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Determinants of Foreign Direct Investment in ASEAN: Evidence from ASEAN 4 Countries (Cambodia, Laos, Myanmar, and Vietnam)

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Abstract

Most developing countries in the world are working hard to attract more foreign direct investment. Identifying the key determinants of foreign direct investment is therefore seen as an essential task for policy makers. Compared to other parts of the world, the performance of ASEAN countries in attracting foreign direct investment is still poor. This study deals with identifying the determinants of foreign direct investment inflow in ASEAN 4 (Cambodia, Laos, Myanmar, and Vietnam) countries. This study estimates the panel data sample with pooled OLS and fixed and random effect models. The analyzed data covered for the period 2000 to 2020. The empirical results indicate that market size and natural resources are the most robust determinants for FDI inflows into Cambodia, Laos, Myanmar, and Vietnam. Furthermore, the presence of labor costs, infrastructure, and exchange rate exerts a favorable influence on the inflow of FDI to CLMV countries. On the contrary, the findings of the paper reveal that the inflation rate has a detrimental effect on inward FDI. This partly reflects the fact that most of the world's FDI is market-seeking. This study provides a clear understanding of the scope of the research in the field of FDI determinants as the practical implication for future research.

Keywords: ASEAN, Cambodia, Laos, Myanmar, Vietnam, Determinants of FDI, Natural Resources, Market Size.

1. INTRODUCTION

Foreign direct investment (FDI) is a major source for emerging markets and developing economies to boost their economy, particularly in export sectors. As such, most developing countries strive to attract foreign investment in their economy. According to Economou *et al*., (2017), FDI can enhance growth and innovation, create jobs, development of skills, and development of industrial sector in the host country. Higher FDI inflows can reduce capital constraints and contribute to gross output (Fontagné, 1999; Moran, 2006; Saurav & Sinha, 2020). Furthermore, FDI can enhance domestic investment and increase aggregate productivity through positive productivity spillovers and technology transfers (Dang & Nguyen, 2021; Saini & Singhania, 2018). Inflows of FDI into the host countries can also generate the potential for export volume and further chances of accessing the international markets (Dadkhah, 2021; Liu *et al*., 2013).

From the mentioned above the benefits of FDI, it is clear that why developing countries are keen in attracting FDI. Therefore, it is critical for these countries to find what motives outside foreign investors to invest in these countries, especially in the Association of Southeast Asian nations (ASEAN). Over the past two decades, the main factor behind the increase of FDI in the ASEAN was economic growth and trade in the region (Chia, 1993). Consistent with these growths, it is expected to become the fourth-largest market in the world in the near future. However, most of the countries in ASEAN are developing countries with low domestic savings. Similar to other developing countries, these countries always have a strong demand for foreign capital to their economic development. Therefore, attracting FDI is important for ASEAN nations to drive economic growth and export. FDI not only promotes sustainable development but also reduces income inequality and enhances environmental quality (M. Ali, 2013). Moreover, FDI also helps the governments to increase tax revenue, and improves the infrastructural development (Ibid). Thus, it becomes essential to comprehend the factors that influence FDI in ASEAN for the development of both theory and policy.

Several factors influence the influx of FDI. Dunning and Lundan (2008) identified the determinants of FDI location influences investment and classified

them based on the principal motivation of multinational corporations to engage in FDI viz., market-seeking, resource-seeking, efficiency-seeking, and strategic-asset-seeking. Among these, market-seeking is considered to be essential for FDI (Gomez-Mera *et al*., 2014), 70 percent of foreign investors are looking for market-seeking (Ibid). Meanwhile, some researchers underlined that low labor cost is one of the key factors attracting FDI inflows. As foreign investors search for the location that will provide the highest returns on their investment, they do not only look for country with abundant natural resources but also low labor cost (Economou *et al*., 2017; Shaari *et al*., 2023; Yi *et al*., 2019). Others mention that the infrastructure development is an important factor in attracting FDI because in terms of infrastructure projects, the government provides several special incentives for investors (Chia, 1993; Walsh & Yu, 2010). From this, FDI could be attracted (Ibid). On the other hand, Ahmed and Mayowa (2012) claimed that the geographic distance is an important factor to attract FDI. Similarly, Halaszovich and Kinra (2020) analyses the impact of geographic distance (transportation costs) on FDI in Asian region, and found that geographic distance has a significant detrimental effect on FDI.

