

**Outward Investment Surge in the Midst of Weak Inward Investment: Perspectives from the Indonesian Experience during the post-1997 Financial Crisis.**

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**Abstract:**

The objective of our study is to identify a few of possible push and pull factors behind the recent surge of the outward direct investment from Indonesia. The roles of selected primary drivers of the country's general investment climate and the restructured domestic corporate sectors will be examined as possible domestic push factors responsible for the rise of the outward direct investment. In addition, the emergence of the Chinese economy and its possible crowding-out effect would be analyzed. Lastly, the study also examined the role of internalization strategy of ethnic-Chinese businesses in Indonesia.

**JEL Classification:** E66; F23; F41

**Key Words:** Outward Direct Investment; Push and Pull Factors; Investment Climate; Corporate Sector

## **1. Introduction**

Dealing with the rise in the levels of unemployment and poverty has been listed among the top priorities of the present government of Indonesia. Given the new labor entrants into the economy annually, to keep those two promises the government of Susilo Bambang Yudhoyono must achieve an annual GDP growth rate between 6 to 7 percent during his term, i.e. from 2004 to 2009. Based on the first two years performance of the current administration, it will be difficult for the President to deliver his much-awaited promises. In 2005 and 2006, the Indonesian economy grew only by 5.7 percent and 5.5 percent, respectively, driven largely by real consumption growth. To achieve higher GDP growths, a strong surge in investment is vitally needed. During the rapid growth period of 1975 to 1996, the total growths of public and private investment contributed to around 36 percent of the annual GDP growth rates in Indonesia. In 2002-2003, the contribution of investment to GDP growth was merely one percent (Van der Eng (2004)).

Yet, despite the return of some stabilities and improvements in the general macroeconomic indicators, such as inflation, nominal exchange rate, key interest rate, balance of payment numbers and GDP growth rates in the last couple of years, direct investment remained very low and continued to contribute very little to the overall economic growth of the country. The flow of foreign direct investment in the \$276 billion economy was less than \$5.5 billion in 2005 ---around 2 percent of GDP, and this followed a six-year period in which foreigners sold their Indonesian assets to the tune of almost of \$9 billion.

Compounding further the problem of weak inward direct investment, the country has at the same time experienced stronger outflows of direct investment. In 2004 and 2005, the

flows of outward direct investment, reported by the World Investment Report of the United Nation, were averaging around 1.2 percent of the country's GDP.

While a number of studies have examined determinant factors of inward direct investment to Indonesia, we can only find one study that has looked at forces behind outward investment from Indonesia (Lecraw (1993)). The objective of our study is to fill in this gap by identifying a few of possible push and pull factors behind the recent surge of the outward direct investment from the most populous country in Southeast Asia. Various aspects of investment climate in the domestic economy and the role of restructured domestic corporate sectors will be examined as domestic push factors. In addition, we would consider the emergence of the Chinese economy as an external pull-factor. Lastly, we also look at the role of internalization strategy of the ethnic Chinese business firms in Indonesia.

The next section would review a number of stylized facts of the outward direct investment from Indonesia, especially during the post-1997 financial crisis period. Sections 3-6 identify various possible determinant factors of outward investment from Indonesia. A brief concluding remark section ends the paper.

## **2. Brief Stylized Facts**

While the stock of inward direct investment has seen its boom and bust cycles in the past decade, starting with rapid growths in mid-1990s to 1997, followed by dramatic fall in 1999-2002, and strong recovery starting 2003, the stock of outward investment from Indonesia remained steady for most part of the last decade (Figure 1). The strong rush of outward direct investment only began in 2004, and by the end 2005 the stock of outward investment from Indonesia was reported to be close to 90 percent higher than its level in

2003, and more than double of its level in 1997. In a sharp contrast, the stock of inward investment to the country in 2005 was still less than 70 percent of its peak level in 1996.

The World Investment Report 2006 of the United Nations also listed Indonesia among the top 15 developing and transition economies in terms of stocks of outward FDI in 2005. It was the first for Indonesia to be ranked in the top 15 during the last 25 years. Only six other Asian economies were ranked higher than Indonesia as the sources of direct investment.<sup>1</sup> It is important to note however that in comparison to these economies, the outward investment from Indonesia is relatively small. For instance, the Indonesian outward investment in 2005 was only 12 percent and 3 percent of the investments from Singapore and Hong Kong, respectively.

With the massive declines in inward investment, Indonesia had experienced negative net inflows of direct investment with the world economy, started during the height of the 1997 financial crisis period (1998 and 1999) and lasted until 2002 (Table 1). A similar outlook is reported between the Indonesian economy and selected Southeast Asian (ASEAN) partner countries. Given its geographical location, conducive investment climate and dynamic economic growth rates, Singapore remains by far the most favorite destination of Indonesian outward investment to ASEAN.

Investment of the Indonesian firms abroad have targeted a wide array of industries (Table 2). In Singapore, a fair share of the investment targeted the service industries, ranging from financial and insurance services to storage and transport facilities. Driven by various

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<sup>1</sup> Those six economies are Hong Kong, China; Singapore; Taiwan Province of China; People Republic of China; Malaysia; and Korea.

factors to be discussed at the later part of the paper, a number of investment projects has also targeted the labor intensive industries, such as textile, garment and footwear in countries such as Cambodia, Vietnam and China. The boom in the property sector in Asia has too attracted investment commitments from Indonesian firms, including mega projects in various cities in India and China.

Given its size and importance in the local economy, the Indonesian ethnic-Chinese conglomerates have been the main drivers of the outward looking investment strategy ---as will be further elaborated in the paper. Together with the Ciputra Group, the Salim group for instance has signed a memorandum of understanding in August 2006 to invest in various sectors in West Bengal, including major infrastructure projects (such as flyovers, bridges, port), townships, medical centers, and economic zones. The same join-venture is involved in the development of a township project in Beijing, China. Another major Indonesian ethnic-Chinese conglomerate, the Sinar Mas Group, has expanded its business operations to China (Pulp and Paper; Agriculture and Food); Malaysia (Real Estate and Pulp & Paper); and India (Pulp & Paper).

### **3. Investment Climate and Selected Contributing Factors**

As briefly mentioned, a number of possible determinants of outflow investment from Indonesia will be discussed in this study. We start by empirically examining the possible role of general investment climate as push factors for the outward investment. To get more in-depth understanding of the investment climate in the country, the analyses will turn into a selected contributing factors of the rise and fall of investment climate in Indonesia.

### 3.1. General Investment Climate

A number of key indicators of investment climate has persistently been identified by previous studies as determinants of investment in an economy.<sup>2</sup> Those factors can generally be grouped into three categories, namely: 1.) economic risk rating; 2.) financial risk rating; and 3.) investment profile. We adopted these three risk ratings from the International Country Risk Guide of the PRS group. Each rating is indexed to range from 100 (highest risk) to 0 (lowest risk).

The economic risk rating (ERR) evaluates the strength and weakness of the overall macroeconomics positions of an economy. Five factors influence economic risk rating, namely GDP per capita, real annual GDP growth, annual inflation rate, budget balance as a percentage of GDP, and current account balance as a percentage of GDP.<sup>3</sup>

The financial risk rating (FRR) examines the country's ability to finance its official, commercial and trade debt obligation. To assess the financial risk of a country, a few key indicators are observed in the rating such as foreign debt as a percentage of GDP, foreign debt service as a percentage of exports of goods and services (XGS), current account as a percentage of XGS, net liquidity (measured as months of import cover), and exchange rate stability.<sup>4</sup> As for the economic risk rating, each component is assigned its own weight, with

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<sup>2</sup> Refer to Bende-Nabende and Slater (2003), Ghura and Goodwin (2000) and Serven, L. (2002).

<sup>3</sup> Each factor is assigned a different weight. The current account has the highest maximum weight, while the GDP per head is given the lowest maximum weight.

<sup>4</sup> Estimated annual net liquidity expressed as months of cover and calculated as the official reserves of the individual countries, including their official gold reserves calculated at current free market prices, but excluding the use of IMF credits and the foreign liabilities of the monetary authorities (the International Country Risk Guide of the PRS group, <http://www.countrydata.com>).

the maximum weight given to current account factor, and the least weight for the net liquidity.

