ASIAN ECONOMIC INTEGRATION REPORT 2016

HIGHLIGHTS

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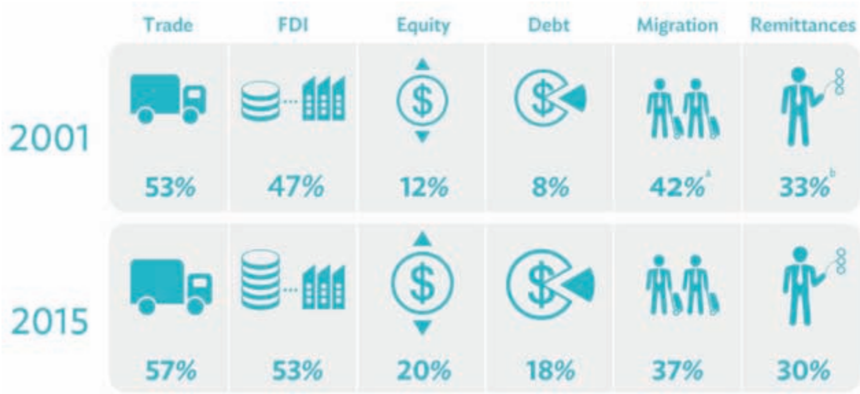
Trade and Investment

With the continued anemic global economic recovery, trade growth in Asia and the Pacific decelerated in 2015, falling further behind growth in gross domestic product. Asia's trade growth by volume decelerated to 2.3% in 2015, below the 2.7% growth in global trade, and falling further below the region's gross domestic product (GDP) growth rate of 5.3%. Developing Asia's exports grew 3.0% in 2015, on par with advanced economies. But imports grew a meager 1.7% compared with 4.5% in advanced economies. The slower-than-expected global economic recovery was the main culprit, but other structural and policy factors also played a role—including a slowdown in global value chain (GVC) expansion and the People's Republic of China (PRC)'s economic shift away from low-cost manufacturing. Rising protectionism has become an increasing concern to international trade prospects. The number of antidumping duty cases against the region's exporters increased from 181 in 2011 to 279 in 2015.

Trade linkages within subregions have continued to strengthen, while inter-subregional trade linkages weakened. Asian economies traded with regional partners well beyond what geographical, cultural, or economic proximity can explain; with 57.1% of total trade intraregional (Figure 1). By subregion, trade integration—measured by the share of intraregional trade in total trade—is strongest in East Asia, followed by Southeast Asia and Central Asia. However, trade across subregions weakened.

The effect of exchange rates on trade has softened in recent years partly due to the expansion of GVCs, while the negative impact from nontariff barriers has become more significant. After the global financial crisis (GFC), a 1% depreciation in exchange rate is estimated to have increased export volumes by just 0.27%, less than half the level prior to the GFC—and the effect is more short-lived. The use of foreign inputs associated with the region's GVC participation may partly offset the impact of exchange rate movements on exports. However, nontariff measures have become major obstacles to trade. The number of trade remedies (such as antidumping and countervailing duties and safeguards), sanitary and phytosanitary (SPS) measures, and technical barriers to trade has been rising, with negative effects on developing Asia's

Figure 1: Asia's Integration Trends at a Glance
(intraregional share as % of total)



FDI = foreign direct investment.
[a] Migration data in 2000.
[b] Remittance data is only available starting in 2010.
Note: Migration data available every 5 years.
Source: ADB calculations using data from Association of Southeast Asian Nations (ASEAN) Secretariat, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations, World Bank, and national sources.

exports. Agriculture trade is particularly susceptible to adverse impact of SPS measures.

