

# **Trends and Drivers of Bilateral FDI Flows in Developing Asia**

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## **Summary**

South-South FDI flows has been a rapidly growing phenomenon and has generated significant interest from policymakers, academia and the popular press in recent times. Given the aggressive overseas acquisition plans by cash-rich and highly confident firms from Mainland China, India, Hong Kong SAR, Singapore, South Korea, and Taiwan POC, and other Asian countries, as well as by national holdings companies in Asia such as Singapore (Temasek Holdings) and Malaysia (Khazana Nasional Berhad), outward investments from Asia are set to rise even further.

While Asian companies have become significant foreign direct investors abroad, a large share of outward investments from Asia may have been recycled intraregionally. However, unlike trade flows there has been little to no detailed examination of FDI flows between Asian economies at a bilateral level.

This paper uses bilateral FDI flows involving 14 developing Asian countries for the period 1990 to 2005. The primary contribution of this paper is that it one of the first – if not the first – to examine the magnitudes and determinants of FDI flows from developing Asian sources to other developing Asian hosts. The data indicates that around 35 percent of FDI flows to developing Asia between 1990 and 2005 have come from within the region, with over 90 percent of the flows originating from Hong Kong SAR, Mainland China, Singapore, and Taiwan POC. Clearly some of these flows are overstated as they involve recycling or round-tripping of funds (especially between Mainland China and Hong Kong SAR). Against this, trans-shipping from offshore financial centers have not been included, implying a degree of understating. While the intra-Asian flows are substantial, two issues stand out. One, a large part of these flows pertains to bilateral flows between Hong Kong SAR and Mainland China. Two, the data do not indicate that intra-Asian flows are necessarily intensifying. Given that developing Asia is investing aggressively overseas, what this suggests is that relatively more investments are being made outside developing Asia.

The paper finds that an augmented gravity model fits the data fairly well. The baseline OLS regression is able to capture 75 percent of the variations in existing intra-Asian FDI flows. Most of the estimated coefficients are the correct signs and are statistically and economically significant. Intra-regional FDI activity between emerging Asian economies is driven by economic factors such as market sizes (especially in the host country), export intensity, real exchange rate changes, measures of financial depth, institutional factors (such as political risk and legal origin), an operational FTA, and level of financial openness of the host country. As in the case of international trade, distance stands out as an important determinant of bilateral FDI flows even after the inclusion of bilateral FTA, suggesting that transport costs and informational asymmetries are factors that could hinder FDI flows. There is clearly a need for more work in this area.