The third rating is the investment profile (IP). This rating assesses factors affecting the risk to investment in a country that are not covered by other ratings. Three key factors are assessed for the investment profile, namely contract viability/expropriation, profits repatriation and payment delays.

Based on these three ratings, a number of interesting analyses can be derived on the investment climate of Indonesia relative to major Southeast Asian economies and other emerging Asian economies. The MIT economies (Malaysia, Indonesia and Thailand) were found to be the most severely crisis affected countries in 1997 (Figures 2-4), with investment climates gravely deteriorated. The financial crisis of 1997 had transformed a group of countries with the most conducive investment climate, as shown by all three categories of ratings, in the southeast Asian region since mid-1980s into the worst one for at least two years of the crisis period (1998-1999).

Taking a closer look at the sub-components of the ERR, the sharp fall in the real GDP growth rates clearly was the major factor in increasing the level of investment risk. The ERR for the MIT economy was as low as 21.4 (out of 100 points) in 1996, and increased to its worst level in two decades at around 50.8 in 1998. For the case of Indonesia, the problems in the macroeconomics indicators were more widely spread. The deteriorations of the ERR in 1998-1999 for Indonesia were the results of drastic worsening in all five components of the

ERR, namely GDP growth rates, current account balance, budget, inflation and GDP per capita level.<sup>5</sup>

Relatively the same magnitude of upsurge was also reported for the FRR. From the measures of the ability level to finance the debt/obligation, the MIT countries shared a multiple set of common problems. The rise in the exchange rate volatility was a clearly a factor during the early stages of the 1997 financial crisis. All three countries faced a severe decline in the international liquidity and a rapid accumulation of foreign debt. Debt service was particularly a major issue in Indonesia.

Since 2000, the three ratings have consistently indicated improvements in the overall investment climate and macroeconomics conditions in Indonesia. However, with the exception of the ERR, both the financial risk rating and the investment profile rating in 2004/2005 were still relatively higher than the rates reported a couple of years before the outbreak of the 1997 financial crises. Furthermore, looking at the three indicators across key major Asian economies, the investment environment in Indonesia remained among the most risky one.

To confirm the contribution of investment climate in explaining the outflow of direct investment from Indonesia, we conducted an ordinary least squares autoregressive distributed lags (ARDL) panel regression for the case of the MIT economies (Malaysia, Indonesia and

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<sup>5</sup> For the sake of brevity, we do not report the breakdowns of the three ratings. The sub-components can however be made available upon request.



Thailand) during the period from 1990 to 2004.<sup>6</sup> A general to specific approach of Henry (1976) is adopted to derive the final test results. As shown in Equation 1, the lags of the changes in the investment climate variables are included to allow more time for the impact of the decline (or improvement) in those indicator on the outflows of the direct investment.<sup>7</sup>

**Equation 1:**

$$\Delta \log(OutFDI_{it}) = \alpha + \lambda \Delta \log(OutFDI_{i(t-1)}) + \sum_{t-k}^t \beta_{t-k} \Delta \log(ERR_{i(t-k)}) + \sum_{k=0}^{k=2} \delta_{t-k} \Delta \log(FRR_{i(t-k)}) + \sum_{k=0}^{k=2} \gamma_{t-k} \Delta \log(IP_{i(t-k)}) + \varepsilon_{it}$$

Where:  $\Delta \log(OutFDI_{it})$  is the change of the outward direct investment from each of the MIT economies.  $\Delta \log(ERR_{i(t-k)})$ ,  $\Delta \log(FRR_{i(t-k)})$  and  $\Delta \log(IP_{i(t-k)})$  capture the rise and fall in the economic risk, the financial risk and the investment profile indicators, respectively. All variables are in the log-forms, and hence the coefficient estimates  $(\beta, \delta, \gamma)$  are the elasticities.  $(\varepsilon)$  is the independently distributed error term.

Early literatures, including Bende-Nabende and Slater (2003). Ghura and Goodwin (2000) and Serven (2002) have investigated a wide range of determinant factors of investment inflows. Theoretically, we would expect an improvement in the investment profile and financial risk indicators should attract more investment locally, hence less

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<sup>6</sup> Data limitation prevents us from exclusively conducting a time-series test for Indonesia. The fixed-effect variable included is the individual country dummy. We conducted as well the least square random-effects model, and the results are consistent with the fixed-effects model.

<sup>7</sup> Given the limited degree of freedom, we only included up to two years lag for the initial general regression.

outward investment ---  $\sum_{k=0}^{k=2} \delta_{t-k}$  and  $\sum_{k=0}^{k=2} \gamma_{t-k}$  to be positive. The return of more conducive economic environment (or decline in economic risk), on one hand, should generate more investment for the domestic economy. However at the same time, improved confidence on the economy as a whole should also boost more confidence for the local corporate sectors to chase better returns abroad. Thus,  $\sum_{k=0}^{k=2} \beta_{t-k}$  could either be positive or negative. We also include the adjustment variable,  $\Delta \log(OutFDI_{i(t-1)})$ , to capture the possibility that the level of outward direct investment at time ( $t$ ) is going to be influenced by the past year level ( $t-1$ ).

Consistent with the general findings of early studies, uncertainties with investment climate had partly been responsible for the outflows of direct investment from the MIT economies ---with the R-square of around 0.41 (Table 3). Changes in the investment profile ( $IP$ ) has the most immediate and significant impact on the outward investment, while the financial risk ( $FRR$ ) had the least impact and took about two years to have some bearings on the outward investment of these economies. Interestingly, the test result also suggest that an improvement in the overall economic risk of these economies would actually lead to more capital outflows. Next, we look at a number of primary factors contributing to the worsening of the investment climate in Indonesia.

### **3.2. Corruption Abuses**

Considerable attention has been placed on the increasing cost of corruption and on its influence on both inward and outward direct investment of the country. A report done by University Indonesia suggested that bribes to the government bureaucracy raised business

cost by at least 10 percent during the post-1997 crisis period.<sup>8</sup> The under funded judicial branches of the government (from the police to Supreme Court Judges) and the decentralization measure to give more autonomy to local governments have been noted as factors contributing to the high rate of corruption abuses in the country during the post-1997 financial crisis.

Although there are evidences of concrete efforts to eradicate corruption in Indonesia, the most recent annual report by the Political and Economic Risk Consultancy for 2007 reserves the dubious distinction as the most corrupt country in Asia to Indonesia. The ranking was based on the surveys done on expatriates working in each of the listed economies, namely China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Taiwan, Thailand, Singapore and Vietnam. The corruption abuses in Indonesia have been found to be most rampant among this group of economies for ten consecutive years since 1997 (Figure 5).

Several findings from the survey are worth highlighted for the case of Indonesia:

- Corruption abuse is rated as a major deterrent to place investment in Indonesia.
- In contrast to the case of Thailand, where the abuses were felt significantly more in the public sector, the rampant of the corruption practice in Indonesia has been rated equally extensive in both sectors.

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<sup>8</sup> “Indonesia: Investment Climate Statement 2003”, the Embassy of the United States web-site (<http://www.usembassyjakarta.org/econ/investment3.html>).

- Although there is an indication of improvement, the commitment of the government to fight corruption has been rated as “not serious”. Similarly, the effectiveness of the judicial system in particular to address corruption practices in the country is rated very low.

### **3.3. Labor Law: Going Over Board?**

The post-President Suharto period (i.e. since mid-1998) has seen a number of revisions of the Manpower Acts, including the 2003 Manpower Act giving workers many benefits and freedoms to organize. With the post-1997 revision, the current labor law has arguably swung from one in which workers being oppressed by the government to workers having too much power.

The Law No. 13 of 2003 Manpower Act has, in particular, been blamed for the rise in the labor cost in the country. One apparent source of the rising cost is the severance compensation. Under the present Labor Act, employers were to be compensated not only when they were fired but also when they voluntarily quit the jobs. The cost of firing workers in Indonesia is now among the most expensive in the world, well over 100 weeks of wages (Table 4). The latest “Doing Business” indicator of the World Bank show that the severance pay in Indonesia is doubled that of Thailand, and is significantly higher than the rates in key neighboring major economies in Asia. From the cost perspectives of hiring and firing employer, Indonesia has in general been rated as the most expensive and the least flexible.