In addition, previous literature has shown that national policies and macroeconomic indicators have a significant impact on FDI inflows. Typically, previous empirical studies have been conducted on a large scale in many developing countries to obtain scientific evidence for the influence of national policies and national macroeconomic variables to attract FDI inflows. Besides, these empirical studies also demonstrate that FDI's primary focus is business activities and often flows into economies with many comparative advantages, such as lowering production costs, lower risks, tax incentives, and human capital (Hoang & Bui, 2015; Sasana & Fathoni, 2019; Zhang & Daly, 2011). In general, the factor determining FDI is trade openness. Several studies found that greater trade openness can boost FDI (Khamphengvong *et al*., 2018; Simon, 2015). As openness allows foreign firms to contribute to rapid economic growth driven by exports, and thus ensuring higher FDI inflows (Wadhwa & Reddy, 2011). In the work of Yi *et al*., (2019) maintained that exchange rate movements have a significant impact on FDI inflows, although, the impact of the exchange rate on the FDI depends on the investment motive. If the motive of the investment is based on production cost calculation (cost-oriented firm), depreciation of the currency taking place in the investment destination country will increase the FDI inflows.

In this context, this study aims to investigate the key motivation of FDI inflow to ASEAN 4 (Cambodia, Lao PDR, Myanmar, and Vietnam). These countries are the latest ASEAN members, which have lesser economic development than the original member states of ASEAN such as Thailand, Indonesia, Malaysia, Singapore and the Philippines. However, CLMV countries have advantages in natural resources and labor. Furthermore, in terms of population and space, CLMV constitutes a significant market. According to the literature on FDI, market size is one of the key determinants of FDI (Dunning & Lundan, 2008). This will enable us to find answers to the following questions: What are the determinants of FDI inflows to CLMV nations?

2. Empirical Literature and Hypothesis

2.1. Market Size

Market size is considered as the determinant and motivation of FDI based on Dunning's theory. Many studies have found that market-seeking motivations appear to be the most robust and important factor driving FDI. According to Shan *et al.*, (2018), the motivation for the companies' overseas investments is the size of the market in the host country. In general, most firms invest in search of new market opportunities and a large market is necessary for the efficient utilization of resources and the exploitation of economies of scale and scope (Ahmed & Mayowa, 2012). Theoretically, a larger market is more attractive for foreign investors since the benefits of larger-scale production are more likely to be captured (Simon, 2015; Zhang & Daly, 2011). Furthermore, some researchers have agreed that more opportunities exist for foreign investors if the market size is large. Previously, Breivik (2014) found that foreign investors are attracted by market growth as a more rapidly growing economy provides greater profit opportunities than an economy that is growing slowly or not at all. Moreover, Hoang and Bui (2015) found empirical evidence for the fact that foreign investors favor faster-growing markets that offer more potential and promising prospects. In sum, a nation with a large GDP and a higher rate of GDP growth is expected to attract more FDI.

Market size is usually measured by total GDP or GDP by population, while GDP growth rates reflect the nation's prospect for economic development. Akin (2009) found that FDI is concerned with the size of the market in emerging countries not on a per capita basis but rather in aggregate size. However, Chakrabarti (2001) stated absolute GDP that is a poor indicator since it reflects the size of the population rather than the income per capita. Nonetheless, both variables as well as GDP growth are adopted to investigate the impact of host market size. To find out whether FDI is driven by a market-seeking motive, the following hypotheses are to be tested:

Hypothesis 1: Market size is positively connected to FDI
Hypothesis 2: Market growth is positively linked to FDI

