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# Investment in Regional Trade Agreements and Free Trade Agreements: How Big the Benefit for Developing Economies in Asia-Pacific?

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# Investment in RTAs/FTAs: How big the benefit for developing economies in Asia-Pacific?

*Tony Irawan PhD*

*Faculty of Economics and Management*

*Bogor Agricultural University-Indonesia*

# Background

- This session will provide an in-depth look on the **WTO-plus elements of** trade in services and **investments in RTAs/FTAs within and outside the APEC region**, the impediments that economies encounter when concluding such negotiations and the consequent contribution to greater integration of markets.

# Background


- Investment in RTA/FTA = higher degree of financial integration / financial liberalization
- Q1: is it good for the economy?

Economic growth

Volatility

# Background


- Investment in RTA/FTA = higher degree of financial integration / financial liberalization
- Q2: Does RTA/FTA with the element of investment results higher foreign investment in the economy?

# Q1: Investment in RTAs/FTA, is it good for the economy?

# Financial Integration and Economic Growth

- ***Theoretically ??***
- 2 channels (Prasad et al., 2003) :

Direct → augmentation of domestic saving; lower cost of capital due to better risk allocation; transfer of technology; development of financial sector.

Indirect → promotion of specialization; inducement for better policies; enhancement of capital inflows by signaling better policies.

# Financial Integration and Economic Growth

- ***Empirically ?***
- no robust significant impact of financial integration on economic growth (Edison et al., 2002)
- the impact depend on the composition of capital flows → portfolio equity “yes” but bond “no” (Reisen and Soto, 2001)

# Financial Integration and Economic Growth

- ***Empirically ? (continued)***
- FDI flows tend to be positively associated with output growth if the host economy :

  - have a sufficient level of human capital (Borenzstein, De Gregorio, and Lee (1998))

  - have a well-developed domestic financial markets (Alfaro et al., 2003)

# Financial Integration and Volatility

- Theoretically?
- lower the volatility of macroeconomic fluctuations in capital-poor developing economies by providing access to capital that can help them diversify their production base (Kose et al., 2005)
- lead to increasing specialization of production based on comparative advantage considerations → vertical integration across economies → making economies more vulnerable to industry-specific shocks (Kalemli-Ozcan, Sorensen, and Yosha, 2003)