The impacts of the high severance pay on the economy, especially labor intensive industries, are multifaceted. Companies have been prevented to down-side and reduce their labor forces due to expensive severance pay. Instead, they are forced to close down (and

declare bankruptcy). In early 2006, quotas imposed by the European Union on shoe imports from China and Vietnam generated strong interests from investors (especially foreign) in investing in Indonesia. However, “when companies come to see us and see this labor law, they postpone their investment” says the Chairman of the Indonesian Shoe Manufacturers’ Association.<sup>9</sup>

Efforts had been pushed by the present government to revise the 2003 Manpower Act and this reform process was to be part of the investment-promotion package, spelled out in a Presidential instruction issued in February 2006. In early-2006, the committee working on the revision of the Act proposed around 50 different changes to the current law which would allow companies to hire contract-based workers and outsource permanent jobs and core businesses to other companies. The proposal was however withdrawn due to heavy protest at the Presidential Palace in April 2006. Needless to say, the road to reform the labor law will remain bumpy. There are now about 188 labor unions in the country of which at least 68 are active and spread under four confederations. Compounding the already complex labor market condition in Indonesia, the fragmentation makes it even more difficult for the labor unions to agree on a common agenda for dialogue with both the government and the business community.

### **3.4. Weak and Under funded Infrastructure**

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<sup>9</sup> As quoted in: “Daily Policy Digest: Indonesia Labor Rule Takes Toll on Investment”, National Center for Policy Analysis, December 8, 2006.

To achieve the targeted growth rate of 6-7 percent per annum between 2005-2009, an estimate of \$150 billion is needed to upgrade the nation wide infrastructure in the country. Investment in infrastructure has however shrunk from 6 percent of GDP before the break of 1997 financial crisis to a paltry 2 percent in 2000, and only recovered to about 3 percent in 2004/2005 (Guerin (2006) and World Bank (2007)).

The lack of infrastructure investment has partly been the impact of fiscal restraint and tight monetary policy implemented for a number of years during the post-1997 period. Largely due to the high cost of restructuring of the banking and corporate sector, the total central government debt outstanding rose to as high as 100 percent of GDP in 1999, and gradually declining to about 44 percent of GDP by June 2006.<sup>10</sup> The annual interest payment of this debt was averaging about 18% of total annual central government expenditure from 2001 to 2005. In comparison, the average annual development spending of the central government during the same period was only about 14 percent of its annual expenditure (the World Bank (2007)).

The lack of infrastructure investment has been compounded further by the decision of the provincial governments to park their development funds in Bank Indonesia certificates (SBI), instead of pumping the fund into much-needed development projects. Due to the efforts of mopping up the excess liquidity resulted from the injection of capital to the trouble banks at the early stage of the 1997 financial crisis and the intervention to manage the volatility of rupiah, the 3-month SBI rates were hovering around 13.5 percent per annum

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<sup>10</sup> The regional governments in Indonesia had very small debt outstanding, less than 0.5 percent of the total government debt.

during the period of 1999 to 2005 (Siregar and Rajaguru (2005) and Siregar (2005)). The relatively high return from what considered to be a safe instrument has turned the SBI into a more attractive investment choice than investing in the real sector. Contributing to the overall lack of liquidity, the commercial banks in Indonesia were reported to hold around 22 billion dollar worth of SBI in early 2007.

To attract investment into the country, the Investment Summits I and II were organized in Jakarta in January 2005 and November 2006, respectively. Unfortunately, limited achievements have been reported so far. During the first summit, 91 infrastructure projects worth a total of \$145 billion were to be bid. By mid 2006, only three pipeline gas contracts, one power plan contract, and three toll road contracts were awarded. Many blame the failure of the first summit due to inability of the government to follow through the investment plans.<sup>11</sup>

### **3.5. High Starting-Up and Operating Cost**

With the challenges and shortcomings elaborated above, it is therefore not surprising that the cost of starting-up business in Indonesia has been estimated to be the highest among major Asian economies (Table 5). The high number of procedures (second only to China in the list) is exposing potential investors to not only delays in getting the required business permit (as reflected by the length of time to get the permit), but also to rampant corruption abuses discussed earlier. During his meeting with the Vietnamese Business Delegation in

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<sup>11</sup> Our discussions with various sources (including market players and government officials) suggest that too much “back-door” interventions by the high-ranking officials and/or their business associates have resulted in a low realized number of investment projects.

early 2006, the coordinating Minister of Economic and Industry, Mr. Boediono, admitted that the investment regulation and taxation in Vietnam are more advanced than those in Indonesia. Boediono highlighted among others the need to eliminate complicated investment rules, such as different treatments for local and foreign investors, and to reduce corporate tax.

More importantly, the list of contributing factors to investment climate discussed earlier have raised not only the starting cost in Indonesia, but also the operation cost of already established firms in all sectors of the economy. As percentage of income per capita, the cost of starting-up business in Indonesia is close to 90 percent. Only Cambodia reports a higher rate. Naturally, the worst-hit sector is the labor intensive one, such as textile, garment and footwear.

Another contributing factor to the rise in the operating cost has also been the volatile and increasing price of crude oil in recent years. In its efforts to reform the budget, the government of Indonesia has been pushing for massive cuts in oil subsidies, especially since 2005. A study done by the Citigroup has indicated that the Indonesian economy is among the most adversely exposed to the volatile global oil price. The study claims that if the price of crude oil were to reach US\$100 per barrel, it would raise the domestic inflation rate by about 1.4 percent in Indonesia. At the same time, the economic cost of the high crude oil price is estimated to be 1 percent of its GDP (Table 6). The adverse impact of rising and more volatile oil price on the local economy will likely to heighten under the current push to further reduce price subsidies of different oil products.

#### **4. Revitalized Corporate Sector**



Another potential driver of the outward direct investment is the balance sheet position of the domestic firms. Weak corporate sectors had largely been blamed for the severity of the East Asian financial crisis in late 1990s. The restructuring of both corporate assets and liabilities have therefore been a priority in most crisis effected economies in Asia, including in Indonesia. Have the corporate restructuring process been a successful one in most of the crisis-effected economies? Three common measures of corporate sector vulnerability are considered in our study: 1.) leverage rate to gauge solvency ; 2.) liquidity; and 3.) profitability. Leverage is measured as the ratio of total liabilities to total assets. Interest coverage ratio captures the liquidity position. The commonly used ratio of return to equity is adopted as a measure of profitability. Looking at these three indicator, the outcomes of the post-1997 balance sheet restructuring of the corporate sectors in key crisis-effected economies of the ASEAN-4 plus Korea, and Indonesia, have in general been mixed (Table 7).<sup>12</sup>

The devaluation of the local currencies in 1997 led to exorbitant insolvency rates among the corporate sectors of the ASEAN-4 plus Korea and Indonesia. The firms in this region continued to be highly leveraged in recent years, even compared to the position of the corporate sectors in Emerging Asia in general. As experienced by other corporate sectors in the region, the corporate sector in Indonesia managed to reduce their leverage, albeit at a

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<sup>12</sup> Indicators of corporate vulnerabilities are adopted from the Corporate Vulnerability Utility (CVU) Database system of the International Monetary Fund. For cross-country comparisons, we apply market capitalization-weighted averages for all of the CVU indices. The CVU database only includes China, India, Indonesia, Korea, Malaysia, Philippines, Sri Lanka, Taiwan and Thailand in the Emerging Asia group of economies. The ASEAN-4 plus Korea are arguably the worst 1997 crisis-effected economies. The ASEAN-4 here include Indonesia, Malaysia, Philippines and Thailand.

very modest rate. From 2002 to 2003, the rate increased again, but still lower than the pre-1997 levels.

The most encouraging trend has been with the return to equity indicator. The corporate sectors of the crisis effected economies have in general been enjoying strong annual profit since early 2000s, at the rates higher than the average for the rest of the corporate sectors in emerging Asian economies. Based on the ROE ratios, the Indonesian firms are surprisingly found to be relatively more profitable than their counterparts in the region.

