FDI Inflows to the Crisis-Affected Countries

Introduction

Foreign direct investment was a key factor in the rapid economic growth and structural transformation of East Asian countries in the lead-up to the crisis, enabling them to maintain investment levels well above their domestic saving capacity. FDI played an even more important role in their industrial transformation through transfer of technology, management practices, and marketing know-how, while improving the overall quality of investment.

The crisis revealed structural weaknesses in the financial and corporate sectors of the affected countries, sparking fears that FDI flows to them would decline permanently, thus delaying the recovery and undermining the long-term growth potential of these countries. How far these fears have been realized is an issue examined in this section. It documents the trends in FDI flows to the affected countries in recent years, the emerging policy environment toward FDI, the challenges that remain, and the role played by FDI in adjusting to the crisis, and finally pulls together key conclusions.

Postcrisis Trends

The crisis can be said to have generated positive as well as negative impacts on FDI. On the negative side, domestic demand contraction caused by output collapse and lowered immediate growth prospects discouraged domestic market-oriented foreign investment. Policy uncertainty, particularly during the initial adjustment phase, hampered all types of foreign investment.

But there are at least two ways in which the crisis could have had an indirect positive impact on FDI. First, large currency depreciations reduced domestic production costs and asset values, making foreign investment more profitable. Since depreciation of host country currencies makes foreign firms wealthier in terms of their purchasing power, investment can increase. Second, revisions to FDI laws that were included among crisis management and corporate restructuring packages in affected countries (in Korea and Thailand, in particular) opened up new opportunities for cross-border M&As.

During the precrisis period the level of FDI inflows to the affected countries increased sharply from a total of $1.7 billion in 1980-1984 to almost $20 billion in 1996 (Table 1). The share of the affected countries in global FDI inflows also increased from 3.4 percent to 5.2 percent over the same period. In 1998, when the crisis kicked in, the level of FDI inflows fell from $19.2 billion in 1997 to $16.7 billion in 1998, before increasing again in 1999 to $17.4 billion.

The FDI figures for the five affected countries taken in aggregate mask significant intercountry variation in fortunes. Within this broader picture, each country has its own story to tell.

Table 1: **Foreign Direct Investment Inflows: East Asia in a Global Context, 1980-1999***

	1980-1984	1985-1989	1990-1994	1995	1996	1997	1998	1999
(a) Level ($ billion)								
World	49.3	128.5	200.5	328.9	377.5	473.1	680.1	865.5
Developing Countries	11.9	22.3	61.1	106.2	145.0	178.8	179.5	207.6
East Asia	4.4	10.3	34.5	63.4	81.3	82.1	75.8	83.5
PRC	0.5	2.5	16.1	35.8	40.2	44.2	43.8	40.4
Hong Kong, China	0.7	1.6	4.5	3.3	10.5	11.4	14.8	23.1
Singapore	1.4	2.4	5.2	7.2	9.0	8.1	5.5	7.0
Taipei,China	0.2	0.8	1.2	1.6	1.9	2.2	0.2	2.9
Five Affected Countries	1.7	3.0	9.4	13.9	19.7	19.2	16.7	17.4
Indonesia	0.2	0.4	1.7	4.3	6.2	4.7	-0.4	-3.2
Korea, Rep. of	0.1	0.7	0.8	1.8	2.3	3.1	5.2	10.3
Malaysia	1.1	0.8	4.2	4.2	7.3	6.5	2.7	3.5
Philippines	0.0	0.4	0.8	1.5	1.5	1.2	1.8	0.7
Thailand	0.3	0.7	1.9	2.1	2.4	3.7	7.4	6.1
(b) As a Percentage of Gross Fixed Capital Formation								
World	4.0	4.1	5.1	5.4	5.9	7.5	11.1	11.4
Developing Countries	3.8	3.9	6.9	7.3	9.1	10.8	11.5	12.1
East Asia	2.4	4.0	7.8	8.1	9.1	9.9	11.5	14.5
PRC	0.6	2.2	8.8	12.7	14.3	14.6	12.9	13.2
Hong Kong, China	7.1	12.1	5.6	4.2	3.2	2.7	2.0	3.2
Singapore	18.9	29.3	28.1	25.4	25.6	22.1	17.6	18.5
Taipei,China	1.2	3.6	2.5	2.5	3.0	3.4	0.4	0.7
Indonesia	0.9	1.8	3.8	6.7	8.8	6.8	-0.8	-1.2
Korea, Rep. of	0.3	1.5	0.7	1.1	1.3	1.8	5.5	7.4
Malaysia	11.5	9.3	15.7	12.1	17.0	15.1	13.9	16.2
Philippines	0.4	6.2	6.5	9.0	7.8	6.2	12.8	13.1
Thailand	2.6	4.5	4.5	2.9	3.1	7.8	25.1	26.7

*FDI is defined as the sum of equity capital, reinvested earnings, and intra-company loans by foreign firms or their affiliates.
Source: UNCTAD, *World Investment Report* (various years), and IMF, *International Financial Statistics* (CD-ROM).

