



UNIVERSITI PUTRA MALAYSIA

**ECONOMIC INTEGRATION, FOREIGN DIRECT INVESTMENT
AND GROWTH IN ASEAN FIVE MEMBERS**

YEW SIEW YONG

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**DOCTOR OF PHILOSOPHY
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AND GROWTH IN ASEAN FIVE MEMBERS**

By

YEW SIEW YONG

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**ECONOMIC INTEGRATION, FOREIGN DIRECT INVESTMENT
AND GROWTH IN ASEAN FIVE MEMBERS**

By

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November 2007

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Faculty: Faculty of Economics and Management

This study examines the effects of economic integration on FDI flows and the effects of FDI flows on economic growth in ASEAN5 countries. ASEAN, as an RTA is facing economic threats from China and India and other RTAs. Individually, the economies of ASEAN are small. To face the threats, ASEAN need to integrate economically to form a larger market size and functionally to facilitate the attraction of capital inflows to achieve medium and long run growth in the hub and spillover effects in the peripheral countries.

The study applies panel data techniques (unit root and cointegration tests) on annual data from Indonesia, Malaysia, Philippines, Thailand and Singapore over the period from 1970 to 2005. After confirming the stationarity and long-run relationships, we applied the Pedroni's FMOLS method to estimate the variable coefficients. We found market size, economic integration, human capital, infrastructure and existing FDI stock to be robustly significant (1%) to FDI for ASEAN5. We also found that FDI,



economic integration and human capital to be robustly significant (1%) to economic growth, manufacturing sector growth and high technology sector growth for ASEAN5. The FDI flowing into ASEAN5 was found to be market seeking in nature while human capital was found to be inversely proportional to the per capita income of the five countries. The high level of elasticity of existing FDI stock on FDI inflows suggest the existence of bottlenecks or saturation of FDI inflows arising from sectoral bias.

The effect of FDI on economic growth of ASEAN5 countries was found to be higher for countries with higher per capita income. At the same time, the human capital variable was found to be higher in elasticity as the growth variable move from economic growth to manufacturing growth to high technology growth. Coupled with strong intra-industry trade in the manufacturing sector of ASEAN5, an integrated approach to draw in FDI and promote manufacturing and high technology growth should be accelerated. The machinery and electrical appliances industry contributes the highest trade in the region and is highly integrated in intra-industry trade within the region. The key hubs of the industry within the region are Malaysia and Singapore.

From the robust significance of integration level, human capital, FDI inflows and growth, an integrated open liberalization approach must be adopted with particular focus on human capital development, for ASEAN5 to meet the challenges ahead.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**INTEGRASI EKONOMI, PELABURAN ASING LANGSUNG DAN
PERTUMBUHAN DI KALANGAN ASEAN LIMA**

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Kajian ini mengkaji kesan-kesan integrasi ekonomi terhadap aliran FDI and kesan-kesan aliran FDI terhadap pertumbuhan ekonomi untuk negara-negara ASEAN5. ASEAN, sebagai suatu Perjanjian Perdagangan Serantau, sedang mengalami desakan ekonomi daripada Cina and India dan juga Perjanjian Perdagangan Serantau yang lain. Jika dibahagikan secara individu, ekonomi negara-negara ASEAN adalah kecil. Untuk menghadapi desakan-desakan ini, ASEAN perlu digabungkan dari segi ekonomi supaya mewujudkan suatu pasaran yang lebih besar dan dari segi fungsi supaya menglicinkan kemasukkan modal pelaburan asing untuk mencapai pertumbuhan jangka masa sederhana dan juga jangka masa panjang di pusat Perjanjian Perdagangan Serantau dan mengalirkan kesan-kesan pertumbuhan ini ke negara-negara pinggiran.