# Financial Integration and Volatility

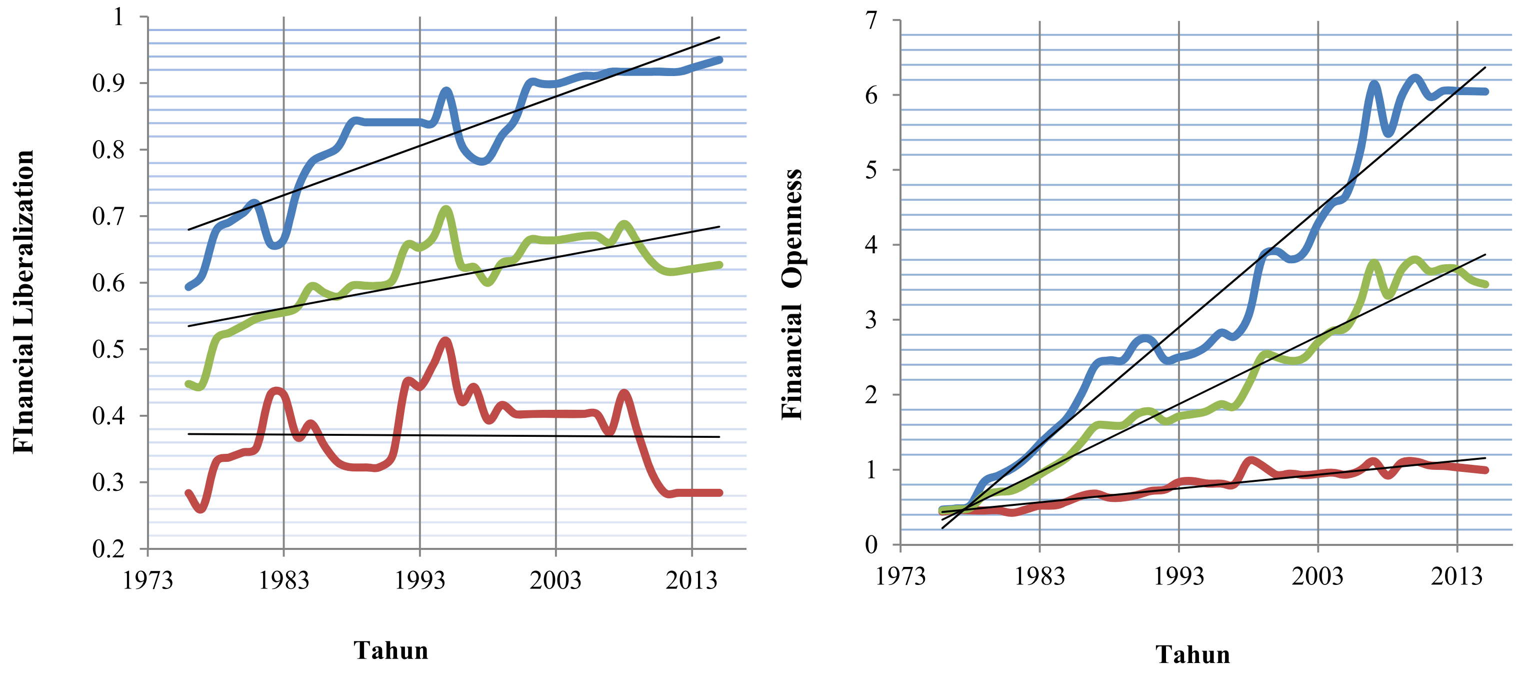
- Empirically?
- Financial integration does not have a statistically significant impact on the volatility of the output (Kose et al., 2003)
- Equity market liberalizations are associated with lower volatility of output and consumption growth (Bekaert et al., 2003)
- financial openness is associated with lower output volatility in developing economies (IMF, 2002)

# Current Condition in Asia Pacific

Developed economies are still dominant in the capital flow (including portfolio equity, FDI, debt, financial derivatives, and FX reserve)

Source: External wealth of nations  Mark II Database, average 1995-2014

# Financial Liberalization and Openness in the Asia-Pacific Region



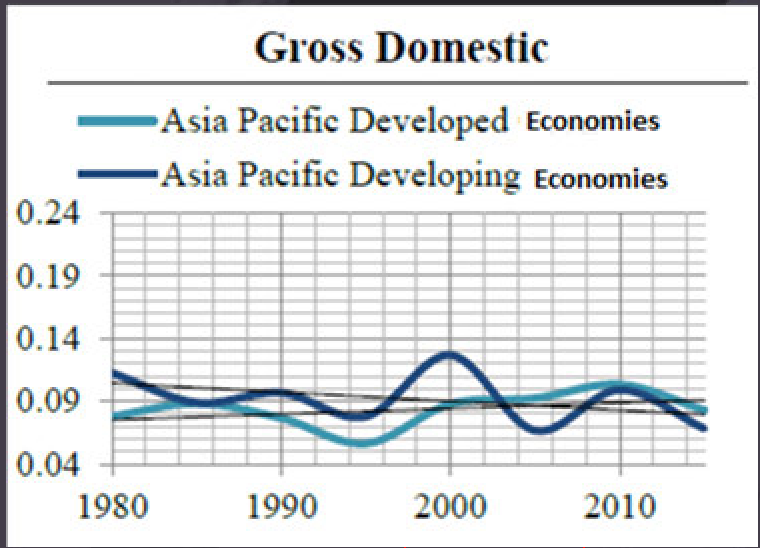

Source: Feriansyah, Achsani and Irawan (2017) based on methodology of Chinn and Ito (2007)