In Korea the crisis-driven slowdown in FDI inflows lasted only for about two quarters. From then on, they started to increase significantly as investors responded to new FDI liberalization initiatives and participated in M&A activities. Total flows in 1999 were significantly higher than levels recorded in 1996. Although the FDI postcrisis increase was aided by a decline in net outward investment by Korean companies (reflecting their domestic financial troubles), the overall rise in inflow was not much different from that of gross inward flows. While the influx of FDI has taken place across all production sectors, emphasis has fallen on the financial sector, where most of the foreign M&A activity took place under the banking sector restructuring program.

Table B-2 on page 20 provides more recent data covering the first nine months of 2000. Although these data are not strictly comparable (they are derived from individual country sources and are net of overseas investment by domestic firms), they do provide indicative information on trends. In 2000, it appears that FDI began to taper off, coming off the peak recorded in 1999.

In Thailand, the pickup in FDI inflows started about the second quarter of 1998. Compared to 1997, the amount of inflows doubled in 1998, after which a decline set in. Net direct investment data in Table B-2 for the first nine months of 2000 confirm this downward trend. This decline may be a reflection of investor weariness resulting from the slowdown in both the rate of asset disposals and the reform momentum.

In sharp contrast to Thailand and Korea, FDI flows to Indonesia have been negative since 1998, and the outflow is on the increase. The outflow in the first nine months of 2000 has already exceeded the total outflow in 1999 (Table B-2). The volatile political and security situations in the country are undoubtedly to blame.

The amount of FDI flows into the Philippines has remained relatively small and changed a little throughout (although it fell in 1999). Despite a small pickup in 1999, FDI inflows to Malaysia have been falling since 1996. This trend appears to have continued into 2000 (Table B-2). There may be a number of reasons for this.

First, unlike in Korea and Thailand, M&A activity has not been an important component of foreign capital inflows during this period. Despite the severity of the downturn, corporate distress was far less widespread in Malaysia than elsewhere, and there were simply fewer bargain assets. Malaysia did not promote acquisitions/takeovers by foreign companies as part of its corporate and bank restructuring process.

Second, compared to Korea and Thailand (in particular, the former), Malaysia's foreign investment regime has remained more liberal and for a longer time, and in some sectors the presence of multinational enterprises (MNEs) had already reached high levels before the onset of the crisis. Thus the postcrisis increase in FDI in the former countries compared to Malaysia may also reflect "catching-up" by foreign firms following the new FDI liberalization initiatives.

Third, in the immediate precrisis years, intra-regional inflows (particularly those from Korea and Taipei,China) accounted for more than a third of total FDI flows to Malaysia and these have dwindled following the onset of the crisis. In other words, supply factors may also account for part of the slowdown. These factors suggest that the FDI slowdown in Malaysia does not reflect a reversal in attitudes of foreign investors toward Malaysia as an investment site, but rather a temporary adjustment period. It is likely that FDI flows will increase again in the future when these factors no longer operate.

There has been some shift in the shares of individual countries in terms of total FDI to the East Asian region (Table 2). The PRC continues to attract about half of total FDI flowing to the region. There has been a compositional shift, which began before the crisis and continued into the recovery, that has favored Hong Kong, China, in particular.

Table 2: **Country Composition of FDI Inflows to East Asia, 1990-1999** (%)

	1990-1994	1995	1996	1997	1998	1999
East Asia	100.0	100.0	100.0	100.0	100.0	100.0
PRC	44.2	58.0	49.4	51.9	54.1	44.5
Hong Kong, China	12.4	5.3	12.9	13.4	18.3	25.4
Singapore	14.2	11.7	11.1	9.5	6.8	7.7
Taipei,China	3.2	2.5	2.3	2.6	0.2	3.2
Five Affected Countries	26.2	22.4	24.2	22.4	20.5	19.2
Indonesia	4.7	7.0	7.6	5.5	-0.5	-3.5
Korea, Rep. of	2.3	2.9	2.8	3.6	6.4	11.3
Malaysia	11.5	6.8	9.0	7.6	3.3	3.9
Philippines	2.3	2.4	1.8	1.4	2.2	0.8
Thailand	5.4	3.3	3.0	4.3	9.1	6.7

Source: UNCTAD, *World Investment Report* (various years), and IMF, *International Financial Statistics* (CD-ROM).