Kajian ini menggunakan teknik data panel (ujian punca-punca unit dan ujian ko-integrasi) terhadap data tahunan negara-negara Indonesia, Malaysia, Philippines, Thailand dan Singapura dari tahun 1970 ke 2005. Selepas pengesahan kepegunan/

stationariti dan perhubungan jangka masa panjang, kami telah menggunakan kaedah FMOLS Pedroni untuk menganggarkan koefisien pengbolehubah-pengbolehubah. Kami dapati bahawa saiz pasaran, integrasi ekonomi, modal manusia, infrastruktur dan stok FDI masa kini mempunyai tahap signifikan yang tinggi (1%) kepada FDI untuk ASEAN5. Kami juga dapati bahawa FDI, integrasi ekonomi dan modal manusia adalah signifikan ke tahap tinggi (1%) terhadap pertumbuhan ekonomi, pertumbuhan sektor pembuatan dan pertumbuhan sektor teknologi canggih di ASEAN5. FDI yang mengalir ke dalam ASEAN5 didapati bermotif pasaran manakala modal manusia didapati berkait songsang dengan pendapatan per kapita di kelima-lima negara ini. Tahap keanjalan stok FDI masa kini yang tinggi menunjukkan bahawa terdapat sumbatan pertumbuhan untuk FDI ataupun FDI yang wujud telah mencapai titik muatan dalam sektor tertentu.

Kesan FDI terhadap pertumbuhan ekonomi negara-negara ASEAN5 adalah lebih tinggi untuk negara-negara yang mempunyai tahap pendapatan per kapita yang tinggi. Pada masa yang sama, tahap keanjalan modal manusia kepada pertumbuhan meningkat dari sektor ekonomi am ke sektor pembuatan dan seterusnya ke sektor teknologi canggih. Seiringan dengan perdagangan intra-industri sektor pembuatan yang tinggi, cara menarik FDI dan cara promosi sektor pembuatan dan sektor teknologi canggih yang berintegrasi perlu dipercepatkan. Industri mesin dan alatguna elektrik adalah industri yang menjelma perdagangan yang tertinggi dan juga mempunyai nilai integrasi intra-industri yang tinggi. Pusat-pusat industri ini terletak di Malaysia dan Singapura.

Dari tahap signifikan yang kukuh untuk integrasi ekonomi, modal manusia, pengaliran masuk FDI dan pertumbuhan, cara integrasi yang terbuka dan longgar

mesti dilaksanakan dengan pengfokusan terhadap pertumbuhan modal manusia, untuk ASEAN5 menghadapi cabaran di masa depan.

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I certify that an Examination of Committee has met on 21 November 2007 to conduct the final examination of Yew Siew Yong on her Doctor of Philosophy thesis entitled “Economic Integration, Foreign Direct Investment and Growth in ASEAN Five Members” in accordance with Universiti Pertanian (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the student be awarded the Degree of Doctor of Philosophy.

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DECLARATION

I declare that the thesis is my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously, and is not concurrently, submitted for any other degree at Universiti Putra Malaysia or at any other institution.

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LIST OF ABBREVIATIONS

| | |
|--------|--|
| “+3” | China, Japan and Korea countries |
| AEC | ASEAN Economic Community |
| AFTA | ASEAN Free Trade Area |
| AHLTF | ASEAN High Level Task Force |
| AIA | ASEAN Investment Area |
| AICO | ASEAN Industrial Cooperation |
| ASEAN | Association of South East Asian Nations |
| ASEAN5 | Indonesia, Malaysia, Philippines, Singapore and Thailand |
| CEPT | Common Effective Preferential Tariff |
| CEECs | Central and Eastern European Countries |
| CER | Closer Economic Relations |
| CMLV | Cambodia, Myanmar, Laos and Vietnam |
| CUSFTA | Canadian-US Free Trade Agreement |
| DC | Developed Country |
| EAEC | East Asian Economic Caucus |
| EC | European Community |
| EEC | European Economic Community |
| EFTA | European Free Trade Area |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FTA | Free Trade Area |
| GDP | Gross Domestic Product |
| GFCF | Gross Fixed Capital Formation |
| HTEX | High Technology Exports |



| | |
|----------|--|
| IAS | Integration Achievement Score |
| IMP | Internal Market Program |
| IMF | International Monetary Fund |
| IPI | Industrial Production Index |
| IREINA | Index of Relative Economic Integration for North America |
| LDCs | Less Developed Countries |
| M & As | Merger and Acquisitions |
| MERCOSUR | Southern Common Market |
| MNEs | Multinational Enterprises |
| NAFTA | North American Free Trade Area |
| NTB | Non-Tariff Barrier |
| OECD | Organization for Economic Co-operation and Development |
| OLI | Ownership, Location and Internalization |
| RTAs | Regional Trade Agreements |
| SITC | Standard International Trade Classification |
| TFP | Total Factor Productivity |
| TNCs | Transnational Corporations |
| UNCTAD | United Nation Conference on Trade and Development |
| WTO | World Trade Organization |



