The rapid economic growth of east asia economics essay

Economics

INTRODUCTION

Foreign Direct Investment (FDI) is a form of long term investment by which investors transfer funds or assets such as production tools and machineries from one country (called capital exporting country) to another country (called host country) and establish a new company or buy the share of an established company. Therefore, the investors might control the company fully or partially (Sornarajah, 1994). Furthermore, FDI provides many advantages to the host country such as: creating job opportunities, increasing local economic growth, providing residuals in form of machineries and technology, opening export market channels for local businessman, increasing foreign exchange reserves and state tax revenue, enduring interest rate and foreign exchange fluctuation, and providing political and security protection (Suhardi 2010). Therefore, FDI is very important as the driving force of the economic growth for the host country, especially developing countries. Asian Development Bank (2012) stated that the economic growth in Asia will be slightly slowing down because of the global economic deceleration in late 2011. However, Asian countries succeeded to maintain the growth level. ADB predicted that the GDP growth of developing countries in Asia will decrease to only 6. 9% in 2012 and reaches 7. 3% in 2013. In 2010, after Asia recovered from economic crisis, its GDP growth increased as much as 9. 1%. However, it decreased by 7. 2% in 2011. Meanwhile, the economic growth in South East Asia decreased to 4. 6% in 2011 and predicted to reach 5. 2% in 2012 and 5. 7% in 2013. This improvement is mainly contributed by Indonesia that maintains its strong growth and Thailand that has recovered from the natural disaster. ADB predicted that Thailand will reach 5. 5% growth in 2012, after sinking to only 0. 1% in 2011. Furthermore, Indonesia will maintain the good performance by reaching 6. 4% in 2012 and 6. 7% in 2013. (ADB, 2012)The rapid economic growth of East Asia and South East Asia has brought in US$ 336 Billion, approximately 22% of global FDI in 2011. South East Asia received FDI as much as US$ 117 billion (26%). This shows that many investors are becoming more interested in investing their money in South East Asia. Companies from foreign countries consider several attractive factors to invest their money into Asian countries such as its cheap labors, low production cost, and re-importing products to their home countries. However, their view has changed because many people in Asia also have a potential to become the consumers. Based on UNCTADs' world investment prospect survey (WIPS) 2012-2014, six Asian countries were listed as top ten prospective FDI destinations and China grabs the first place. Surprisingly, Indonesia bursts in the top five. (UNCTAD, 2012)Based on the fact mentioned above, Indonesia is highly likely to become the main source of economic growth in South East Asia region, because of its potentials such as natural resources, populations with high consumerism, and labor force, despite the fact that Indonesia has been struggling to eliminate corruption, increase the infrastructure level and reduce the complexity of regulations. Indonesia economic condition has not fully recovered yet from the 1997 economic crisis. The statistical data from BKPM shows that the FDI level in 2003 was still smaller than 1997 by one third and in 2006, it only increased as much as 8. 6% from 2003 level. Moreover, Indonesia's share in foreign direct investment to the gross domestic product decreased from 1. 68% in 1995 to only 0. 78 in 2002 (BKPM, 1990-2011). Meanwhile, other countries like China and India have emerged as attractive investment destinations. In order to attract more investors, the government of Indonesia has established new investment Law Number 25 Year 2007 concerning direct investment that provides tax holiday, fiscal fascilities, simpler investment procedure, and other incentives to the investors. Furthermore, Untung (2010) describes that in the globalization era, regulation in investment field should be reviewed in order to accomodate business world development. Moreover, in this advanced information and technology era, capital flow movement is very rapid. Therefore, investors will invest their money in countries which provide fiscal facilities and incentives. One of the most important and attractive factors is government regulations in the host countries that protect and guarantee their businesses. Therefore, the governments should provide a better investment climate for FDI in order to improve their economic growth. There are many research has been done to analyze the impact of FDI on economic growth as follows. Alfaro (2003) examine the relation between FDI and GDP by emphasizing the role of FDI in each main economic sector such as primary, manufacturing and services to promote economic growth of Organization for Economic Co-operation and Development countries (OECD). She finds that only FDI in primary and manufacture sector have positive and significant effect on economic growth. Therefore, the different treatment between FDI sectors is needed in order to reach the optimal advantage of the FDI inflows. Based on the findings, I conduct the similar analysis by expanding the FDI sectors into agriculture, mining, forestry, fishery, industry, construction, trade and services sector, because FDI in these sectors have the significant portion of the total FDI in Indonesia. As a result, this research will be more accurately identify which FDI sectors that need government attention to be improved to boost the economic growth of Indonesia. Therefore, the government will effectively impose the supportive policy for FDI. Furthermore, Borensztein, Gregorio, and Lee (1998) analyze the effect of FDI through education channel as the proxy of human capital on the GDP growth of the 69 developing countries. They find that the countries which have high education level will improve the impact of FDI on economic growth. This evidence shows that the higher the education levels, the higher the ability for a country to absorb the technological advance from FDI. Therefore, education is one of the important factors that support the FDI in improving the economic growth. I also analyze the education effect in the present study by introducing the interaction term between education and FDI in order to examine its effect on supporting FDI to bolster the economic growth. Sahoo et al (2010) investigate the relation between FDI, GDP, and infrastructure development in China for the period 1975-2007. The result shows that the FDI and infrastructure development have a positive and significant effect on economic growth in China. Therefore, Indonesia should follow China strategy in providing better infrastructure condition that is required by the investors to support their business activities. Based on this finding, I examine the infrastructure effect by proposing the interaction term between infrastructure levels such as road length, electricity distributions, and water distributions and FDI, in order to examine the role of each of the infrastructure form on supporting the FDI to promote the economic growth. In addition, Chieng and Zhang (2012) conduct a study about two-way relations between FDI and GDP in Vietnam. They are significantly and positively affect each others, especially in the region that has better socio-economic conditions. In Indonesia, the FDI projects are also mainly located on the area which has better socio-economic condition. Therefore, this phenomenon need to be examined further in order to identify which areas or provinces in Indonesia that is required to improve their economic condition in order to attract more FDI. Finally, I propose the interaction term between FDI and FDI in urban area in each province in order to examine the effect of FDI in urban area on the FDI impact on the economic growth in Indonesia. In brief, many researchers have been analyzed the impact of FDI, education, and infrastructure on economic growth through simple OLS method. However, in this present study, I propose conditional model by introducing the interaction term between FDI and education, infrastructure, and FDI in urban area in separate model, in order to capture the effect of each variables on the role of FDI in enhancing the economic growth. Therefore, this research is very important to provide the government with the approximate level of the education, infrastructure and FDI in urban area that should be fulfilled in order to effectively improve the FDI effect on bolstering the economic growth in Indonesia. This present study also involves other factors such as trade openness, labor force, government expenditure, domestic direct investment, and export as the control variables that determine the economic growth in Indonesia. Furthermore, I utilize panel data analysis of 30 provincial data of Indonesia for period 2002-2009. The remainder of the paper is structured as follows: Chapter 2 reviews the theoretical literature concerning GDP and its determinants in developing countries. In the third chapter, an overview about the GDP and FDI in Indonesia is provided. Chapter 4 describes the testable hypothesis of this present study. In the fifth chapter, the econometric models are presented. The analysis and discussion of the empirical results are presented in Chapter 6. Finally, Chapter 7 presents policy implications and conclusions.