Taken together, the share of the affected countries in total East Asian FDI has fallen only slightly. This better than expected outcome can be explained in terms of rapid increases in FDI associated with M&A activity in Korea and Thailand in particular, a faster than expected growth recovery in the region, and further liberalization of FDI policy regimes following the crisis.

FDI Policies in East Asia

Prior to the crisis, Korea (like neighboring Japan and Taipei,China) had adopted a relatively cautious approach toward FDI. Although there were some notable measures relaxing restrictions on FDI in the 1990s, Korea's overall stance remained lukewarm. In contrast, the affected countries in Southeast Asia began encouraging FDI as far back as the late 1970s in a much more aggressive manner as part of their outward-oriented development effort. By the time the crisis hit, all of these countries had quite liberal FDI regimes.

The crisis triggered significant changes in policy toward FDI in all of the affected countries.

- Korea underwent the most dramatic change, relaxing considerably its conservative approach toward FDI. In November 1998, as part of the reform program agreed with IMF, the Government enacted the Foreign Investment Promotion Act, with a view to creating a much more investor-friendly policy environment. The main changes included streamlining foreign investment procedures, expanding investment incentives, full-fledged liberalization of cross-border M&As, and allowing foreign ownership of land.
- In Thailand, foreign investment liberalization was an important part of the IMF-led reform package. Key initiatives included further liberalization of brokerage services; the wholesale and retail trade; nonsilk textiles; hotels; and garment, footwear, and beverage production. The Government amended the Condominium Act in late 1998, allowing foreigners to purchase 100 percent of buildings of 2 acres or less.
- Indonesia too committed to various FDI-related policy changes as part of the IMF reform program. Measures implemented include significantly narrowing the list of sectors that are closed to foreign investment (in July 1998) and lifting restrictions on foreign investment in wholesale trade. A proposal to reorganize the Investment Board

into a new institution under the Coordinating Minister for Economic Affairs, focusing on investment promotion rather than regulation activities, has been derailed by political turmoil.

- Malaysia has continued to promote FDI aggressively, despite its radical policy shift in September 1998. Capital controls were confined to short-term capital flows and aimed at making it harder for short-term portfolio investors to speculate, and for offshore hedge funds to drive down the currency. No new direct controls were imposed on import and export trade, and profit remittances and repatriation of capital by foreign investors remained free. Immediately following the imposition of capital controls, BNM experimented with new regulatory procedures in this area. But these were swiftly removed in response to protests from firms. Moreover, measures were introduced to further encourage FDI participation in the economy. These included allowing 100 percent foreign ownership of manufacturing regardless of the degree of export orientation; increasing the foreign ownership share limit in telecommunication projects, stockbroking, and insurance companies; and relaxing curbs on foreign investment in landed property.
- In the Philippines, the crisis has not resulted in any significant shift in the country's policy toward FDI. However, the emphasis on the promotion of export-oriented foreign investment, which started in earnest in the late 1980s, seems to have received further impetus from the crisis.

The Role of FDI in Adjustment to the Crisis

FDI has assisted in the adjustment to the crisis in at least two ways. The first relates to the existing *stock* of FDI when the crisis hit, and is associated with the performance of foreign-owned firms relative to domestically owned firms. The second relates to new *flows* of FDI in the aftermath of the crisis, and is based on M&A activity associated with the corporate and bank restructuring process.

In Korea, Malaysia, Philippines, and Thailand the share of FDI in total fixed capital formation was higher in 1998 and 1999, compared to precrisis levels (Table 1). Thus, FDI has been more resilient to the crisis than domestic private investment. Depending on the policy, FDI can act as an effective cushion against the overall collapse in investment during a crisis.