CHAPTER 1

INTRODUCTION

1.1 Introduction and Brief Overview

This study is on ASEAN5 (Indonesia, Malaysia, Philippines, Singapore and Thailand), their economic integration effects on foreign direct investment (FDI) flows and the effects of FDI on their growth. This chapter contains background information on ASEAN5, foreign direct investment (FDI), economic integration and growth followed by discussions on the problem statement, the objectives and the significance of the study. The chapter will close with the organization of the study.

1.1.1 Origins and Evolution of ASEAN

The Association of South East Asian Nations, ASEAN, was established on 8th August 1967 in Bangkok. The five original members of ASEAN are Indonesia, Malaysia, Philippines, Singapore and Thailand. The association was extended to include Brunei in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and lastly, Cambodia in 1999. ASEAN covers 4.5 million square kilometers, is populated by 550 million people, with a gross domestic product of USD 737 billion and a total trade of USD 720 billion. It is by no means, a small entity, and its significance on the global economic map cannot be understated.

The original purpose of the formation of ASEAN was more for security than for economic integration. The formation years were during the years of the Vietnam

War. Subsequent years were years of the theory of dominoes and the fear of communist takeover of the South-east Asian region. Over the seventies, not much emphasis was placed on economic development. Each country was more concerned on solving their individual economic dilemmas. Up until the early eighties, the agenda was still more political and security than economic. In the early eighties, the main focus was on the Vietnamese occupation of Kampuchea and the flow of Indo-Chinese refugees into ASEAN countries, particularly Thailand and Malaysia.

The eighties saw the development of preferential trade agreements on tariff items. In 1980, there were 6,581 items of trade preferences. This has grown to 15,925 in 1990. On the economic front, ASEAN started planning their joint investment in 1980. A urea plant each in Indonesia and Malaysia were planned while Singapore, Thailand and the Philippines look into the diesel engine, soda ash and copper fabrication plants respectively. On the external front, ASEAN continue to engage with the same group of dialogue partners, namely, Australia, Canada, European Community, United States of America, United Nations Development Program and Japan. The focus of the dialogue with ASEAN's dialogue partners were mainly on broad-based projects, market access and to a limited extent, tariff reduction.

Towards the end of the eighties, more and more emphasis was placed on economic integration of ASEAN. The ASEAN Tariff Quota Scheme was formalized in 1985 and new Intra-ASEAN trade initiatives were put into place to improve preferential trade agreements in 1988 over five years to 1992. This set the stage for the formation of ASEAN Free Trade Area (AFTA). The roll-back of non-tariff barriers was also discussed.

Korea started dialogues with ASEAN in 1989, mainly on market access and investment opportunities. The turn of the nineties decade saw the awareness of ASEAN members on the fast changing political and economic environment in the world. There was a concerted effort among member nations to project themselves as an economic grouping. There were joint stands on anti-tropical timber and oils and the General System of Preferences (GSP) issue. Statistical data within the group were consolidated along similar lines in preparation for future integration. At the same time, the number of preferential trade agreement items reached 15,295 and non-tariff barriers roll back had progressed further.

1992 was a milestone year for ASEAN. This is the year of the fourth Heads of Government summit. With the ending of the cold war and the arising of a new international political and economic structure, ASEAN leaders saw the need for a new and higher level of regional cooperation. The Heads of Government and their Economic ministers signed two major agreements:

- Framework of Agreement on Enhancing ASEAN Economic Cooperation; and
- The Common Effective Preferential Tariff (CEPT) and the ASEAN Free Trade Area (AFTA) agreements.

These two agreements call for a reduction of tariff for all manufactures and processed agricultural products to an ultimate range of 0 to 5% within 15 years from 1st January 1993 and a comprehensive removal of non tariff barriers.