Interest Coverage Ratio (ICR) index confirmed a substantial improvement in the liquidity position of the firms . More importantly, the strong growths of the ICR rates of the corporate sectors in emerging markets in Asia during early to mid-2000s are just another set of evidences suggesting that the region has indeed been facing excess liquidities and contributing to the global imbalances. In contrast to their counterparts in ASEAN and Korea, there had been more moderate improvement in the liquidity position of the corporate sector in Indonesia. Only in 2004 that the firms in Indonesia were more liquid than they were during the pre-crisis.

The relevant question for our study then: *has the improvement in the overall balance sheet of the corporate sectors contributed to the rise in the outflow of direct investment, including from Indonesia? Does the return of strong profits and liquidities in early 2000s especially contribute to strong surges of outflows in recent years?* To address these questions, an ordinary least squares autoregressive distributed lags (ARDL) panel regression

is conducted for the case of the MIT economies (Malaysia, Indonesia and Thailand) on the following equation.<sup>13</sup>

**Equation 2:**

$$\Delta \log(OutFDI_{it}) = \alpha + \lambda \Delta \log(OutFDI_{i(t-1)}) + \sum_{t-k}^t \beta_{t-k} \Delta \log(Leverage_{i(t-k)}) + \sum_{k=0}^{k=2} \delta_{t-k} \Delta \log(profit_{i(t-k)}) + \sum_{k=0}^{k=2} \gamma_{t-k} \Delta \log(liquidity_{i(t-k)}) + \varepsilon_{it}$$

Where:  $\Delta \log(OutFDI_{it})$  is the change of the outward direct investment from each of the MIT economies.  $\Delta \log(leverage_{i(t-k)})$ ,  $\Delta \log(profit_{i(t-k)})$  and  $\Delta \log(liquidity_{i(t-k)})$  capture the rise and fall in the economic risk, the financial risk and the investment profile indicators, respectively. All variables are in the log-forms, and hence the coefficient estimates ( $\beta, \delta, \gamma$ ) are the elasticities. The lags of the change in the investment climate variables are included to allow more time for the impact of the deterioration (or improvement) in the corporate sector balance sheet on the outflows of the direct investment.<sup>14</sup> As for the previous regression, the general to specific approach of Henry (1976) is adopted to derive the final test results.

The improvements in the profitability and liquidity positions of the corporate sector are expected to induce more investment by the firms. Some of these investments may very well be carried out abroad ---thus ( $\delta$ ) and ( $\gamma$ ) are expected to be positive. In addition, a

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<sup>13</sup> As in the case of investment climate, data limitation prevents us from exclusively conducting a time-series test for Indonesia. The fixed-effect variable included is the individual country dummy. We conducted as well the least square random-effects model, and the results are consistent with the fixed-effects model.

<sup>14</sup> Given the limited degree of freedom, we only included up to two years lag for the initial general regression.

lower leverage ratio, implying less debt burden, should free up more capital to be invested. Hence,  $(\beta)$  is expected to be negative. Note:  $(\varepsilon)$  is the independently distributed error term. As for the early regression, we include the adjustment variable,  $\Delta\log(OutFDI_{i(t-1)})$ , to capture the possibility that the level of outward direct investment at time  $(t)$  is going to be influenced by the past year level  $(t-1)$ .

The test results suggest that overall improvement in the balance sheet of the corporate sector has indeed partly been responsible for the rise of outward investment from these three economies (Table 8).<sup>15</sup> The adjusted R-square is over 40 percent. In particular, the decline in the leverage position and the rise in the liquidity are found to be significant determinant factors. The regression results suggest that the strong liquidity position, especially in 2004, and the relatively lower debt burden since 2002 contributed to the swelling of outward investment in 2004 and 2005 from Indonesia. Combining the test results posted in Tables (3 and 8) with the stylized facts, one can also further argue that despite the investment opportunities in Indonesia, the poor investment climate and other less-conducive economic conditions had discouraged the relatively liquid domestic firms to invest in the local economy.

### **5. China Factor: Crowding-out or Crowding-in effect?**

Seemingly unaffected by the rise in labor and property cost in recent years, the rapidly expanding market size of the Chinese economy continues to play a major factor in

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<sup>15</sup> The role of  $\Delta\log(OutFDI_{i(t-1)})$  is not found to be strongly significant for this regression.

attracting investment to that economy. By early 2004, the total GDP of China was already more than double that of the total ASEAN-5 economies (Indonesia, Malaysia, Philippines, Thailand and Singapore). From less than \$5 billion in 1990, annual inflows surged in response to pro-FDI policy reforms, exceeding \$35 billion by the middle of the decade. Annual inflows have remained in the \$40-55 billion range since 2000. In the process, China has become one of the world's top destination for FDI: its share in flows to developing countries has averaged close to one fourth in the decade since 1993; similarly, in the same period, it has attracted more than half of all FDI flows to emerging Asia. Over 80 percent of the world's 500 largest companies have set up their businesses in China by end 2005.

The meteoric rise of China has raised concerns among its neighboring countries, including Japan. A number of recent studies examined potential "crowding out effects", with China diverting and pulling away investment from other emerging economies in Asia. Chantasawat, et.al. (2004), Mercereau (2005), Eichengreen and Tong (2005), and Wong (2006) have addressed this important question (not only for the case of emerging Asia, but also for other developing economies) from different perspectives. All of the studies reach a broadly similar conclusion that the inflows of FDI in most Asian countries seem to be *positively* related to flows into China, and that there is no strong evidence of a crowding out effect for most Asian countries.<sup>16</sup> Some of these studies have even shown some evidences of crowding-in effects of the emergence of the Chinese economy on some sectors of its neighboring economies in Asia. Trade integration among the ASEAN economies and China for instance has risen in recent years.

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<sup>16</sup> Only Mercereau finds a negative effect of China for two Asian countries, Singapore and Myanmar.

However, if we refer to a number of recent trends, including that of the Japanese direct investment to East Asian economies, it remains to be seen whether crowding-in or –out effects would dominate. By observing Figures 6 and 7, there is no positive correlation between the Japanese direct investments to China and to the MIT (Malaysia, Indonesia, and Thailand) economies. The MIT countries were among primary destinations of Japanese FDIs from late 1980s to 1998. As high as around 50 percent of total Japanese FDIs to emerging Asia countries was absorbed by the MIT economies during that period. With the meltdown of these economies and prolonged weak market confidence during the post crisis, the value and share of Japanese FDI to this group of Southeast Asian economies dropped and reached its lowest level since late 1980s in 2004. The most severe drop was reported in Indonesia. This country received more than 25 percent of Japanese FDI to emerging Asia in 1992 and only around 3 percent in 2004. China has replaced the MIT economies as the largest recipient of Japanese FDI since 2002. As much as 50 percent of Japanese FDIs to emerging Asia in 2003 and 2004 were absorbed by China.

Labor intensive manufacturing industries of the Southeast Asian economies have been the biggest losers from direct competition with China, in particularly, footwear and garment industries in Indonesia. With poor investment climate, due in particular to rising labor unrests and weak legal system, and disappearance of low cost advantage (worsened further by the cut of the government fuel subsidies), a number of key multinational and Indonesian-owned companies in these industries have shifted major shares of their production lines to China. The annual realized foreign direct investment in leather goods and footwear industry in Indonesia declined massively from around US\$140 million in 1997 to only about 13 million in 2004.

The crowding-in *vis a vis* crowding-out effects of China for Asia clearly warrants further studies. However there are inter-related lessons ought to be underlined from the Japanese FDI to East Asia and the competitions among the labor intensive industries in Asia. The prolonged weak market confidence in a number of East Asian economies during the post crisis was an important impetus contributing to the dominant of China as the major destination of the direct investment from Japan. At the same time, the potential crowding-in effects of China also suggest that the economic benefits to be gained by the emerging markets in Asia from the growing Chinese economy are huge. At the end, the commitment to improve its investment climate should influence significantly whether a country in the Asian region, in particular, stand to benefit or loss-out from the rise of the Chinese market.

## **6. Internationalization Strategy of Ethnic Chinese Businesses**

The role of Indonesian ethnic Chinese in the local economy and in explaining the trend of outward investment is vitally significant. In late 1990 and early 2000, the ethnic Chinese control over 80 percent of corporate assets and 160 of the 200 largest businesses in Indonesia (Yeung (1999)). As discussed earlier, this group of businesses is an important driver of the surge of outward direct investment from Indonesia. To understand what is behind the surge of outward investment from Indonesia, it is therefore imperative that we consider the development strategy of this key group of businesses in the country, particularly its internalization strategy.