2.2 Labor Cost

The low cost of labor is one of the key elements that draw foreign investors and multinational companies to a country (Breivik, 2014; Manolom & Bodhisane, 2020; Yi *et al*., 2019). Countries that provide relatively lower labor costs are more attractive choices for multinational firms that can fragment their production

process and through this strategy substantially reduce their production costs and increase their profits. Empirical studies on the determinants of FDI so far have shown a positive correlation between FDI and low labor costs. For example, research conducted by S. Ali and Guo (2005) and Sasana and Fathoni (2019) have found that positive correlation between FDI and lower wage costs. Similarly, Economou *et al*., (2017); (Philakone, 2023) have confirmed that labor costs and FDI are positively correlated in emerging countries. The following hypothesis is to be tested

Hypothesis 3: Labor cost is associated positively with FDI

2.3. Resource-Seeking FDI

In general, natural resources are regarded as historical determinants of FDI. In the period from the 19th century to the eve of World War II, natural resources accounted for 60 percent of the world stock of FDI (Utter, 2011). Dunning and Lundan (2008) agreed that companies may establish foreign subsidiaries to exploit natural resources in order to acquire raw materials for their industrial operations and secure a continual supply of the needed raw materials. However, natural resources can have a negative effect on FDI inflows through the appreciation of the exchange rate caused by the influx of capital into the sector. This appreciation reduces the competitiveness of firms in tradable goods sectors. Which can lead to a net decline in overall FDI. Cheung and Qian (2009), and Shan *et al.*, (2018) have found an insignificant relationship between FDI and natural resources. However, in general, previous studies have indicated that natural resources are positively related to FDI inflow (Breivik, 2014; Kyophilavong *et al*., 2017; Walsh & Yu, 2010). Therefore, we derive the following hypothesis:

Hypothesis 4: The natural-resource endowment of the host country is associated positively with FDI

2.4. Inflation

The inflation rate is often regarded as a measure of macroeconomic and financial stability (Dang & Nguyen, 2021). The unpredicted inflation rate in the host country creates uncertainty and discourages FDI activities (Buckley *et al*., 2015). A high rate of inflation is argued to hamper FDI since it devalues the domestic currency and reduces the real return on investment. However, the majority of studies provide evidence in support of the negative and statistically significant impact of inflation rate on FDI inflow in different economies (Hoang & Bui, 2015; Ruiz, 2005; Simon, 2015; Udomkerdmongkol *et al*., 2008). Therefore, the hypothesis is that the lower the inflation rate of the host country, the higher the propensity for FDI.

Hypothesis 5: inflation is expected to be negatively associated with FDI

2.5 Exchange Rate

Theoretically, a change in currency exchange rate can have either positive or negative relation with FDI. Meanwhile, it was proposed that investors tend to select locations characterized by depreciated currency value. Empirical evidence by Udomkerdmongkol *et al*., (2008) suggested that a weaker currency is more favorable for FDI projects as firms take advantage of relatively low prices in host markets to purchase facilities. Hoang and Bui (2015) examine the relationship between exchange rate and FDI: a weaker host country currency tends to increase inward FDI within an imperfect capital market model as depreciation makes host country assets less expensive relative to assets in the home country. Moreover, Ahmed and Mayowa (2012) and Yi *et al.*, (2019) confirmed that exchange rate depreciation in host countries tends to increase FDI inflows. On the other hand, Walsh and Yu (2010) argued that a stronger real exchange rate might be expected to strengthen the incentive of foreign companies to produce domestically: the exchange rate is in a sense a barrier to entry into the market that could lead to more horizontal FDI. However, the mainstream research appeared to suggest that the exchange rate is more likely to affect FDI decisions because it impacts the real value of an investment when investing and when transferring revenue. In particular, a reduced currency value tends to be associated with larger FDI inflows. Therefore, a negative relationship between the host country's currency and FDI is expected.

