Does Japan Allocate its Foreign Aid towards Economic Relation?
*Relationship between Foreign Aid and FDI*

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## SECTION 1

### *Introduction*

Japan's foreign aid policy can be traced back since 1954 just after Japan joined the Colombo Plan[1] on October 6, 1954. The plan was a framework for bilateral arrangements involving foreign aid and technical assistance for the economic and social development of the South and Southeast Asia region. The allocation of Japan's foreign aid was directed towards war reparation negotiations and economic cooperation with the Asian nations that Japan had occupied during the World War II.

However, Japan's foreign aid policy had changed dramatically in the 1970-80s. By 1978, Japan appeared as a major bilateral donor in Asia and by the year 1989, Japan emerged as the number one donor in the world surpassing the United States (US)[2]. The policy changed following the 1973 oil crisis that stimulated Japan to redesign its foreign policy to secure a steady supply of energy and other resources during this period. Foreign aid was utilised as an essential instrument to protect diplomatic interests with resource-rich countries outside of Asia.

By 1980-90s, Japan's foreign aid policy was directed towards building economic and political relation mainly among Asian countries. In 1990s, the Ministry of International Trade and Industry (MITI) wanted to use the Official Development Assistance (ODA) to restructure Japan's FDI and trade relations with Southeast Asia[3]. Meanwhile, the Ministry of Foreign Affairs (MOFA), on the other hand, was more incline to use aid as a diplomatic lever. As a

[1] The Colombo Plan was established during the Commonwealth Conference of Foreign Ministers, held in Colombo, Sri Lanka, in January 1950.
[2] http://www.mofa.go.jp/policy/oda/cooperation/anniv50/pamphlet/progress2.html
[3] Japan's ODA Charter (adopted June 30, 1992) made Asia a priority region for Japanese ODA.

result both commercial and strategic perspectives dominated the aid flow of Japan in the 1990s.

**Table 1: Typology of foreign aid by DAC members**

| Size % of GNI | >0.5 | 0.3-0.5 | <0.3 |
|---|---|---|---|
| Humanitarianism | Denmark, Sweden, Norway, Netherland | Finland, Switzerland, Germany, Ireland | |
| Ex-colony Management | France | Belgium, United Kingdom | Australia, Portugal |
| Economic Relation | | Canada, Austria | Italy, Greece, Spain, New Zealand, **Japan** |
| National Security | | | United States |

Source: Bokyeong Park from Korea Institute for International Economic Policy, Korea and Hong Sik Lee from Inha University, Korea in their Working Paper Series Vol. 2008-08 for the The International Centre for the Study of East Asian Development, Kitakyushu

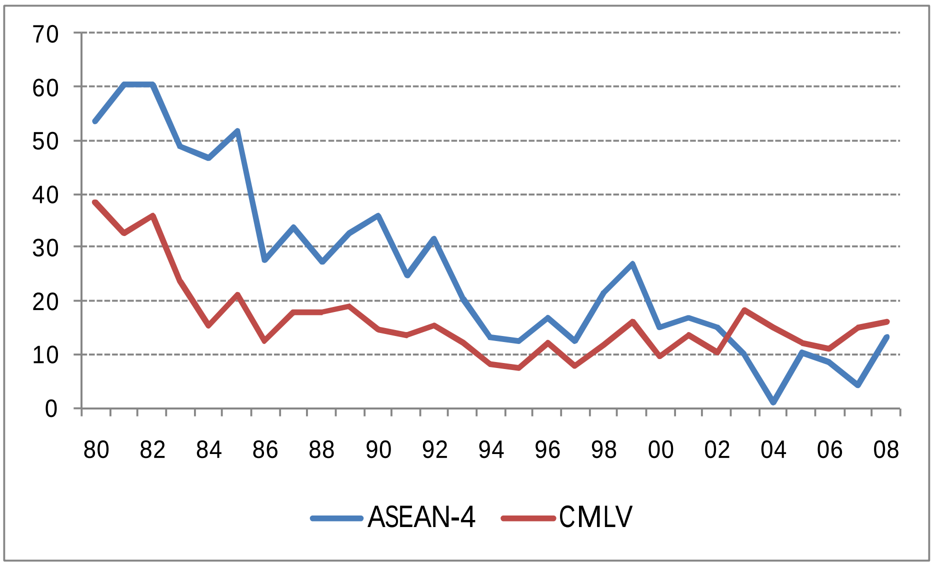
From the typology Table 1 above, it is worth noting that Japan along with other DAC members including Italy, Greece, Spain and New Zealand had been directed its foreign aid towards building their economic relation. Japan's foreign aid was mainly allocated to infrastructure and building trade capacity that are considered important to expand its influence both political and economic relation with the recipient countries[4].

