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The Examination of the Effects of FDI on International Trade of the ASEAN Economic Community

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Abstract

The examination of the effects of foreign direct investment on international trade and trade balance was conducted within the member states of the ASEAN Economic Community, which include Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam, covering the period from 2001 to 2022. To derive empirical insights, various static panel data models were employed, specifically the Pooled Ordinary Least Squares, Fixed Effect, and Random Effect models. In addition to FDI, the analysis incorporated three key variables: the real GDP growth rate, inflation rate, and foreign exchange rate, to evaluate their influence on international trade. The findings of this research indicate a positive correlation between net FDI inflows and trade levels, suggesting that increased FDI contributes to enhanced trade activity. Furthermore, the results emphasize that a rise in the real GDP growth rate and a depreciation of the exchange rate can foster a favorable trade balance, while an increase in the inflation rate tends to have a detrimental effect. Consistency across all panel data models was observed, with the Hausman test indicating that the Random Effect model is the most suitable for this analysis.

Keywords: *AEC, FDI, International Trade, Static Panel Data Models.*

Introduction

The economic advancement of a country is contingent not solely upon internal investments but also significantly influenced by external investments. Foreign direct investment (FDI) plays an essential role in fostering economic growth across nations. It acts as a compelling attraction for governments globally, making substantial contributions to the progress of developing countries (ESCAP, 2023). FDI has been found to provide not only financial resources but also technological advancements and productivity enhancements across various sectors within the host nation. This phenomenon significantly supports the increase of domestic production levels (Behera, 2023). In addition to boosting productivity through the transfer of expertise from developed countries to emerging economies, FDI inflows play a crucial role in generating employment opportunities in the recipient countries. Research by Ahmed et al. (2023) has highlighted that these inflows also have a beneficial effect on the international trade capabilities of these nations, facilitating their integration into the global market. A study involving 66 developing countries indicated that FDI not only fosters a positive relationship with trade but also acts as a driving force for domestic investment (Makki & Somwaru, 2004).

China's strategy of encouraging trade-FDI has produced remarkable outcomes. Studies indicate that FDI enterprises have been instrumental in strengthening China's competitive edge and promoting the specialization of its export goods within the international marketplace (Lemoine, 2000). Furthermore, the error correction model reveals that FDI has significantly impacted international trade in Pakistan over the long term. The empirical findings from this study also lend additional support to the FDI-driven endogenous growth theory (Farid et al., 2023). FDI is crucial for improving the productivity and efficiency of host nations, especially regarding the quality of goods manufactured, as it enables the transfer of technology from developed to developing countries. Comprehensive studies conducted in various regions have consistently indicated that FDI inflows encourage trade between home countries and the global market, particularly highlighting the trend of developing nations exporting to more developed economies such as those in the European Union (Carril-Caccia & Pavlova, 2018). This facilitation not only contributes to advancing the level of development but also improves the quality of life for individuals in their home

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countries by generating job opportunities and promoting the transfer of knowledge, thereby enhancing human capital.

The government of the AEC, which consists of ten member states—Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam—shares a common goal with other regions worldwide: to attract FDI from developed nations. This strategy is designed to create opportunities for the local population to gain new skills and access advanced technologies, thereby improving their capacity for international trade and strengthening their competitiveness in the global market. The aim of this research is to conduct an empirical analysis to assess the possible effects of net inflows of foreign direct investment on the international trade of the AEC. This study is guided by a central research question: does an increase in net inflows of foreign direct investment enhance the international trade of the member states within the AEC?

Literature Review

An analysis was carried out utilizing monthly time series data spanning from January 2005 to July 2018. The research applied an autoregressive distributed lag (ARDL) methodology for co-integration to examine the impacts of FDI, the industrial production index, the domestic producer price index, the real effective exchange rate, and the interest rates on domestic commercial credits on export performance. The results indicated a positive relationship between FDI and exports in Turkey, corroborating the findings of Basilgan and Akman (2019). In a similar vein, Mukhtarof et al. (2019) identified a significant positive effect of FDI on exports in Jordan. Additionally, the Granger causality test revealed a short-term causal link between FDI and exports, while in the long term, FDI was found to positively affect exports in India, as noted by Jena et al. (2020). The study carried out in the ASEAN-5 region, specifically in Indonesia and Vietnam, uncovered a significant empirical finding indicating that FDI positively influenced exports. This effect was especially pronounced in fostering economic growth within the host nations (Purusa & Istiqomah, 2018; Nguyen, 2020; Millia et al., 2021). Conversely, in India, the relationship was different, as FDI did not exert a notable impact on exports; rather, it was determined that exports played a crucial role in attracting FDI (Sultan, 2013).