A recent study by Yeung (1999) underlines four driving forces behind the internalization of ethnic Chinese businesses in Southeast Asia:

1. Tighter competition from global players domestically;

2. Saturated home markets;
3. Their home-based competitive advantages dissipate quickly through deregulation and;
4. Their family successors are more outward looking in business practices and opportunity-seeking.

With the push for economic reforms aiming at attracting foreign investment to the local economy in most of the major Southeast Asian economies since early 1980s, the monopolistic advantage and subsidies often enjoyed by the major ethnic-Chinese conglomerates dissipated. On the other hand, the rise of the Southeast Asian economies, especially the export-oriented sectors, opened up new opportunities for the domestic firms to take advantage of the economic scale available in the International market. At the same time, there has been a gradual transition of management control to the younger generation of these largely family businesses. More and more of the new generation of business leaders looked to establish market shares abroad. The opening of China and the emergence of its special economic zones facilitate further the “regionalization” of the ethnic Chinese businesses. The Salim group of Indonesia, the Kuok brothers of Malaysia and the Charoen Pokphand of Thailand were some of the leading ethnic Chinese conglomerates expanding their networks to different parts of Asia.

It is also important to note here that the violent anti-Chinese riots in Solo and Jakarta on the eve of the former President Suharto’s fall in May 1998 had also been responsible for a sudden outflow of capital, not only owned by the ethnic Chinese, from the local economy. Since then, there has been continuous efforts by the government of Indonesia to improve the social and political environment of Chinese Indonesians (Efferin and Pontjoharyo (2006)). These steps included the ratification of the United Nations Conventions on the Elimination of



All Forms of Racial Discrimination (Wie (2006)). These efforts have however seen limited success in attracting back capitals parked abroad by Indonesian citizens (including that of Chinese ethnics). A recent report published in a local magazine claims up to US\$87 billion of Indonesian-owned assets / capital were still parked in Singapore in late 2006.<sup>17</sup> Without a significant improvement in the overall investment climate in Indonesia, it is doubtful that a substantial repatriation of these capital will take place.

## **7. Concluding Remarks**

During the early to mid-1990s, the stock of inward direct investment continued to dwarf the stock of outward investment. In 1997, the stock of direct investment in Indonesia was close to 5 times of that outward investment. During the next decade, the landscape of the local economy has changed drastically. The economy has seen negative inward investment for five consecutive years (1998-2002), during which the inward investment downed by more than 75 percent from its highest level in 1997. At the same time, there has been a continue steady flow of outward investment, contributing to net negative flows of inward investment during that five year span starting 1998.

Our study has also shown that the outward investment of the Indonesian businesses has targeted sectors which have been in badly need of capital injections locally. Infrastructure sector in Indonesia for instance is in a dire-need of fresh capital to help support the overall target of GDP growth rates between 6 to 7 percent annually. Similarly, the more important than ever labor intensive industries, such as textile, garment and footwear, have seen less and

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<sup>17</sup> “Indonesian Rich People’s Money Flourishing in Singapore”, INFO Bank, December 2006, pp.92-95.

less fresh investment commitments, compounded by the closures of major firms such as NIKE.

A list of key determinant factors of outward direct investment has been identified in this study. Given the recent experiences of what could be considered as the lost decade for the Indonesian economy, the economic and social cost of future failure to significantly eradicate corruption abuses, improving investment rules and regulations, reforming the labor law, and addressing infrastructure needs, will escalate exponentially in the near future. Addressing the challenges discussed earlier should also help position the local economy to compete and to benefit from the rapid development of the Asia region, pushed by the surges of the economies of China and India in the near future.

The study has also highlighted other factors contributing to the rise in outward investment from Indonesia. The internationalization strategy of the major ethnic-Chinese conglomerates has started as early as late 1980s and early 1990s. The capacity of the locally-owned firms to compete in the global market should be positively recognized. Some promising progresses have also been reported from the corporate sector restructuring in the country. Key performance indicators of the corporate sectors in the country suggest that the local firms are liquid and in position to expand their productions again.

The present and future task for the government of Indonesia is therefore to ensure that the recent progress in the corporate sector and also the emergence of the Indonesian conglomerates as the regional major corporations should not be a zero-sum game where the local economy is going to be left behind. In addition to its commitment to urgently address the set of challenges discussed in the paper, it is also imperative that the governments of Indonesia strategically designs its macroeconomic policies to assist the local industries to

move into higher value-added manufacturing chains of productions and service industries.

With the rise of China and India, followed by the rapid emergence of the indo-Chinese economies, the old strategy of competing on labor cost and market size would no longer be effective.

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**Table 1: Outward and Inward Direct Investment Flows**

Country	Average 1995-1997	Average 1998-1999	2000	2001	2002	2003	2004
<b>Outflows from Indonesia to Selected ASEAN (in millions of US\$)</b>							
<b>Brunei</b>	11.34	5.74	2.11	0.2	2.69	4.24	0.62
<b>Malaysia</b>	59.35	21.06	26.40	-2.75	62	2.73	4.43
<b>Myanmar</b>	2.3	2.9	7.51	3.48	3.43	5.63	2.10
<b>Philippines</b>	2.6	13.59	2.79	n/a	-0.01	0.01	n/a
<b>Singapore</b>	453.72	336.60	59.50	354.60	400.80	219.20	260.90
<b>Thailand</b>	9.6	1.95	4.26	n/a	2	4	n/a
<b>Vietnam</b>	13.67	2.51	7	5.06	0.57	n/a	1
<b>Total Outflows to ASEAN (1)</b>	552.64	384.71	109.57	361.72	471.48	235.81	269.05
<b>Total Inflows from ASEAN (2) (in millions of US\$)</b>							
	358.23	-233.10	-232.55	-239.98	1,336.62	383.96	31.66
<b>Total Net Inflows with ASEAN (2-1) (in millions of US\$)</b>							
	-194.41	-617.81	-342.12	-601.7	865.14	148.15	-237.39
<b>Total Net Inflows with the World (in millions of US\$ and in % of GDP)</b>							
<b>in millions of US\$</b>	4,374	-1,111	-4,700	-9,702	-8,282	3,211	2,121
<b>% of GDP</b>	11.6%	17.5%	12.3%	5.0%	-0.1%	1.3%	2.7%
<b>Source:</b> The ASEAN Secretariat Database and the United Nation Database.							

**Table 2:**  
**Selected Destinations and Targeted Sectors of Outward Investment from Indonesia**

<b>Country of Destination</b>	<b>Targeted Industries / Sectors</b>
India	Cement; Real Estate; Infrastructures; Health-Care Facilities; Pulp and Paper.
Cambodia	Textile
China	Infrastructure; Textile; Real Estate; Agriculture & Food; Pulp & Paper; Consumer Products; Chemical
Malaysia	Oil; Real Estate; Pulp & Paper.
Singapore	Finance & Insurance; Health-Care Provider; Manufacturing; Oil Industry; Storage & Transport; Food Industry; Resort and Industrial Development (& Real Estate)
Sri Lanka	Textile
Thailand	Textile
Vietnam	Farming Equipment; Hotel; Mining; Real Estate; Textile
Source: The Business Times Singapore (Sept 11, 2006); AsiaNews.it (Dec/12/2005); UBS Investment Research; various official web-sites of the relevant economies.	

