

**Foreign Direct Investment in the APEC Region:
The Role of Country Risks**

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In a recent paper the authors (Lee and Rajan) examined trends and patterns of bilateral FDI flows with APEC economies. Unlike trade flows, there has been little to no detailed examination of FDI flows between APEC economies at the bilateral level, especially with regard to developing member economies. The handful of papers that have examined FDI to selected Asian economies using bilateral data only consider FDI from OECD economies as the source since they use data from the OECD. In contrast, the focus of our paper was on intraregional FDI flows among both industrialised as well as developing APEC economies, thus making the coverage far more extensive and informative compared to other such studies.

The data indicates that around 40 percent of FDI inflows to APEC members have come from within the region and there is evidence that this share has been rising over the last decade. About 60 percent of APEC's FDI outflows have been channeled to member economies, and this share, while high, appears to have been quite steady over the last decade. Clearly some of these flows are overstated as they involve recycling or round-tripping of funds (especially between China and Hong Kong, China). Against this, trans-shipping from offshore financial centers have not been included, implying some underestimation of flows.

Apart from China-Hong Kong, China; Canada-United States bilateral flows tend to dominate intra-APEC flows. These two sets of bilateral flows constitute above 40 percent of intra-APEC FDI flows. The United States; Canada; Japan; and Hong Kong, China are together responsible for 75 percent of intra-APEC outflows, while the United States; Canada; China; and Mexico constitute 75 percent of intra-APEC FDI inflows. This heavy concentration of FDI flows within APEC is a relatively under-appreciated fact. This suggests that there is significant potential for enhancing intra-APEC flows by focusing on member economies which have relatively under-developed cross-border links. But how?

Distance and the commonality of language seem to be strongly associated with bilateral FDI flows. Distance and language are proxies for information asymmetries, and hence efforts to share more information among APEC member economies are expected to strengthen the investment linkages in the APEC region. While relatively little can be done about physical distance (beyond improving transportation channels), APEC economic policymakers can facilitate intraregional investment flows by investing in superior telecommunications capabilities and other trade and investment facilitations measures to boost cross-border informational flows so as to reduce transactions costs.

More interestingly, the intra-APEC dummy is strongly positive and statistically significant, suggesting that the APEC region is closely interlinked in terms of FDI flows. Specifically, the coefficient of 0.601 on the APEC membership dummy illustrates that the APEC members enjoy 82 percent (or 1.8 times) more FDI flows among themselves than with non-APEC member economies. However, the inclusion of lagged export in the regression equation causes the intra-APEC dummy to become economically and statistically insignificant. This finding suggests that the reason for the more intensive FDI engagement with APEC was largely due to significant trade links between the member economies. More exports tend to promote bilateral FDI flows. This complementarity between trade and FDI may either be reflective of the vertical segmentation of production and trade in APEC (especially within East Asia), or that exports tend to be the initial mode of entry into a foreign market followed by greater FDI. In other words, greater exports bring with it more information and

understanding about local markets after which the market is serviced via FDI. Regardless of the exact reasons for the complementarity between trade and FDI, steps to enhance intra-regional trade among APEC members ought also to help facilitate the cross-border FDI flows as well.

Lastly, the paper found that economies with lower country risk appear to attract more FDI inflows. Particularly, our results suggest that the most important component of this risk pertains to political risk (as opposed to financial or economic risks). The link between political risk and cross-border capital movement deserves special attention, as such a link may be seen as one particular channel through which institutions are able to promote productivity growth. Indeed, good governance infrastructure exerts a positive influence on economic growth through the promotion of investment (domestic and foreign alike), while institutional underdevelopment is a key explanatory factor for the lack of foreign financing in the developing economies.

Individual and regional efforts to improve institutional quality of member economies are expected to contribute to increasing intra-regional FDI flows in the region. Other aspects such as more stable political systems, improvements in socioeconomic conditions, reduction in corruption and enhancement of law and order are all important objectives in and of themselves and will obviously contribute to greater FDI flows. APEC-wide action plans and capacity-building programs could be useful in some instances to member economies, helping to contribute to enhanced intraregional economic ties.

APEC has in place several Action Plans and capacity building programs which seek to improve the institutional settings in economies. They include actions which can be chosen by economies to most suitably reflect their particular circumstances. The APEC-OECD Integrated Checklist on Regulatory Reform, the Investment Action Plan and elements of the Leaders' Agenda to Implement Structural Reform are all relevant to suggesting economies implement sound institutional settings that underpin investment. This research shows that benefits are likely to accrue if economies implement them.

There are many ways of extending this research. We consider two possibilities below.

First, the analysis here suggests quite a strong degree of complementarity between trade and FDI within APEC. At least part of this is related to the high level of vertical specialization that occurs in the region, especially within East Asia. That is, due in large part to FDI, the production of manufactured goods has been fragmented across the region and this, in turn, has generated a huge expansion of intraregional trade in parts and components. Thus, international product fragmentation is an important feature of the deepening interdependence in East Asia and more broadly in the entire APEC region. Therefore, more in-depth analysis is needed to understand the FDI-trade linkages and the phenomenon of product fragmentation within the APEC region and what role policy could play to further enhance these trade and investment links.

Second, most analysis of FDI fails to differentiate between Greenfield and Mergers and Acquisitions (M&As). The latter are likely more affected by financial variables such as stock market capitalization, liquidity etc and their macroeconomic and development consequences could be quite different from Greenfield investments. Analysis of M&A data which is based on economy of ownership rather than flow of funds also overcome the problems of transshipping and round tripping that is pervasive in most capital flows data.