Hypothesis 6: The depreciation of the host country's currency helps to increase FDI

2.6 Infrastructure

Gomez-Mera *et al*., (2014), Sanfilippo (2010), and Shaari *et al*., (2023) indicated that there is a positive effect of infrastructure on attracting FDI. In general, well-functioning infrastructure is essential and fundamental for business operations. Therefore, it can be argued that well-established and advanced infrastructure facility attracts FDI as they depict the prosperity of the country and provide a more appealing environment for any firm to operate in. Furthermore, good infrastructure increases the productivity of investments and reduces operational downtime. In addition, previous studies show that upgrading infrastructure in the host countries, such as transportation, electric power transmission, information, and communication networks, can attract more FDI. Therefore, the following hypothesis has been formulated:

Hypothesis 7: Host country's level of infrastructure development is associated positively with FDI

3. DATA AND METHODOLOGY

3.1 Data Collection and Variables Description

The variables and proxies used in this study are those commonly selected in the literature to examine the determinants of FDI inflows in CLMV countries (Cambodia, Laos, Myanmar, and Vietnam). The number of FDI projects undertaken by foreign firms in CLMV countries is the dependent variable, and it is measured in millions of USD. Absolute GDP, GDP growth, GPD per

capita, natural resources, infrastructure, exchange rate, and inflation are treated as independent variables.

In this study, the absolute GDP variable is used to explain the market size (MS), and it is measured in millions of USD, while the GDP growth variable is used to explain the market growth (MG), and it is measured in current percentage (%). In addition, GDP per capita is used to explain in terms of labor cost (WAGE) and it is calculated in the US dollar.

In this study, the percentage of the population using the internet is used to explain the level of infrastructure (INF) in CLMV countries. Furthermore, as a proxy for natural resources (NR) the value of total natural resources rents (natural gas rents, coal rents (hard and soft), mineral rents, and forest rents in CLMV countries was used. The total natural resources rents are calculated in percentage of GDP.

An exchange rate (EX) is calculated in the host country's currency against the U.S. dollar. Inflation (INR) is measured as consumer price (annual %). All the data ranging from 2000 to 2020 were extracted from the World Bank World Development Indicators (World Bank).

Table 1: Summary of the variable analyzed in this study

Variables	Proxy	Unit Measurement	Expected Sign	Source
FDI (FDI)	FDI projects in the host country	million US dollar	N/A	WDI, 2020
Market size (MS)	Absolute GDP	million US dollar	+	WDI, 2020
Market growth (MG)	GDP growth	Percent (%)	+	WDI, 2020
Wage (WAGE)	GDP per capita	US dollar	+	WDI, 2020
Natural resources (NR)	Natural resources rents	% of GDP	+	WDI, 2020
Exchange rate (EX)	Exchange rate of the host country currency against the U.S. dollar	host country currency	-	WDI, 2020
Inflation rate (INR)	Host country's annual inflation rate	Percent (%)	-	WDI, 2020
Infrastructure (INF)	Mobile cellular subscriptions (per 100 people)	Per 100 people	+	WDI, 2020

3.2 Model Specification

To analyze the key determinants of FDI inflows to ASEAN4 (Cambodia, Laos, Myanmar, and Vietnam) countries, this study estimated fixed and random effect models and then used the Hausman test to decide which model fit best our data. The study has followed panel data analysis for the estimation of regression models. The model is econometrically estimated as follows:

FDI=f (market size, marke growth, wage, natural resources, exchange rate, inflation, infrastructure (1)

Formally, the equation of the model can be written as:

$$FDI_{it} = \beta_0 + \beta_1 MS + \beta_1 MG + \beta_3 WAGE + \beta_4 NR + \beta_5 EX + \beta_6 INR + \beta_7 INF + \varepsilon_{it} \quad (2)$$

Where, FDI refers to FDI projects in ASEAN-4 (Cambodia, Laos, Myanmar and Vietnam) countries, MS is market size, MG is market growth, WAGE is wage costs, NR refers to the natural resources, EX is the exchange rate, INR is the inflation rate, INF is infrastructure , i *and* t represent country and period β_0 is intercepted, $\beta_1 - \beta_7$ are the coefficients of the independent variables, and ε_{it} is the random error.