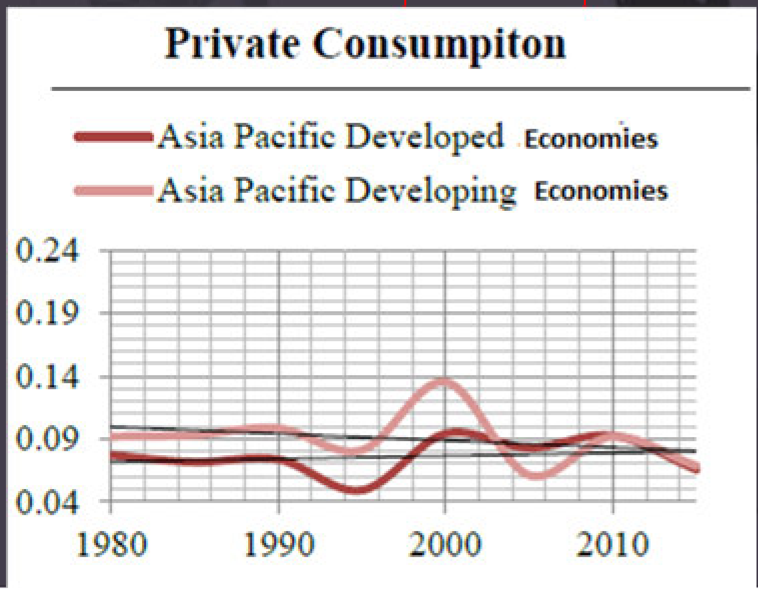
Asia-Pacific Developed Economies

Asia-Pacific Developing Economies

Asia-Pacific (agregate)

# Several Indicators in the Asia Pacific Region




- Volatility of GDP, measured as standard deviation of GDP → developing economies vs developed before and after the global financial crisis 2008 and asian crisis 1998.
- Private consumption also suggest the same pattern.

**Source: Feriansyah, Achsani and Irawan (2017)**

# The Impact of Financial Liberalization (de facto and de jure) on macroeconomic volatility in Asia Pacific region

| | *Vgdp* | |
|---|---|---|
| Financial openness | -0.0062*** | 0.0525** |
| | (0.005) | (0.029) |
| Asia-Pasifik developed economies (dummy) | | 0.0726** |
| | | (0.018) |
| Financial openness × Asia-Pasifik developed economies (dummy interaction) | | -0.0561** |
| | | (0.015) |
| Financial liberalization | -0.0033 | |
| | (0.840) | |
| Trade openness | 0.0188* | 0.0075 |
| | (0.068) | (0.327) |
| Income per capita | 0.0103*** | 0.0082*** |
| | (0.000) | (0.000) |
| Inflation | -0.0277 | -0.0204 |
| | (0.706) | (0.755) |
| Inflation volatility | 0.4419* | 0.4509** |
| | (0.061) | (0.039) |
| Terms of trade volatility | 0.4679*** | 0.5313*** |
| | (0.003) | (0.001) |
| Discretionary fiscal policy | 0.1170 | -0.0225 |
| | (0.512) | (0.919) |
| Fiscal policy procyclicality | 0.0338* | 0.0354** |
| | (0.095) | (0.040) |
| Financial development | 0.0082 | -0.0037 |
| | (0.605) | (0.815) |
| Institutional quality | 0.0005 | -0.0025 |
| | (0.910) | (0.585) |

Financial liberalization (de facto) is expected to lower output volatility.

However, when dummy slope is used → the impact is different between developed and developing economies.