On the international front, a comprehensive settlement of the Cambodian (previously Kampuchean) problem was in sight and Korea has received full dialogue partner status. At the same time, the East Asian Economic grouping proposal first raised in

1991 was developed further into a concept paper. The expansion into an intra-regional grouping of East Asian nations was seen to hold vast potential to further enhance the dynamism of regional economics and the promotion of free trade. However, the members who initiated the idea had proposed not to institutionalize the grouping.

On the launching of AFTA in 1993, the Economic Ministers of the grouping agreed on a three stage program to harmonize ASEAN tariff nomenclature through the consolidation of CEPT submission by tariff lines, the identification of problems areas and the resolution of problem areas. ASEAN had also initiated dialogues with India and China.

With the launching of AFTA, trade of ASEAN nations increased substantially. Exports from ASEAN increase by 20% from USD205 billion in 1993 to USD247 billion in 1994. This made ASEAN the fourth largest trading group after the United States, European Union and Japan. Intra-ASEAN trade expanded even faster. Intra-ASEAN exports increase by 34% from USD44 billion in 1993 to USD59 billion in 1994. Encouraged by the results, the CEPT timeframe was brought backwards from 15 years to 10 years for the achievement of tariff of 0 to 5%. To ensure that a comprehensive liberalization of trade occurs, ASEAN had lined up various programs encompassing technical, administrative and regulatory aspects of trade. Progress was also made to eliminate non-tariff barriers to trade.

Vietnam joined ASEAN in 1995. At the same time, ASEAN's trade liberalization efforts started to move outside the region to cover open regionalization which will

eventually lead to global trade liberalization. External relations in the nineties had become more complex with the inclusion of more dialogue partners including Pakistan and Russia, and with Cambodia receiving observer status. The Mekong Basin project joint development effort was spawned together by ASEAN+3 members.

In 1996, the time frame for the realization of CEPT to 0 to 5% tariff was called to be moved backwards to 2000 instead of 2003. The HS 8 digit code was harmonized and some key services were liberalized. By then, 94% or 45,609 tariff lines were included in the CEPT list. Another milestone was reached by ASEAN in 1996 with the establishment of the ASEAN Investment Region concept. This concept calls for joint efforts to enhance the region's attractiveness and competitiveness for promoting direct investment from external as well as ASEAN sources. This led to the finalization of the ASEAN Investment Area (AIA) agreement providing plenty of opportunities for complementary advantages for investors to exploit regional business strategies and attract greater sustainable levels of FDI flows into the region.

Laos and Myanmar joined ASEAN in 1996. Only Cambodia was left out of the desired 10 nations. Pushing ahead with the open regionalization effort, ASEAN established linkages with other Regional Trade Agreement (RTA) groupings including NAFTA, MERCOSUR, EFTA and Southern Africa Development Community.

The ASEAN Industrial Cooperation (AICO) scheme started on 1st November 1996 with the aim to increase ASEAN's industrial production. Under AICO, companies

enjoy preferential tariff rates of 0 to 5% upon approval. With all these efforts, FDI into ASEAN increased from USD11.9 billion in 1990 to USD19.6 billion in 1995.

After an extended growth period, ASEAN together with her East Asian neighbours suffered a setback from the 1997 Asian Financial Crisis. This shock further amalgamated the grouping and her relationships with China, Japan and Korea. The steps taken to go back on track include the reduction of dependence on the US dollar and the promotion of the use of regional currencies, the increase in transparency and encouragement for greater disclosure, the call on G7 countries to grant greater market access and the encouragement of banks to maintain credit support for ASEAN economies. ASEAN remain steadfast in pushing for an open trade regime and investment environment. Despite the crisis, ASEAN leaders met in 1998 in an informal summit to conceive ASEAN Vision 2020. This vision envisage the group of South East Asian countries that are outward looking, living in peace, stability and prosperity, bonded together in partnership in dynamic development and in a community of caring societies. This vision sets the grouping towards full integration in the long run.

The informal grouping of ASEAN + 3 was inaugurated in the December 1997 summit. Despite the crisis, intra-ASEAN trade grew from USD36.8 billion in the first half of 1997 to USD44.78 billion in the first half of 1998, arising mainly from electrical appliances and machinery industry.

Cambodia joined ASEAN in 1998 making ASEAN complete with 10 members. 1997 was a year of crisis management and the year of 1998 is a recovery year. The