Asia continues to be the world's top destination for foreign direct investment, attracting $527 billion in 2015, up 9.0% over 2014. Global foreign direct investment (FDI) increased to a record $1.8 trillion in 2015, with nearly 30% going to the region. Outward FDI from Asia and the Pacific declined to $418 billion, down 9.4% from 2014. Intraregional FDI (from and to Asia and the Pacific) has increased over time (about 52.6% of total FDI inflows to the region in 2015). East Asia received 60% of total intraregional inflows in 2015, with Southeast Asia attracting 24%. FDI in Asia is driven predominantly by export-oriented multinationals investing in manufacturing (*See Asian Economic Integration Report 2016* Special Theme: What Drives Foreign Direct Investment in Asia and the Pacific?).

Finance

Financial integration continues to increase gradually in the region; but still lags far behind trade integration. With greater financial openness, Asia's cross-border portfolio investment and bank claims increased from $3.0 trillion in 2001 to $11.0 trillion in 2015. However, Asia's share in global cross-border portfolio investment and bank claims remained a modest 16.2% in 2015, slightly up from 14.1% in 2001. The degree of regional financial integration also pales when compared with regional trade integration (see Figure 1). In 2015, while intraregional trade was nearly 60% of Asia's total trade, intraregional crossborder portfolio investment and bank claims were just about 20% of the region's total.

Asia's financial links with the rest of the world remain stronger than those within the region. Asia's cross-border portfolio investment and bank claims primarily go to a few large economies outside the region. As of 2015, the main destinations for the region's portfolio investment were the United States (US) (37.7%) and the European Union (EU) (25.4%) for debt; and the US (25.8%), Cayman Islands (25.0%), and the EU (14.6%) for equity. The intraregional investment share remained low at 17.9% for debt and 19.8% for equity—compared with the EU's intraregional share at 65.5% for debt and 55.7% for equity. Asia's cross-border bank claims are also mainly directed outside the region—29.4% to the US and 27.2% to the EU. Asia's cross-border bank liabilities are primarily concentrated in the EU (36.9%) and the US (32.9%).

Financial flows have become more stable since the GFC. Capital flow volatility (measured by standard deviation normalized by GDP) across all types of investment flows—equity, debt, and other investment flows—declined in the 2009–2015 post-GFC period compared with the 1999–2007 pre-GFC period. The drop in volatility suggests more stable capital flows to the region, which may have benefited from various regional initiatives. These include macroprudential and capital flow management measures aimed at strengthening financial stability and deepening the regions' capital markets—particularly local currency bond markets. Other contributing factors could be strengthened capital and liquidity standards, enhanced supervision, and the improving quality of financial market infrastructure.

Movement of People

Migration from Asia increased between 2010 and 2015—although the increase was directed more to outside Asia than within the region. Asia and the Pacific is the largest source of international migrants (83.3 million), accounting for more than a third of the 243.7 million migrants worldwide as of 2015. Asia and the Pacific is also a host to more than 42 million international migrants—up from around 40 million in 2010. However, Asia's intraregional migration (30.6 million) as a proportion of its total outbound migration decreased slightly—from 38.0% in 2010 to 36.7% in 2015.

Economic factors—such as better living conditions and job opportunities—are often behind the attraction of voluntary international migration. Among seven Asian economies with 2015 GDP per capita above $20,000, six posted net inbound migration—the exception was the Republic of Korea. By contrast, those with GDP per capita below $20,000 showed net outbound migration. Migration is a significant determinant of home country remittances. A 1 percentage point increase in a given economy's outward migrant stock as share of total population is estimated to increase remittances as a share of GDP by almost 0.3 percentage points.

Remittances and tourism receipts play an important role in economic growth and development in many Asia and the Pacific economies. Remittances and tourism receipts are an increasingly important and stable source of external financing for many developing Asian economies. On average, remittances in 2015 accounted for 1% of GDP ($271.1 billion) in Asia and the Pacific including the region's more advanced economies. South Asia and Central Asia are most dependent on remittances--for example, the remittance receipts in Nepal and Tajikistan reached 31.5% and 28.9% of their respective GDP in 2015. A slowdown in remittances from the Middle East and the Russian Federation due to the oil price plunge and the economic slump underscores the growing challenges of economic diversification and strengthening competitiveness in these subregions. In 2014, Asia and the Pacific received the second largest amount of tourism receipts ($341.8 billion, or 24% of the global total) after the EU ($470.4 billion, or 33%). Tourism receipts in the Pacific reached almost 6% of GDP, compared with the regional average of 1.4%. Smaller island nations such as the Maldives, Palau, and Vanuatu are most vulnerable to volatility in tourist flows with more than 30% of GDP coming from tourism receipts.