There is anecdotal evidence suggesting that MNEs in general increased their exports, in absolute terms and as a share of total sales, following the crisis. There is firm evidence that relates to US affiliates operating

in the affected countries. The share of exports from US affiliates in total exports of the affected countries increased from 3.2 percent in 1995 to 5.2 percent in 1998 (Table 3). Further, as local sales declined sharply following the onset of the crisis (by 30 percent in the affected countries between 1997 and 1998), the affiliates of US MNEs were quick to redirect their sales from host country to external markets to minimize the impact on their overall performance. Consequently, the ratio of exports to total sales of these affiliates shot up in all of the affected countries.

Table 3: **Exports of Majority-Owned Affiliates of US MNEs in Affected Countries, 1995-1998**

	1995	1996	1997	1998
	As a Percentage of Total Host Country Exports			
Five Affected Countries	3.2	3.9	4.3	5.2
Indonesia	0.5	0.5	0.5	0.5
Korea, Rep. of	0.5	0.6	0.5	0.5
Malaysia	6.6	8.3	10.7	14.8
Philippines	9.1	9.4	9.3	9.1
Thailand	5.2	6.1	6.3	8.8
	As a Percentage of Total Sales by MNEs			
Five Affected Countries	45.8	50.4	53.3	67.4
Indonesia	17.0	19.3	17.3	32.2
Korea, Rep. of	15.9	16.3	15.8	19.1
Malaysia	59.1	66.8	68.6	85.4
Philippines	40.6	44.2	47.1	54.2
Thailand	59.6	61.0	60.9	72.8

Source: Lipsey, Robert E. (2001), *Foreign Investment in Three Financial Crises*, NBER Working Papers 8084, Cambridge, MA: National Bureau of Economic Research.

With strong export performance, total employment in US affiliates in the affected countries declined at a much slower rate compared to total national employment in these countries. Similarly, the decline in fixed capital formation (expenditure on plant and equipment) by affiliates in 1998 in the affected countries was far smaller than the massive contractions recorded in national fixed capital formation estimates. This suggests that despite the crisis, US firms have taken a relatively optimistic view of long-run prospects for the region. All in all, these findings support the hypothesis that foreign-owned firms have behaved differently from domestically-owned ones in their response to the Asian crisis and that this behavior has aided the affected countries' adjustment process. It appears that FDI presence has added to the agility of the affected countries.

M&A activity has been driving the corporate and bank restructuring process in the affected countries, contributing to a more sustained recovery. All affected countries have benefited from increased M&A activity, although to varying degrees (Table 4).

Table 4: **Mergers and Acquisitions by Foreign Firms in Affected Countries, 1998 to 2000, Announced Value** ($ million)

	1998	1999	2000
Indonesia	35.98	545.69	1,441.51
Korea, Rep. of	1,864.65	3,914.24	3,723.57
Malaysia	1,334.46	867.38	250.23
Philippines	1,478.64	293.03	1,126.69
Thailand	829.24	1,014.58	314.27

Source: Bloomberg.

- Korea has received by far the largest inflow of capital associated with M&As, in line with comprehensive liberalization of policies governing such inflows.
- Thailand received large inflows associated with M&As in 1998 and 1999, but these have tailed off sharply in 2000. The drop-off might be related to the slowdown in the pace of debt restructuring, but perhaps the more attractive assets have already been sold.
- Continued political uncertainty has limited flows to Indonesia, despite the large number of potentially attractive opportunities. Inflows did shoot up in 2000, however, and this may reflect recent optimism associated with improved debt restructuring.
- Inflows associated with M&A activity have been relatively low in Malaysia, and are falling. This is not surprising given that Malaysia has not been encouraging such activity, preferring instead for the restructuring process to be internally driven.
- Even though the Philippines was the least affected by the crisis, it has been an active site for M&As. Unlike in other affected countries where corporate distress has been the driving factor, most of its M&As have been linked with consolidating market positions and refocusing or streamlining operations.

The Future of FDI and Related Issues

With an eye to attracting future FDI, some regional and multilateral initiatives have been undertaken in the Association of Southeast Asian

Nations (ASEAN) region. These initiatives are likely to receive added emphasis in the postcrisis era. The idea of forming an ASEAN Investment Area (AIA) first formally surfaced at the 1995 Bangkok Summit and the framework agreement was subsequently signed in October 1998. With the AIA, there will be joint extra-regional promotional efforts, and perhaps some moves to harmonize certain aspects of the FDI regulatory regime within the region. But it is difficult to envisage much more than this. For example, attempts to develop common FDI policy regimes (including not just regulatory but also fiscal provisions) would almost certainly flounder, as would the concept of offering preferential treatment to investors from other member countries. In short, while initiatives such as this can play a complementary role, the success of countries in the region in attracting FDI will continue to depend on the efficacy of unilateral action.