**Table 3:**

$$\Delta \log(OutFDI_{it}) = \alpha + \sum_{t-k}^t \lambda_{t-k} \Delta \log(OutFDI_{i(t-k)}) + \sum_{t-k}^t \beta_{t-k} \Delta \log(ERR_{i(t-k)}) + \sum_{k=0}^{k=2} \delta_{t-k} \Delta \log(FRR_{i(t-k)}) + \sum_{k=0}^{k=2} \gamma_{t-k} \Delta \log(IP_{i(t-k)}) + \varepsilon_{it}$$

Explanatory Variables	Coefficients	t-statistics
$\alpha$	0.121	2.706***
$\lambda_{t-1}$	0.248	2.538***
$\beta_t$	-0.375	-2.327***
$\delta_{t-2}$	0.278	2.118***
$\gamma_t$	0.567	3.945***

Adj R-squared = 0.41; Durbin-Watson stat = 2.326; Prob (F-stat) = 0.011  
 Noted: \*\*\* significant at 1%; \*\* significant at 5%; \*significant at 10%

**Table 4: Employment Flexibility and Hiring and Firing Costs.  
Selected East Asian Countries, 2007**

Country	Hiring		Firing		Rigidity of Hours Index (0-100)*	Rank
	Difficulty of Hiring Index (0-100)*	Cost of Hiring (% of salary)	Difficulty of Firing Index (0-100)*	Cost of Firing (weeks of wages)		
Indonesia	61	10	50	108	20	140
Cambodia	56	0	30	39	60	124
India	33	17	70	56	20	112
Philippines	56	9	20	91	40	118
Vietnam	0	17	70	87	40	104
Korea	11	18	30	91	60	110
China	11	44	40	91	20	78
Thailand	33	5	20	54	0	46
Malaysia	0	13	10	88	20	38
Singapore	0	13	0	4	0	3

\*/ Index at 100 suggests most rigid or difficult and 0 captures most flexible.  
 Source: "Doing Business in 2007", the World Bank.



**Table 5: Starting Business indicators, Selected East Asian Countries, 2007**

Country	Procedures (number)	Time (days)	Cost (% of income per capita)	Minimum capital (% of income per capita)	Rank
Indonesia	12	97	86.7	83.4	161
Cambodia	10	86	236.4	66.2	159
China	13	35	9.3	213.1	128
Korea	12	22	15.2	299.7	116
Philippines	11	48	18.7	1.8	108
Vietnam	11	50	44.5	0.0	97
India	11	35	73.7	0.0	88
Malaysia	9	30	19.7	0.0	71
Thailand	8	33	5.8	0.0	28
Singapore	6	6	0.8	0.0	11

Source: "Doing Business in 2007", the World Bank.

**Table 6:**  
**Asia Emerging Markets Most Exposed to an Oil Shock (Oil Price =US\$100)**  
(Rank by Most Adversely Affected)

Impact on GDP (in %)		Impact on CPI Inflation (in %)	
Singapore	-1.4	India	2.1
Thailand	-1.3	Thailand	1.8
Philippines	-1.2	Philippines	1.7
China	-1.1	Indonesia	1.4
Indonesia	-0.9	Malaysia	1.4
Malaysia	-0.8	Singapore	1.4
Hong Kong	-0.7	Korea	0.7
India	-0.6	China	0.5
Korea	-0.3	Taiwan	0.5
Taiwan	-0.1	Hong Kong	0.1

Source: Global Economic Outlook and Strategy, Citigroup, July 20, 2006.

**Table 7: Corporate Sector Vulnerability**

<b>1. Leverage: (Ratio of Total Liabilities to Total Assets (in %))</b>			
<b>Period</b>	<b>Emerging Asia</b>	<b>ASEAN-4 &amp; Korea</b>	<b>Indonesia</b>
Average 1994-1996	44.46	50.65	45.91
Average 1997-1998	45.55	58.57	59.82
2001	43.62	52.50	59.86
2002	44.19	51.42	50.20
2003	44.39	49.74	49.59
2004	44.72	49.25	51.23
<b>2. Profit (Return on Equity (in %))</b>			
<b>Period</b>	<b>Emerging Asia</b>	<b>ASEAN-4 &amp; Korea</b>	<b>Indonesia</b>
Average 1994-1996	16.62	16.30	21.74
Average 1997-1998	13.42	8.34	4.26
2001	13.40	11.51	25.56
2002	15.04	16.57	40.23
2003	16.85	18.43	25.83
2004	20.94	22.61	28.17
<b>3. Liquidity: (Interest Coverage Ratio (in %))</b>			
<b>Period</b>	<b>Emerging Asia</b>	<b>ASEAN-4 &amp; Korea</b>	<b>Indonesia</b>
Average 1994-1996	20.51	20.28	12.50
Average 1997-1998	19.79	13.35	16.84
2001	28.20	11.54	8.97
2002	27.56	17.57	7.88
2003	42.80	18.96	9.48
2004	37.03	26.08	13.15

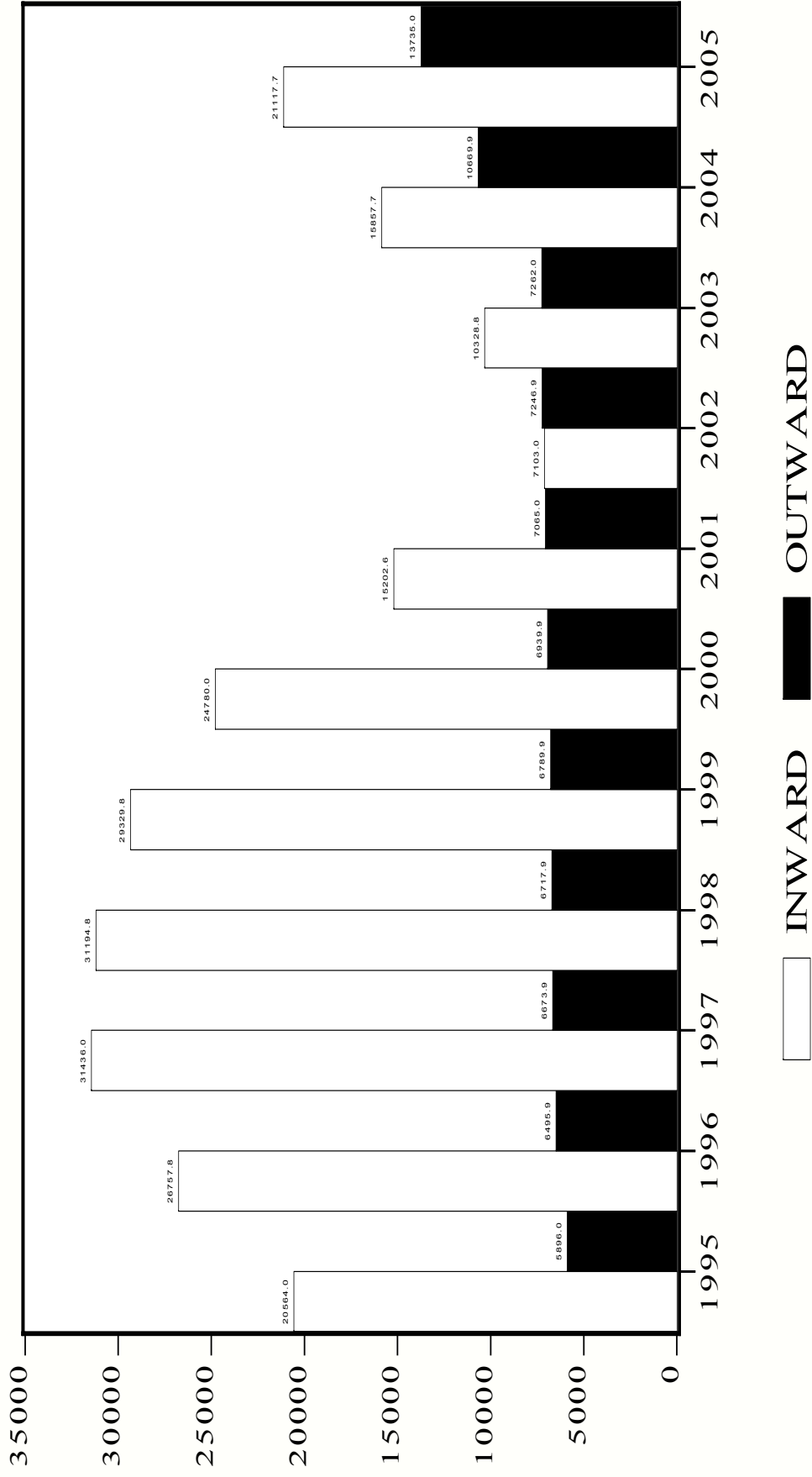
Source:  
The Corporate Vulnerability Utility Database System of the International Monetary Fund.