### *Japan foreign aid allocation*

Since the past, Asia has been the top recipient of Japan foreign aid. Among the Asian countries, ASEAN countries were the top recipient of Japan's foreign aid. Their economic relation can be traced back since the World War II.

[4] Japan's Ministry of Finance

**Graph 1: Japan's Aid Allocation to ASEAN (% of Total Aid)**

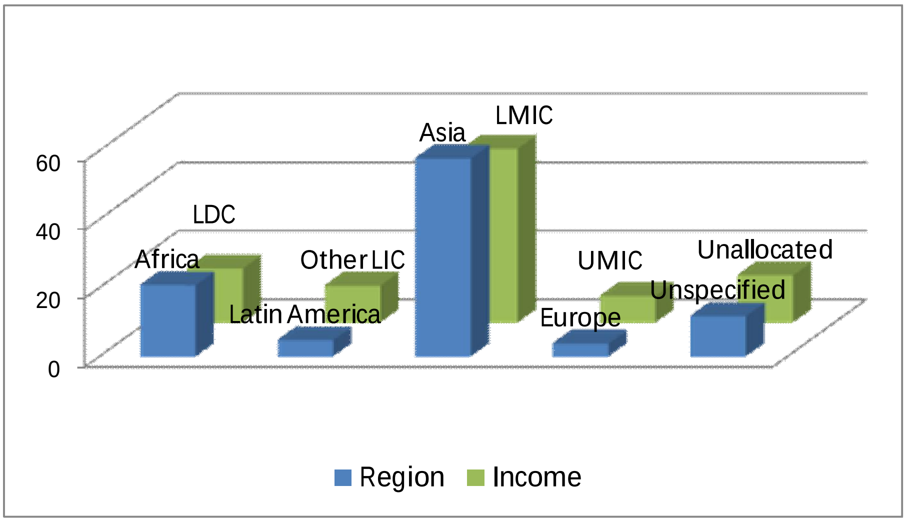



Source: OECD – DAC, www.oecd.org/dac/stats

In the 1980-90s, the ASEAN-4 countries, namely Malaysia, Thailand, Indonesia and Philippines were among the top recipient of Japan's foreign aid. From Graph 1 shown above, we can see that the trend continued throughout the 1990-00s, but saw a slight decrease in 1997-98 following the break out of Asian Financial Crisis. Despite, the slow growth recorded in these countries, Japan continued to provide its foreign aid mainly in the infrastructure sector that was deem to help somewhat weather the crisis.

For the past 30 years, Japan had closer economic and political relation with the ASEAN-4 countries. The graph also clearly pointed out that Japan's foreign aid was most directed to ASEAN-4 countries in the past. However since the last 10 years, Japan had started to build its relation with other ASEAN countries namely Cambodia, Myanmar, Laos and Vietnam (CMLV countries). We could see that Japan's foreign aid has increasingly allocated its foreign aid to the CMLV countries due to its growing importance in the ASEAN bloc.

**Graph 2: Japan's 2009 Aid Allocation by Region and Income (%)**




Source: OECD – DAC, www.oecd.org/dac/stats

Following the Asian Financial Crisis, Japan continued to be the top donor of foreign aid to Asian countries. From Graph 2 shown above, the share of ODA allocated in 2009 to lower middle income countries (LMIC) which mainly consists of Asian countries remain elevated at 58%[5]. However, the share of foreign aid has fallen substantially from the past. This has been seen due to the increased interest to Sub Saharan Africa countries, with Japan's foreign aid allocation amounted to 21%.