In addition, all variables in this study take the natural logarithm, therefore, the function into logarithm takes the following form:

$$lnFDI_{it} = \beta_0 + \beta_1 lnMS + \beta_2 lnMG + \beta_3 lnWAGE + \beta_4 lnNR + \beta_5 lnINF + \beta_6 lnEX + \beta_7 lnINR + \varepsilon_{it} \quad (3)$$

4. EMPIRICAL RESULT AND DISCUSSION

4.1Descriptive Statistics

Table 2 below presents the descriptive statistics of all variables used in this study. From the table, FDI shows the highest maximum (9.687), while market growth shows the lowest maximum (2.617). In addition, FDI shows the largest mean with its value of 6.875, while inflation shows the lowest mean (1.622).

Table 2: **Summarized Descriptive Statistics for FDI in CLMV countries**

Variables	Obs	Mean	Std. Dev	Min	Max
lnFDI	84	6.875	1.726	1.609	9.687
lnMS	84	3.102	1.384	0.548	5.848
lnMG	83	1.949	0.563	-2.302	2.617
lnWage	84	6.866	0.701	5.708	8.184
lnNR	84	1.703	0.781	-.336	3.004
lnINF	78	1.622	1.039	-1.966	4.044
lnEX	84	6.366	3.004	1.694	9.273
lnINR	84	2.777	2.313	-3.526	5.040

Source: From the calculation on Stata17 software

4.2 Correlation Analysis

Table 3 below provides the correlation coefficients matrix between FDI and all variables used in this study. As shown in Table FDI inflows are positively correlated to market size (0.916), but negatively correlated to market growth (-0.289) and resource (-0.229), contrary to expectations. Furthermore, inflows of FDI are positively correlated to wage cost (0.773), and infrastructure (0.659). Moreover, the results showed that FDI inflows are negatively correlated to inflation (-0.183), and exchange rate (-0.183).

Table 3: Results of correlation among independent and dependent variables

	lnFDI	lnMS	lnMG	lnWAGE	lnNR	lnINF	lnEX	lnINR
lnFDI	1.000							
lnMS	0.916	1.000						
lnMG	-0.289	-0.302	1.000					
lnWAGE	0.773	0.716	-0.427	1.000				
lnNR	-0.229	-0.072	0.337	-0.266	1.000			
lnINF	-0.183	-0.074	0.196	-0.309	0.442	1.000		
lnEX	-0.225	-0.328	-0.366	0.207	-0.544	-0.406	1.000	
lnINR	0.659	0.502	-0.545	0.774	-0.451	-0.390	0.452	1.000

Source: From the calculation on Stata 17 software

4.3 Pool, Random Effect and Fixed Effect Regression Models

Table 4: Regression results of the determinants of FDI inflows to CLMV countries

Dependent variable: FDI			
Variable	(1) Pooled OLS	(2) Fixed effects (FE)	(3) Random effects (RE)
lnMS	0.592*** (0.206)	0.724** (0.385)	0.594*** (0.100)
lnMG	0.594*** (0.095)	0.017 (0.246)	0.592*** (0.217)
lnWAGE	0.474*** (0.172)	0.833** (0.377)	0.474*** (0.182)
lnNR	-0.406*** (0.091)	0.166 (0.182)	-0.406*** (0.096)
lnINF	-0.023 (0.058)	-0.029 (0.058)	-0.023 (0.061)
lnEX	-0.200*** (0.039)	-0.130*** (0.043)	-0.200*** (0.041)
lnINR	0.321*** (0.047)	0.152** (0.076)	0.321*** (0.049)
Constant	1.658 (1.007)	-1.031 (1.598)	1.658 (1.064)
Observations 77 R-squared 0.9330			
Hausman 19.52 Prob (0.0067)			

Standard errors are in parenthesis, ***P <0.01, **P <0.05, and *P < 0.1, denote significance at the 1%, 5%, and 10% levels, respectively. Source: From the calculation on Stata 17 software.

Table 4 for regression Model-1, Model-2 and Model-3 represent pooled OLS, fixed effects, and random effects regression models respectively. The selection of the best model that fits the data well is decided based on the Hausman test which showed that its calculated value is 19.52 with a P value of 0.0067 which is less than the critical value at a 5% level of significance. Therefore, a random effect model is selected to interpret.