**Table 8:**

$$\Delta \log(OutFDI_{it}) = \alpha + \lambda \Delta \log(OutFDI_{i(t-1)}) + \sum_{t-k}^t \beta_{t-k} \Delta \log(Leverage_{i(t-k)}) + \sum_{k=0}^{k=2} \delta_{t-k} \Delta \log(profit_{i(t-k)}) + \sum_{k=0}^{k=2} \gamma_{t-k} \Delta \log(liquidity_{i(t-k)}) + \varepsilon_{it}$$

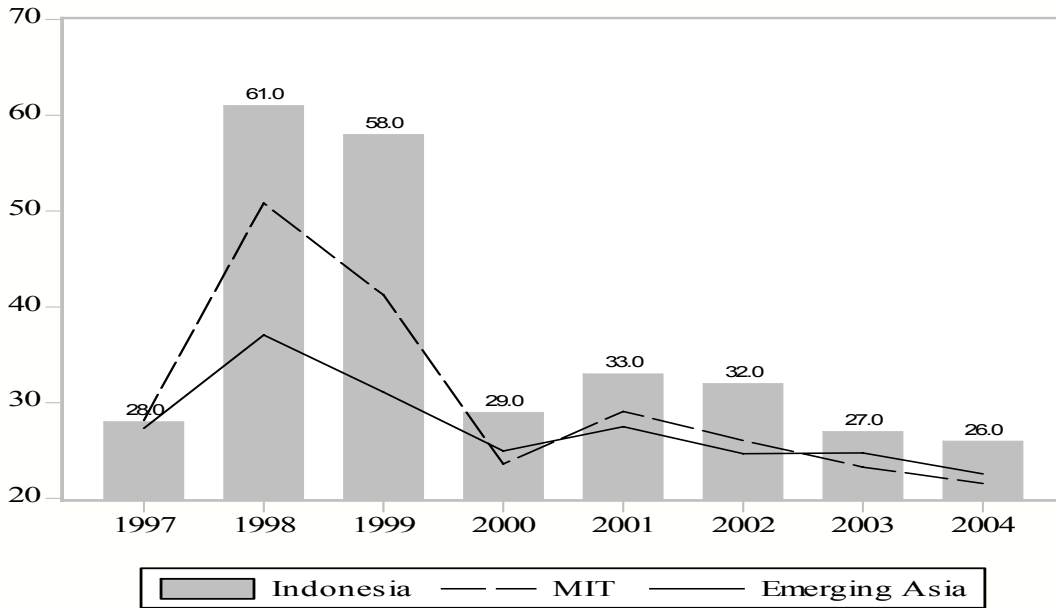
<b>Explanatory Variables</b>	<b>Coefficients</b>	<b>t-statistics</b>
$\alpha$	0.062	2.131**
$\beta_t$	-0.912	-2.716***
$\beta_{t-2}$	-0.764	-2.352***
$\gamma_t$	0.176	2.423***
$\gamma_{t-1}$	0.109	1.829*
Adj R-squared = 0.42; Durbin-Watson stat = 2.355; Prob (F-stat) = 0.015 Noted: *** significant at 1%; ** significant at 5%; *significant at 10%		

**Figure 1: Stock of Inward and Outward Direct Investment (in millions of US dollar)**



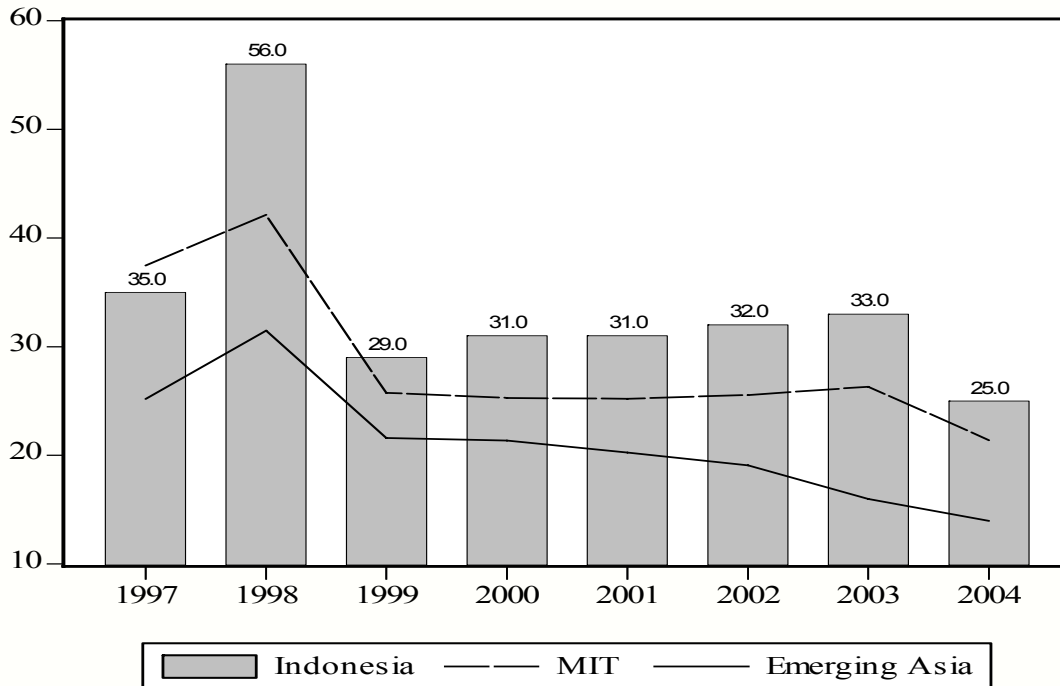
Source: The United Nation Database.

**Figure 2: Economic Risk Rating (ERR)**



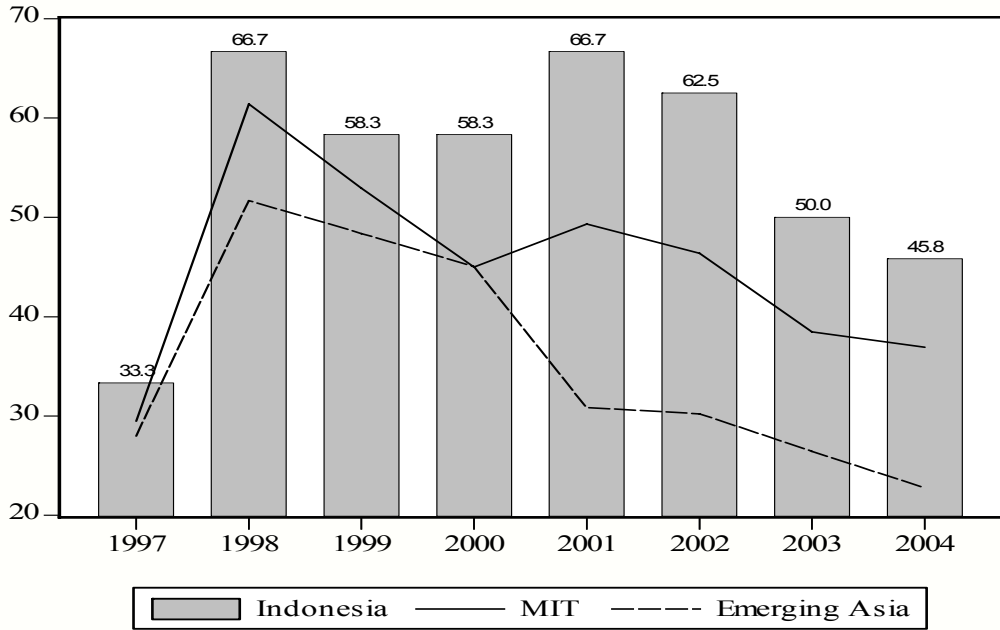
Source: The International Country Risk Guide of the PRS Group. Rating: 0 (lowest risk) – 100 (highest risk). MIT covers Malaysia, Indonesia and Thailand; Emerging Asia includes the MIT, Philippines, Singapore, Korea, India and Hong Kong.