One of the key questions among international scholar is: whether foreign aid promotes growth? There has been widely debated among scholars and practitioner on the effectiveness of aid in promoting growth. Although aid may be a dubious predictor of economic growth[6], but still it is largely effective at accomplishing it's most basic goals: the creation of infrastructure, the provision of public goods, and the support of industrial and agricultural sectors. Here I will argue that foreign aid allocated for building political and economic

[5] See graph 1. www.oecd.org/dac/stats

[6] Burnside and Dollar (2004), argued that there is simply no evidence that aid promotes growth in all institutional environments.

relation could promotes investment and trade. As foreign aid given for the development of infrastructure and building trade capacity would later result in an increase in FDI inflows.

This paper attempts to investigate the relationship between foreign aid and foreign direct investment (FDI) in ASEAN country. In order to see the relationship between aid and FDI, this paper would use a cross sectional time series analysis. This paper would look at the past trend of Japan's foreign aid to ASEAN-4 countries. The paper would also compare the findings with the recent trend of Japan's aid allocation to the CMLV countries. Through the analysis, I hope to see the linkages between foreign aid in promoting trade and investment in both these subgroups of ASEAN countries. On hindsight, foreign aid could help a recipient country in its economic development through infrastructure and building trade capacity aid. As the country grows further and liberalizes its market, this will attract more FDI to their country.

In order to address all the above issues, this paper would be divided into 4 sections. Section 1: highlights the past and recent Japanese foreign aid allocation. Section 2: Review literature on foreign aid and literature on the linkages between foreign aid with FDI. Based on the literature review, Japanese FDI does have a vanguard effect. This suggests that Japanese foreign aid does attract Japanese Multinational (MNC) companies in investing in the recipient countries. Section 3: Examined historical and recent economic indicators in determining the relationship. This section would also highlight the findings through descriptive inferences. Section 4: The last section would conclude and recommend areas for future research and improvements.

## SECTION 2

### *Literature Review*

There has been vast number of literature arguing the effectiveness of aid in promoting growth. Despite the number of literature available, there are a limited number of literatures that investigate the linkages between foreign aid and FDI. The literature review would be divided into three parts. The first part would focus on the aid and growth relationship and aid allocation pattern. The second part would outline early studies done on foreign aid and FDI linkages. The last part would focus on FDI's determinants which include sound governance and political environment.

Earlier literature on aid and development tried to show the effectiveness of aid in promoting growth. Some of the most cited paper includes Burnside and Dollar (2000) argued that aid itself does not promote growth. However, aid allocated to sound governance country does promote growth. The authors also showed that in the 1990s, aid allocation was favoured to low-income countries those with better institutional quality[7]. Meanwhile, Alesina and Dollar (2000) also argued that they found considerable evidence that that political and strategic consideration plays an important part in foreign aid allocation pattern[8].

They argued that policy performance of the recipient countries is important in determining aid allocation. Strategic factors such as political allies and colonial ties does play a significant role in aid pattern, but the location choice of FDI economic factors such as the enforceability of contracts and openness are considered more important. Despite the differences, most of the empirical analysis done on aid and growth relationship and aid allocation pattern managed to

[7] Burnside and Dollar (2000)
[8] Alsenia and Dollar (2000)

come to a consensus that sound political institution and governance are both important in promoting growth and aid allocation pattern. Therefore, the findings from earlier literature substantiate Japan’s foreign aid policy in allocating its aid to lower-income countries (ASEAN-4) with sound political institution and governance in building its economic and politic relation.

The second part of the literature review would highlight earlier studies done on the relationship between aid and FDI flows. There have not been a large numbers of studies done on the aid and FDI linkages, but among the most cited Japanese literature were done by Hidemi Kimura and Yasuyuki Todo (2007) that found that there is robust evidence that foreign aid from Japan has a vanguard effect, while aid from other donor countries has no such effect.