A research investigation was undertaken to analyze the effects of FDI on international trade across 31 developing Asian nations from 1991 to 2019. Utilizing a dynamic panel data model, the researchers identified a significant relationship between FDI inflows and trade openness in these countries (Sinha & Tirtosuharto, 2023). The results of this analysis are consistent with findings from studies conducted within the West African Economic and Monetary Union (Illa, 2022). Additionally, a relationship between international trade and foreign direct investment (FDI) has also been observed in both the United States and Southeast Asia (Chang & Gayle, 2009; Daniels & von der Ruhr, 2014; Bhasin & Paul, 2016). The research conducted between 2002 and 2020 involved a comprehensive analysis across 110 nations, which included 34 countries from Europe, 28 from Asia and Oceania, 21 from Africa, 17 from North America, and 10 from South America. The primary objective was to investigate the relationship between FDI and net exports through the application of the Granger causality test. The findings derived from the time series data of each participating country demonstrated a notable correlation between FDI and net exports in the majority of regions. Moreover, the results suggested that FDI exerted a causal influence on net exports in specific areas (Lakshani et al., 2023). Additionally, a regression model was employed to assess the impact of FDI on exports and the current account within the Visegrad Group, which comprises the Czech Republic, Slovak Republic, Hungary, and Poland. This analysis, grounded in time series data, uncovered a significant positive effect of FDI inflows on exports in these nations. Furthermore, the results indicated that the relationship between FDI and exports could be facilitated through the transition towards a knowledge-based economy (Lomachynska et al., 2020).

A panel vector error correction model (VECM) was employed to assess the causal interactions among FDI, exports, and economic growth across 16 developing nations, which included eight from Europe and eight from Asia. The analysis indicated that, in the short term, a bidirectional causality existed between GDP and FDI, which subsequently influenced exports in European countries. In contrast, developing Asian nations

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demonstrated a bidirectional causality between exports and economic growth. Over the long term, both regions showed a causal relationship where exports and FDI contributed to economic growth (Mahmoodi & Mahmoodi, 2016). Furthermore, a notable dynamic connection between FDI and international trade has been identified in both developed and developing countries, including those in the Arab region, Turkey, Africa, and Tunisia. Empirical studies have established that FDI not only enhances export activities but also plays a significant role in fostering the overall economic development of these nations (Hailu, 2010; Belloumi, 2014; Basilgan, 2019; Ismail, 2022). Research conducted in Vietnam, South Korea, and various South Asian countries has indicated either a negative significant or an insignificant relationship between FDI and international trade in host countries that faced trade barriers imposed by their trading partners (Jeon, 1992; Dash & Sharma, 2010; Anwar & Nguyen, 2011). These findings align with a study by Voica et al. (2021), which found no significant effect of FDI on trade flows within the European Union, yet they contradict results from certain investigations in Latin America and Mexico (Calega et al., 2014; Cabral & Alvarado, 2021).

Between 1974 and 2014, the Vector Autoregressive (VAR) model, a prominent system of equation models, was utilized to investigate the relationship between FDI and international trade, particularly exports and imports, in Turkey. The results obtained from the VAR model, along with the Johansen co-integration and Granger causality tests, indicated a causal relationship flowing from FDI to both exports and imports, without any reverse causation. Notably, it was found that FDI positively impacts trade in Turkey (Karimov, 2019). In contrast, a different approach was taken in Ethiopia, where a singular regression model known as the Autoregressive Distributed Lag Model (ARDL) was employed to assess the effect of FDI on exports over a time series from 1922 to 2018. This analysis, however, revealed an insignificant relationship between the two variables under consideration (Gebremariam & Ying, 2022). A similar methodology was applied in Nigeria to evaluate the long-term effects of FDI in the primary and manufacturing sectors on total and oil exports. The findings demonstrated a significant impact of FDI in these sectors on both total and oil exports, while the effect of FDI on exports in the services sector was found to be negligible, as reported by Okechukwu et al. (2018). This outcome is consistent with related studies conducted in Bangladesh but stands in contrast to the findings of an empirical investigation in India (Majumder et al., 2022; Mohanty & Sethi, 2021).