Special Theme: What Drives Foreign Direct Investment in Asia and the Pacific?

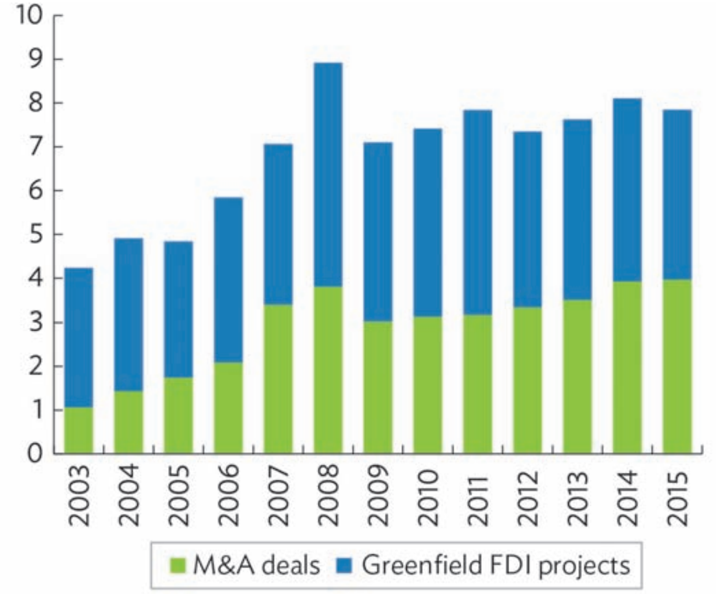
Characteristics of FDI in Asia and the Pacific

FDI contributes to inclusive growth and development by facilitating trade along with technology and skill transfer. FDI's contribution to output by stimulating investment in new infrastructure, other facilities, and boosting production is widely recognized. However, benefits are not automatic and vary by "type" of FDI and subject to the specific economy contexts—the host economy's development stage, absorptive capacity, and investment climate, among others. For example, FDI in extractive industries often proved less beneficial to the host economy, which might have been the cases for unsuccessful FDI experiences in some Central Asian economies. Economic, institutional, and policy factors also exert considerable influence over a firm's decision on whether or how to invest.

Greenfield investments have been preferred to merger and acquisitions (M&As) as a mode of entry for FDI in Asia and the Pacific. FDI can be made through (i) greenfield investments (investments in new assets) or (ii) M&As (takeovers or acquiring existing firms). Firm-level data suggest that, historically, greenfield investments have been the dominant mode of entry for multinationals investing in Asia, although M&As have increased rapidly in recent years (Figure 2). Greenfield FDI is the more common mode of entry in manufacturing, with M&As favored more for services.

Asian multinationals tend to engage more in GVC-FDI than those outside the region. FDI can be categorized by the multinational's investment motivation: (i) to avoid trade barriers and gain better access to local markets by replicating production activities done elsewhere (horizontal FDI); or (ii) to lower costs by placing specific production stages where there is comparative advantage (vertical FDI). Together, vertical and export-oriented FDI can be viewed as GVC investment (GVC-FDI). Firm-level data show most GVC-FDI in Asia is in manufacturing. Japan is the largest source of GVC-FDI in Asia, followed by the Republic of Korea.

Figure 2: Number of FDI Projects—Asia
('000s)



FDI = foreign direct investment, M&A = merger and acquisition.
Source: ADB calculations using data from fDi Markets, Financial Times; and Zephyr M&A database.

"Factory Asia" still helps explain GVC-FDI in Asia and the Pacific. Empirical findings suggest product specialization near the final stage of production processes helps attract GVC-FDI in the region. Developing economies can take advantage of relatively low wages and abundant labor to attract more GVC-FDI.