The results of the random effect model showed that market size (MS) and mark growth (MG) variables have a positive effect and are significant at a 1% level. Therefore, hypothesis 1 and hypothesis 2 are supported for this study, meaning that market size and market growth in CLMV countries are still an important motivation for FDI. Moreover, the analysis suggests that the increased size of the domestic market results in more FDI inflows due to the benefits of economies of scale. According to the results, a 1% increase in the market size variable would lead to about 0.594 percent increase in inward FDI, while a 1% rise in the market growth variable increased FDI by 0.592 percent. The results are in line with the general findings of the literature, including Hoang and Bui (2015), Khamphengvong *et al*., (2018), Yi *et al*., (2019), and Shaari *et al*., (2023), who

argued that large domestic market size and GDP growth attract FDI flows to the host country.

Furthermore, labor cost in CLMV countries seemingly attracts FDI. The coefficient estimates of the labor cost variable (WAGE) is positive and statistically significant at a 1 % level. Therefore, hypothesis 3 is supported for this study. According to the result, a 1% increase in labor cost variable raises FDI by 0.474 percent. The results are similar to the conclusions of S. Ali and Guo (2005), Philakone (2023), and Economou *et al*., (2017) which low labor costs were significant in attracting FDI.

Additionally, the natural resource variable (NR) is significant at the 1% level in explaining FDI inflows to CLMV countries, however, surprisingly, its coefficient shows a negative relationship with FDI. As mentioned before, natural resources can have a negative effect on FDI inflows through the appreciation of the exchange rate caused by the influx of capital into the sector. This appreciation reduces the competitiveness of firms in tradable goods sectors. Which can lead to a net decline in overall FDI. Therefore, hypothesis 4 is rejected.

In addition, the results of the analysis showed that the inflation rate does not significant effect on the inflow of FDI in CLMV. This means that a high inflation rate discourages foreign investors from investing in the host country. Therefore, hypothesis 4 was not supported for this study. Foreign investors will invest in a country where economic stability and a lower of inflation rate are present to preserve the price of goods (Sasana & Fathoni, 2019; Yi *et al*., 2019).

However, the coefficient of the exchange rate is negative with FDI which means that the host country's currency depreciation increases inward FDI to the host country. Therefore, hypothesis 6 is supported for this study. This result is in line with the search conducted by Ahmed and Mayowa (2012), who confirmed that exchange rate depreciation in host countries tends to increase FDI inflows.

Moreover, the results of the analysis show that the level of infrastructure is positive and statistically significant at a 1% level. According to the result, a 1% rise in infrastructure increased FDI by 0.321 percent. The results are in line with the argument of Gomez-Mera *et al*., (2014), Sanfilippo (2010), and Shaari *et al*., (2023), who found that infrastructure is positive and indicates that infrastructure in the host country could bring numerous FDI into the country.

5. CONCLUSION

Over the past two decades, the main factor behind the increase of FDI in ASEAN was economic growth and trade in the region. The inflow of foreign direct investment (FDI) to ASEAN 4 (Cambodia, Laos, Myanmar, and Vietnam) countries has resulted in the emergence of extensive bodies of literature. The rationale for this investment, as well as the elements that impact it, have been examined. However, only a limited number of academics have explored the motivation behind the investment. The objective of this study was to examine the determinants of FDI inflows to CLMV countries, with a specific emphasis on the incentives related to market-seeking and resource-seeking. The research examines the period from 2000 to 2020 when FDI experienced a significant increase in FDI in CLMV countries. This study estimates the panel data sample with pooled OLS and fixed and random effect models. The empirical results indicate that market size and natural resources are the most robust determinants for FDI. Furthermore, the presence of labor costs, infrastructure, and exchange rate exerts a favorable influence on the inflow of FDI to CLMV countries. On the contrary, the findings of the paper reveal that the inflation rate has a detrimental effect on inward FDI. This partly reflects the fact that most of the world's FDI is market-seeking. This study provides a clear understanding of the scope of the research in the field of FDI determinants as the practical implication for future research.

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