Methodology

This study employs a static panel data model to examine the influence of foreign direct investment on international trade within the ASEAN Economic Community (AEC). The model is structured in a general format that facilitates a comprehensive analysis of the relationship between these variables.

$$ITR_{it} = \theta_0 + \theta_1 FDI_{it} + \theta_2 GDP_{it} + \theta_3 INF_{it} + \theta_4 FX_{it} + u_{it}$$

In this context, ITR denotes the trade balance, while FDI signifies the net inflow of foreign direct investment. GDP reflects the growth rate of real gross domestic product, INF represents the inflation rate, and FX is the foreign exchange rate, expressed as the number of units of domestic currency per US dollar (US$). The ITR and FDI metrics are quantified in millions of US dollars, whereas GDP and INF are represented as percentages. It is important to note that GDP, INF, and FX are classified as control variables. The data utilized for the variables ITR, GDP, INF, and FX are sourced from the Asian Development Bank, whereas the FDI dataset is obtained from the World Development Indicators provided by the World Bank. This research aims to estimate the parameters denoted as θ_j, where *j* ranges from 0 to 4. The error term in the panel data regression model is represented as u_{it}, with the indices satisfying $1 \leq i \leq n$ and $1 \leq t \leq T$. It is important to note that u_{it} can be expressed as $\mu_i + \varepsilon_{it}$, where ε_{it} follows a normal distribution with a mean of 0 and a variance of σ_ε^2. The study employs three distinct estimation techniques: pooled ordinary least squares (OLS), fixed effects (FE), and random effects (RE) models. The overall sample comprises 220 observations, which encompass ten AEC member states, indexed as i=1,2,3,…,10, over a span of 22 years from 2001 to 2022.

Empirical Results

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This study employs panel data, which integrates both time series and cross-sectional data. The analysis spans a twelve-year period and encompasses ten ASEAN member states, resulting in a total of 220 observations. The average figures for international trade, foreign direct investment, real GDP growth rate, inflation rate, and foreign exchange rate are recorded at US$ 16,723.13 million, US$ 10,520.32 million, 5.10%, 4.51%, and 4,457.43, respectively. Notably, the region experiences a minimum international trade value of US$ -43,533.42 million, while the maximum reaches US$ 255,483.10 million. Furthermore, the foreign direct investment figures range from a minimum of US$ -4,947.47 million to a maximum of US$ 140,844.10 million (See Table 1).

Table 1. Summary Statistics

Variable	Observation	Mean	SD	Min	Max
ITR	220	16,723.13	41,686.29	-43,533.42	255,483.10
FDI	220	10,520.32	20,767.36	-4,947.47	140,844.10
GDP	220	5.10	3.62	-9.52	14.52
INF	220	4.51	6.07	-2.29	57.00
FX	220	4,457.43	6,501.64	1.25	23,271.21

Source: Constructed by author.

The empirical results derived from three static panel data models—namely the Pooled OLS model, the FE model, and the RE model—are detailed in Table 2. Each model consistently indicates that foreign direct investment exerts a significant positive influence on international trade within the ASEAN Economic Community, as evidenced by the positive slope coefficients of 0.539 for the Pooled OLS model, 0.259 for the FE model, and 0.270 for the RE model. Notably, all slope parameters are statistically significant at the 1% level. These findings suggest that the net inflow of foreign direct investment into the AEC region is likely to enhance international trade activities within the area.