What unilateral policy measures should these countries introduce in order to increase their attractiveness to FDI? They would vary by country, and depend primarily on the existing incentive climate and stage of development.

Among the five affected countries, Korea has undergone the most significant FDI liberalization as part of its overall crisis management package. This policy initiative, coupled with reforms in other areas such as *chaebol* restructuring, revamping of bankruptcy procedures, and banking reforms, seem to have set the stage for rapid expansion in FDI participation in the Korean economy. However, with the rapid recovery from the crisis, resistance of trade unions and other domestic lobby groups against these policies has begun to intensify. Whether the recent pick-up in FDI inflows will eventually become a major force in the economic transformation of Korea depends on the ability of policymakers to resist such pressures.

Despite its unorthodox crisis management policy, Malaysia is likely to soon regain its precrisis position as the most attractive location for FDI among ASEAN countries after Singapore. The constraint in the medium to long run is likely to be the erosion of its comparative advantage in labor intensive assembly activities in the face of tightening labor market conditions. A major challenge lies in developing the domestic human capital base in order to facilitate an upward shift in MNE activities along the value ladder. Over the past decade or so, Malaysia has increasingly relied on migrant workers in order to preserve its comparative advantage in labor intensive production. But, this policy choice could be counterproductive in the long run as it may prevent the structural adjustment required for economic maturity.

In Thailand, crisis-induced FDI liberalization has significantly improved the climate for FDI. However, the twin problems of incomplete banking sector reform and private sector debt overhang could continue to threaten the future attractiveness of the country for domestic market-oriented FDI. In the area of export-oriented FDI, Thailand still has considerable opportunities in labor intensive product sectors compared to Malaysia. But unlike in Malaysia, domestic infrastructure bottlenecks continue to constrain FDI to some degree.

In Indonesia, the entry of FDI into export-oriented manufacturing began just before the crisis. With excess domestic supply of labor and tightening labor markets in neighboring FDI-receiving countries (Malaysia and Singapore, in particular), there is considerable scope for further expansion of these activities. However, there is little that policymakers can do to promote FDI, given the continued policy uncertainty and social unrest. In particular, FDI of “Chinese origin” (especially from Hong Kong, China; Singapore; and Taipei,China) has been a major casualty of the political situation in Indonesia.

In the Philippines, policy reforms from the early 1990s have made considerable leeway in improving the incentive structure for foreign investors. However, the poor state of domestic infrastructure, policy uncertainty, and lack of transparency in investment approval regimes are major stumbling blocks to greater global integration of domestic industry through FDI.

Conclusions

FDI inflows have shown considerable resilience in the wake of the crisis. In countries such as Korea and Thailand, FDI inflows have actually shot up recently, with M&A activity driving most of the increase, contributing to the restructuring process. At the other extreme, Indonesia is still experiencing outflows of all types of capital, and this is unlikely to change until political stability returns. The slowdown in FDI inflows to Malaysia has not relented despite a return to strong growth, but there are reasons for this, and fears that this may be a permanent change appear unwarranted. In the Philippines, FDI inflows have remained relatively small and changed a little throughout. In short, the crisis has not introduced a major discontinuity into the FDI story in the affected countries, apart from a modest decline in inflows in its immediate aftermath, and sharp declines in inflows to Indonesia due mostly to noneconomic factors.

Foreign firms also appear to have played an important role in weathering the crisis. Relative to domestic firms, they displayed greater capacity to switch sales from depressed domestic markets to international markets, allowing them to limit the amount of layoffs and reductions in fixed capital formation, which tempered the contractionary effects of the crisis.

An important side effect of the crisis in all affected countries has been the further liberalization of FDI regimes, which has been encouraging. The commitment of these countries to FDI has not been compromised by the crisis; indeed it has been strengthened as a result. There has been some nationalistic opposition to the increase in foreign ownership during the early postcrisis years, as financial institutions and firms recapitalize their operations through injections of foreign equity. But with the possible exception of Indonesia, where nationalistic opposition to rising foreign ownership could resurface, the principal policy issue now is not whether to promote FDI but how to build on the present proactive strategy toward FDI. Although further liberalization of FDI regimes is required, recent policy changes introduced in all affected countries are encouraging. In light of this, and three years into the recovery, the future of FDI flows to the affected countries looks bright.

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