**Figure 3: Financial Risk Rating (FRR)**



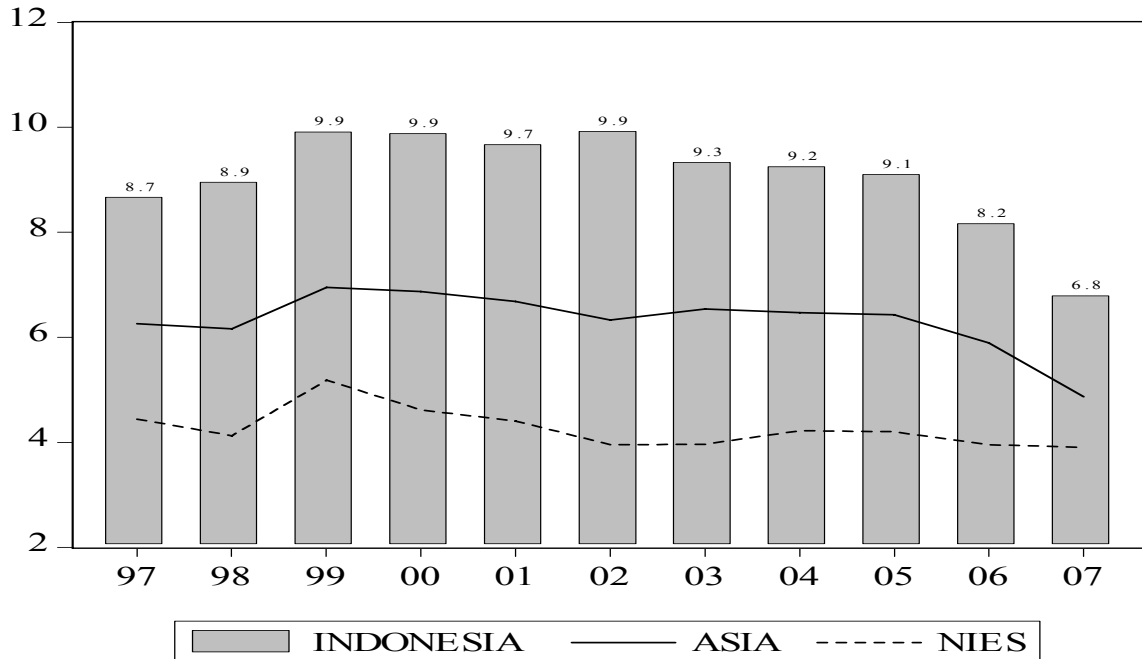
Source: The International Country Risk Guide of the PRS Group. Rating: 0 (lowest risk) – 100 (highest risk). MIT covers Malaysia, Indonesia and Thailand; Emerging Asia includes the MIT, Philippines, Singapore, Korea, India and Hong Kong.

**Figure 4: Investment Profile**



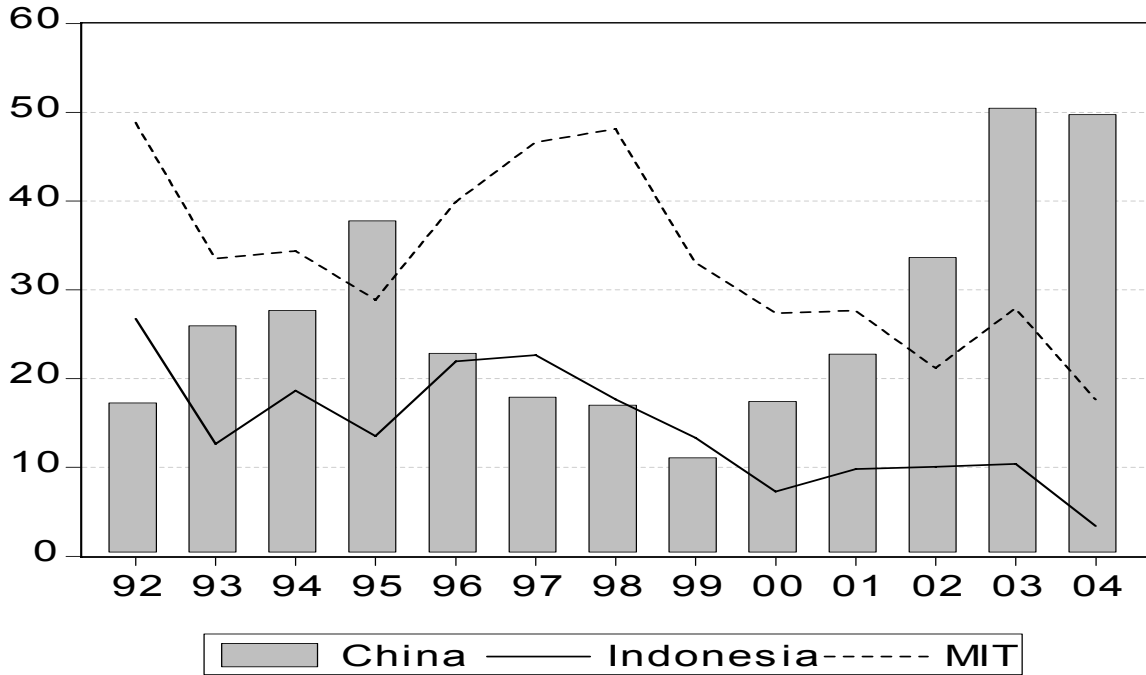
Source: The International Country Risk Guide of the PRS Group. Rating: 0 (lowest risk) – 100 (highest risk). MIT covers Malaysia, Indonesia and Thailand; Emerging Asia includes the MIT, Philippines, Singapore, Korea, India and Hong Kong.

**Figure 5: Corruption Index**



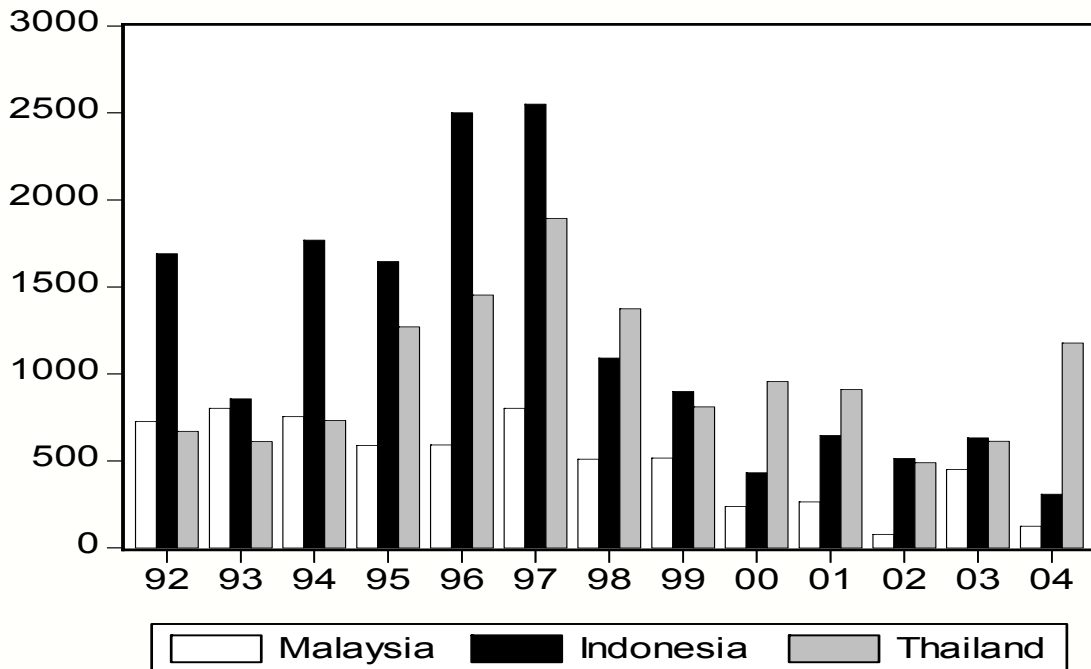
Source: The Political Economic Risk Consultancy LTD. Asia economies include China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam. NIES are Hong Kong, Korea, Singapore, and Taiwan.

**Figure 6: Percentage Share of Japanese FDI to China and MIT  
(Malaysia, Indonesia and Thailand)**



Source: CEIC Database

**Figure 7: Japanese FDI to Malaysia, Indonesia and Thailand  
(in millions of US\$)**



Source: CEIC Database