The estimated parameters for the real GDP growth rate across the models indicate positive values of 1%, 1%, and 5% for the Pooled OLS, FE, and RE models, respectively. These results align with the principles of international trade, suggesting that a more rapidly growing economy correlates with increased trade activity. Conversely, a rise in the regional inflation rate appears to negatively impact international trade, as evidenced by a statistically significant negative slope coefficient. Additionally, exchange rate depreciation is shown to enhance international trade within the AEC, with the coefficients for foreign exchange in each model being positive and statistically significant at levels of 1%, 5%, and 5% for the Pooled OLS, FE, and RE models, respectively.

Table 2. Empirical Results

Variables	Pooled OLS Model	FE Model	RE Model
FDI	0.539***	0.259***	0.270***
	(0.130)	(0.104)	(0.103)
GDP	227.91***	12.745***	41.215**
	(63.742)	(3.0153)	(19.998)
INF	-588.83***	-15.89***	-8.029***
	(190.39)	(4.1925)	(2.792)
FX	1.125***	1.299**	1.010**
	(0.420)	(0.628)	(0.514)
Constance	20136.63***	12886.44***	14029.15***
	(5203.37)	(5730.37)	(5452.45)
Groups	10	10	10
Observations	220	220	220

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F/Wald Chi-square Statistic	8.060***	5.650***	7.070***
Prob > F/Prob > Chi-square	0.000	0.000	0.000
R-squared	0.133	0.032	0.031
Hausman test			
Chi-square(4)		0.600	
Prob > Chi-square		0.963	

***, **, * Significant at 1%, 5%, 10%, respectively. Standard error in parenthesis.

The pooled OLS model yields a calculated F-statistic of 8.060, which is regarded as substantial, indicating that all slope coefficients in this model collectively account for international trade at a significance level of 1%. The FE model also employs the F-statistic, producing consistent results with the pooled OLS regarding the simultaneous test, which assesses whether all slope coefficients, excluding the intercept or constant term, are equal to zero concurrently. In contrast to the pooled OLS and FE models, the RE model utilizes the Wald Chi-square test, which similarly demonstrates that the independent variables collectively account for international trade at a 1% significance level. Furthermore, this study conducts a model selection test, known as the Hausman test, to compare the FE and RE models. The failure to reject the null hypothesis in this test suggests that the RE model is the more suitable choice. Nevertheless, the empirical findings across all models consistently indicate that foreign direct investment, the real GDP growth rate, the inflation rate, and foreign exchange have positive, positive, negative, and positive significant effects on international trade, respectively.

Conclusions

This study employed three distinct types of static panel data models, specifically pooled OLS, FE, and RE models, to examine the impact of FDI on international trade and trade balance within the AEC. The empirical results indicate that a higher net inflow of FDI correlates positively with increased international trade, as evidenced by the positive slope coefficient of FDI across all panel data models. Additionally, the research highlights that an increase in the real GDP growth rate contributes to the enhancement of international trade in the AEC region, while rising inflation rates exert a negative influence. Moreover, the findings align with the theoretical perspective that depreciation of the exchange rate fosters international trade.

The formulation of policies aimed at attracting FDI in the member states of the AEC is essential. To successfully draw in FDI, it is imperative for governments to create an environment conducive to business operations. The influx of foreign capital can significantly finance infrastructure development, generate employment opportunities, and stimulate industrial advancement. Such investments frequently result in enhancements in technology, workforce skills, and management techniques, thereby improving overall productivity and competitiveness. Furthermore, by luring foreign investors, governments can achieve economic diversification, which lessens reliance on a singular industry and diminishes vulnerability to global economic shifts. Implementing policies that safeguard intellectual property rights, maintain a consistent regulatory framework, and provide incentives like tax reductions or subsidies can enhance a nation's appeal to foreign investors. Additionally, FDI plays a crucial role in increasing government revenues through corporate taxation and contributes to the enhancement of infrastructure, including transportation and energy systems, which benefits the broader economy. It can also promote exports by integrating the nation into international supply chains, thereby improving trade balances. Moreover, strategic policies can direct FDI towards sectors that align with the country's long-term objectives, such as sustainable industries or technological advancements. In summary, through the development of focused policies, governments can effectively leverage the advantages of FDI, driving economic growth, encouraging innovation, and enhancing global competitiveness.

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