Determinants of FDI in Asia and the Pacific

Institutional quality matters for FDI, particularly M&As. Among the factors associated with comparative advantage, institutions (or governance), the business environment, and regional integration, the most important driver of FDI in Asia is the quality of institutions measured by perception-based governance indicators. The effect of institutional quality is greater for M&As, although it is significant and positive for greenfield FDI as well. By source economy, FDI from high-income economies is most sensitive to the level of governance in destination economies. By sector, FDI targeting resources are least sensitive.

A better business environment can complement the level of governance quality in destination economies. The business environment—as measured by the Ease of Doing Business indicator—has a positive impact on FDI, with the impact even greater where there is a relatively lower level of governance. Among indicators of the business environment, the ease of "registering property" is most important for attracting greenfield investments, while the ease of "getting credit" matters most for attracting M&As.

Regional Trade Agreements help attract north-south FDI. Regional trade agreements increase greenfield FDI from high-income to low-income economies, perhaps by helping improve the business environment and cutting trade costs. Meanwhile, its effect is negative for greenfield FDI among developing economies—particularly in manufacturing and services—suggesting that FDI among developing economies might be driven more by tariff jumping and market seeking rather than the desire for an export platform for external trade. Nonetheless, the effect of longer-term trade and investment promotion is expected to outweigh a more short-term substitution effect.

Greater domestic production fragmentation helps attract more GVC-FDI. Production fragmentation entails compartmentalizing the production process into small incremental steps. Deepening input-output linkages among parent companies and their industry affiliates not only expands domestic value chains but strengthens an industry's GVC linkages. This helps promote trade in intermediate components and the vertical FDI typically associated with GVCs. Low trade barriers of the host economy also helps attract GVC-FDI.

Bilateral investment treaties (BITs) are important international policy tools in spurring FDI. Despite the growing heterogeneity in the scope and depth of BITs, the treaties generally help both greenfield FDI and M&As. Empirical findings suggest that having investor-state dispute mechanisms (ISDMs) is most effective for BITs to attract FDI—it can increase the number of FDI projects by 35.3%. Separately, nondiscrimination provisions—such as national treatment and most-favored-nation clauses in regional trade agreement investment chapters—are the most effective element in attracting FDI.

Policy Implications

Determinants of FDI vary by mode of entry, a firm's motivation for entering, industrial sector, and the characteristics of source and host economies. Policymakers need to carefully consider the different types of investment that may best suit their development strategies when devising FDI policy on incentives and facilitation in the context of an economy's development stage, comparative advantage, and industrial structure.

Strong political will and commitment help attract FDI in developing Asia. Good governance and quality institutions of the host economy are the most important determinants of a multinational's FDI decisions. Credible policy reforms creating better governance and institutions maximize the host economy's chances of attracting productive FDI. Also, the inclusion of ISDMs into BITs signals a government's commitment to honoring the interests of foreign investors and their investments.

A good investment climate is vital in fostering productive private investment—either domestic or foreign. Creating an investment friendly environment encourages private investment that is key to strong economic growth and rapid poverty reduction. Upgrading the business environment is particularly important for economies with relatively weaker institutions to attract FDI inflows, as improving the general quality of institutions would often require comprehensive and painstaking reforms.

Developing economies need to further develop domestic value chains in manufacturing to attract GVC-FDI. Building strong backward and forward linkages among domestic firms in manufacturing could help facilitate GVC-FDI from multinationals. This could be particularly relevant to economies in Central Asia and South Asia, which have yet to adequately link their manufacturing industries to international production networks.

Asian Economic Integration Report 2016
Highlights

The Asian Economic Integration Report (AEIR) is an annual review of Asia's regional economic cooperation and integration. It covers the 48 regional members of the Asian Development Bank. The AEIR 2016 includes Special Theme: What Drives Foreign Direct Investment in Asia and the Pacific?

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to a large share of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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