- Developed economies (-)
- Developing economies (+)

**rce: Feriansyah, Achsani and Irawan (2017)**

# The Impact of capital flows (inward and outward) on macroeconomic volatility in Asia Pacific region

| | Vgdp | |
|---|---|---|
| total asset / gross domestic product | -0.049*** | |
| | (0.001) | |
| total debt asset / gross domestic product | | -0.044** |
| | | (0.014) |
| total equity asset / gross domestic product | | -0.106*** |
| | | (0.036) |
| total liabilities / gross domestic product | 0.043** | |
| | (0.010) | |
| total debt liabilities / gross domestic product | | 0.054** |
| | | (0.040) |
| total equity liabilities / gross domestic product | | 0.082 |
| | | (0.202) |
| trade openness | 0.025** | 0.017* |
| | (0.012) | (0.075) |
| income per capita | 0.012*** | 0.014*** |
| | (0.000) | (0.000) |
| Inflation | -0.036 | -0.022 |
| | (0.564) | (0.720) |
| inflation volatility | 0.479** | 0.446** |
| | (0.016) | (0.029) |
| terms of trade volatility | 0.4759*** | 0.495*** |
| | (0.003) | (0.005) |
| Discretionary fiscal policy volatility | 0.002 | 0.101 |
| | (0.986) | (0.597) |
| fiscal policy procyclicality | 0.023 | 0.025 |
| | (0.126) | (0.114) |
| financial development | 0.002 | 0.014 |
| | (0.862) | (0.502) |
| institutional quality | -0.002 | 0.001 |
| | (0.575) | (0.758) |

- Capital outflow (asset) is expected to have a negative impact on macroeconomic volatility.
- Total debt and total equity asset have the same positive impact on volatility.
- Capital inflow (liabilities) is expected to have a positive impact on macroeconomic volatility.

**Source: Feriansyah, Achsani and Irawan (2017)**

# Q2: Does RTA/FTA with the element of investment results higher foreign investment in the economy?

# The Impact of FTAs/RTAs on Foreign Direct Investment (FDI)

- Cuevas, Messmacher, and Werner (2005) *NAFTA have a positive impact on FDI inflow into NAFTA members.*
- Pantelidis and Paneta (2016) found that Greek participation in the Eurozone (EMU) is expected to have negative impact on FDI inflows into Greece → foreign investor build a manufacture outside Greece but still within Eurozone → export it to Greece

## The Impact of FTAs/RTAs on Foreign Direct Investment (FDI)

- Velde (2004) argues that participation of developing economy in RTAs will have a positive impact on FDI inflows into developing economies.
- Bae and Jang (2013) found that participation of South Korea in various FTAs/RTAs does not have significant impact on the FDI inflows into the economy.

# The Impact of FTAs/RTAs on Foreign Direct Investment (FDI)

- Ismail et al. (2009) found that AFTA reduce the incentive of ASEAN-5 to invest in other ASEAN5 economies →ASEAN-5 prefer to invest in new ASEAN members →AFTA will create more incentive for Non-ASEAN Members to invest in a relatively more developed ASEAN Members.

## The Impact of FTAs/RTAs on Foreign Direct Investment (FDI)

- Thangavelu and Findlay (2011) found that bilateral FTA does not have significant impact on FDI, while multilateral FTA will have a positive impact on FDI.
- It is also supported by Faiz and Irawan (2017) → IJEPA (Indonesia-Japan bilateral FTA) have no significant impact on FDI inflows from Japan to Indonesia.

# The Impact of FTAs/RTAs on Foreign Direct Investment (FDI)

- Back to the FDI theory:

  - Tariff Jumping motives: FTAs/RTAs → more trade → less FDI

  - FDI export platform → more FDI will be centralized in the most attractive economy in the region

  - Irawan (2015) found that the US FDI outward in the ICT sector is motivated by export-platform FDI and multilateral FTA has a significant impact on FDI outward from the US

# CONCLUSION

- Higher degree of financial integration (through WTO plus) will result lower macroeconomic volatility for developed economies and larger volatility for developing economies in the Asia Pacific region.
- Capital inflows is expected to increase macroeconomic volatility, while capital outflows tend to lower macroeconomic volatility.
- Multilateral trade agreement is more preferable than bilateral trade agreement due to its significant impact on investment

# THANK YOU