries.
 - a. ASEAN should get advantages from the specific plan of Indonesia (Maritime Axis) and China (Maritime Silk Road in 21st Century) to reduce maritime transportation cost in ASEAN without increasing tension between the new power (China) with the current global power (US) and the regional power (Japan).
 - b. To be able to attract FDI and join global production sharing, labour in the ASEAN countries should be trained.
 - c. Incentives such as tax incentives should be implemented in order to attract more FDI.
 - d. For Indonesia, showing clear attitude towards FDI is important therefore Indonesia can participate in a major way in the regional product fragmentation trade, the cross-border dispersion of parts and components production within vertically integrated production processes.
 - e. Several ASEAN countries, Cambodia, Indonesia, Lao PDR, Myanmar, the Philippines, and Vietnam, should focus on labour-intensive FDI. Industry sector absorbs high number of labour.
2. Improve integration within ASEAN and its external partners.
 - a. To further enhance AEC integration, reservation list in ACIA should be trimmed down and ASEAN countries should engage in wider and deeper ASEAN Framework Agreement on Services (AFAS) commitment.
 - b. Connectivity between ASEAN and the Plus Three countries is important. Japan has high interest on investing in ASEAN countries. It is important to maintain good expectation from countries outside ASEAN.
 - c. ASEAN countries should work towards more consistent policy environment, including intellectual property right, competition

policy, and connectivity: physical and institutional for a competitive economic region.

- d. ASEAN should consider the competition from the alternative trading routes in the future: the mainland silk road (China-South Asia) and the Northern Sea Route.
3. Start to look for outward FDI. But in the mean time, the main focus is still to make better condition to attract more inward FDI. Four determinants for outward FDI:
 - a. Open FDI policies.
 - b. Large bilateral trade flows.
 - c. Resource abundance.
 - d. The availability of strategic asset.

Conclusion

Continued FDI inflows are an indispensable ingredient for sustained development of economies aiming at technological and productivity advancement. The AEC is expected to have positive impacts on FDI as the main pillar includes free flow of investments. However, there are several factors that could impede this from happening. ASEAN countries need a well-defined strategy to secure FDI inflows with positive spillover effects. Equally important is the need to harmonize business practices among countries as well as to make the most of human capital and so maximize gains when such positive spillover effects occur. The seminar identified several areas where specific policy action is required (see Key Recommendation).

About the Speaker

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He is Professor of Economics, Arnt-Corden Department of Economics, Crawford School of Economics and Government, College of Asia and the Pacific, Australian National University. He is also Honorary Professorial Research Fellow, School of Environment and Development, University of Manchester, UK. He has been Member of the editorial board of some leading journal. He has published a number of books and academic articles on development economics



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Masahiro Kawai

He is Project Professor at Graduate School of Public Policy, University of Tokyo. He was Dean and CEO of the Asian Development Bank Institute (ADBI) from 2007 to 2014. Dr. Kawai's recent publications focus on economic regionalism in Asia. Dr. Kawai has been President of the Japan Chapter of "Economists for Peace and Security" since 2002. He is also a Councilor of the Bank of Japan, a Senior Research Advisor to the Research Institute of Economy, Trade and Industry, and a Special Research Advisor to the Policy Research Institute of Japan's Ministry of Finance. He has been Editor of some prominent journal. He has published a number of books and more than 150 academic articles on economic globalization, regional economic integration and cooperation in Asia, and the international currency system.

Fukunari Kimura

He has been Professor, Faculty of Economics, Keio University, Tokyo, Japan since 2000. He has been the President of The Japan Society of International Economics since 2010 and Chief Economist of Economic Research Institute for ASEAN and East Asia (ERIA) since 2008. He has also conducted numerous advisory/consultant jobs for the Government, international institution, and industrial associations. His major is international trade and development economics. In particular, he has recently been active in writing academic/semi-academic books and articles on international production networks and economic integration in East Asia.

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Mahendra Siregar

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About the Host

Institute for Economic and Social Research – Faculty of Economics University of Indonesia or well known as LPEM FEUI is a research institute which is an integral part of the Faculty of Economics, University of Indonesia. For more than 60 years, LPEM FEUI has become one of the leading academic institutions in Indonesia, which plays an important role in contributing ideas through research, consulting, and education.