They argued that information on the business environment of a recipient’s country is often inaccessible to foreign firms, unless they actually engage in business activities in the country. They pointed out that through foreign aid, information may spill over to companies and firms of the donor country by the government[9]. Therefore, through foreign aid, information could be easily accessible by Japanese companies and firm in making their business decision. This information is considered one of the important factors that could lead to FDI. Japanese government has also set up agencies such as the Japan International Cooperation Agency (JICA) in helping to facilitate aid allocation to recipient countries. JICA also provides services ranging from conducting research to establishing economic cooperation with the recipient countries.

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[9] Hidemi Kimura and Yasuyuki Todo (2007)

Lastly, I would also like to highlight some of the earlier literature on FDI. Gastanaga et al. (1998) uses policy and institutional variables, namely corporate tax rates, tariff rates, the degree of openness to international capital flows, exchange rate distortions, contract enforcement, nationalization risk, bureaucratic delay and corruption to see the effects of various policies on FDI. Their findings showed that lower corruption and nationalisation risk levels, and better contract enforcement are associated with higher FDI inflows[10].

In another study conducted by Jun and Singh (1996) found that higher political risk attract less FDI. They expanded on earlier studies on FDI by analyzing various factors including political risk, business conditions, and macroeconomic variables. Their findings also revealed that exports generally, especially manufacturing exports, are a significant determinant of FDI flows. They concluded that export orientation is the strongest variable for explaining why a country attracts FDI[11].

## SECTION 3

### *Data Sources*

Dependent Variables

In this paper, the dependent variable would be ODA commitment data. The data has been taken from the OECD Creditor Reporting System (OECD CRS). In this analysis, I would also looked at ODA infrastructure commitment, which includes three sub-categories: Transport and Storage, Communications and Energy Supply and Generation (see attached table: "CRS Categories under which infrastructure ODA is reported and definitions" for full

[10] Gastanaga et al. (1998)
[11] Jun and Singh (1996)

explanations). The purpose of including infrastructure aid as infrastructure help in promoting economic development of a country.

### Independent Variables

Meanwhile, the independent variables include policy indicators that are listed in the World Governance Indicator (WGI), namely control of corruption, government effectiveness and regulatory quality. Other variables include the gross secondary enrolment, cost to start a business, ease of doing business index and the logistic index that were taken from the Education Statistics (EdStats), Doing Business (DB) and the Logistic Performance index of the World Bank database. Data on Foreign Direct Investment (FDI) and trade data were taken from the Asian Development Bank (ADB) Key Economic Indicators database.

### Control Variables

I also employ a series of controls variables, which relevant literature argues are robust predictors of FDI. Earlier cited literatures suggested by Jensen,[12] Li and Resnick[13] includes GDP per capita and GDP growth. GDP per capita is used as a proxy of economic development level. FDI are attracted or deterred by the level of economic development within a country and respond differently at different stages of modernization. Meanwhile FDI is also attracted to economic growth (GDP). Investors want not only to invest in locations with a large available market, but in countries where the market is growing rapidly. Both these data were taken from the Asian Development Bank (ADB) Key Economic Indicators database.

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[12] Jensen (2003)
[13] Li and Resnick (2003)

***Methodology and Hypothesis***

To analyze whether foreign aid works through the trade and investment link it is necessary to show that

(i) Foreign aid promotes economic development, and

(ii) Economic development promotes trade and investment.

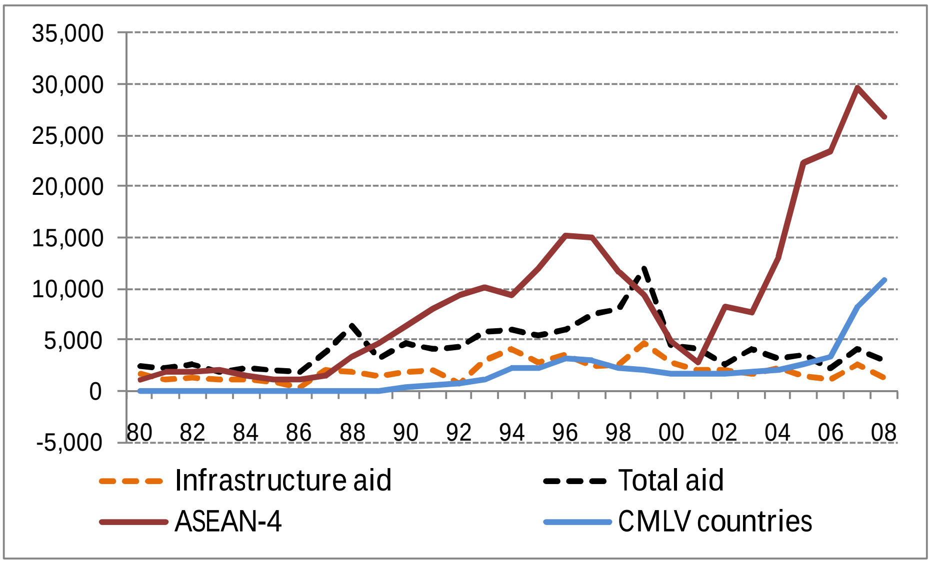
From the arguments presented earlier, the paper's hypothesis is as below:

*$H_1$: Foreign aid promotes foreign direct investment (FDI) inflows.*

The methodology that I would employ is using the cross sectional time series analysis on a dataset comprises of ASEAN countries. I would divide ASEAN into 2 subgroups namely the ASEAN-4 (comprises Malaysia, Thailand, Indonesia and Philippines) and the CMLV countries (Cambodia, Myanmar, Laos and Vietnam). The analysis would cover from the period 1980 to 2008.

***Analysis and Findings***

**Graph 3: Japanese Foreign Aid & FDI to ASEAN (USD million)**




Source: OECD, www.oecd.org/dac/stats, World databank, World Development Indicators (WDI), Asian Development Bank (ADB), Key Economic Indicators

Graph 3 comprises data of Japan's ODA and FDI to ASEAN since 1980 to 2008. The infrastructure ODA is being represented by the blue line. Meanwhile the red line represents Japan FDI to ASEAN-4 countries and the black dotted line represents the FDI to CMLV countries. The graph clearly shows a positive correlation between Japan's ODA and FDI to both the ASEAN-4 and CMLV countries. Since 1980s, Japan's has allocated 30%-60% of its aid to ASEAN-4 countries, while 10%-35% to CMLV countries[14]. As Japan's aid has been allocated towards developing infrastructure and building trade capacity, we could see that the amount of FDI inflows to ASEAN-4 countries has tremendously increase from a mere USD2,000 million in 1986 to a peak of USD15,000 million in 1997/98.

However, both aid and FDI declined substantially following the break out of the Asian Financial Crisis in 1997-98. There are a number of explanations for this decline: a worsening investment climate in ASEAN resulting from the economic slowdown and political and social instability; Japan's continuing economic stagnation and the reduced financial ability of Japanese corporations to engage in outward investments; and the growing attraction of China as an investment destination.

Meanwhile, this has not been the case for the CMLV countries back in the 1980-90s. But the scenario had changed dramatically since then. Japan had shown an increased interest in the CMLV countries in 2000s. Japan had increased its aid allocation towards the CMLV countries in 2000s. This has somewhat helped in the development of their economy as Japan continued to implement the same policy that it have used in the past through allocating aid for infrastructure projects. As infrastructure aid helped the recipient countries with better access of ports, roads, schools and etc, this has helped the economy to grow substantially.

[14] See graph 1

Therefore, from graph above and the literature I've pointed out earlier (Hidemi Kimura and Yasuyuki Todo, 2007), there is strong relationship between Japan's ODA and FDI inflows to the recipient country. Through foreign aid, the government have been actively providing information to companies and firms on the economic situation in the recipient country. Through exchanges of information, businesses could get a clearer picture of the recipient's countries situation[15].

This has been clearly the case for the ASEAN countries in the past with the establishment of the ASEAN Promotion Centre on Trade, Investment and Tourism in 1981[16]. The Centre was established with the purpose of promoting exports from ASEAN member countries to Japan, particularly semi-processed and manufactured products. The Centre also tries to promote foreign investment from Japan to the ASEAN member countries. The Centre was jointly funded by contributions from Japan (90%) and ASEAN member countries (10%), with its headquarter located in Tokyo.

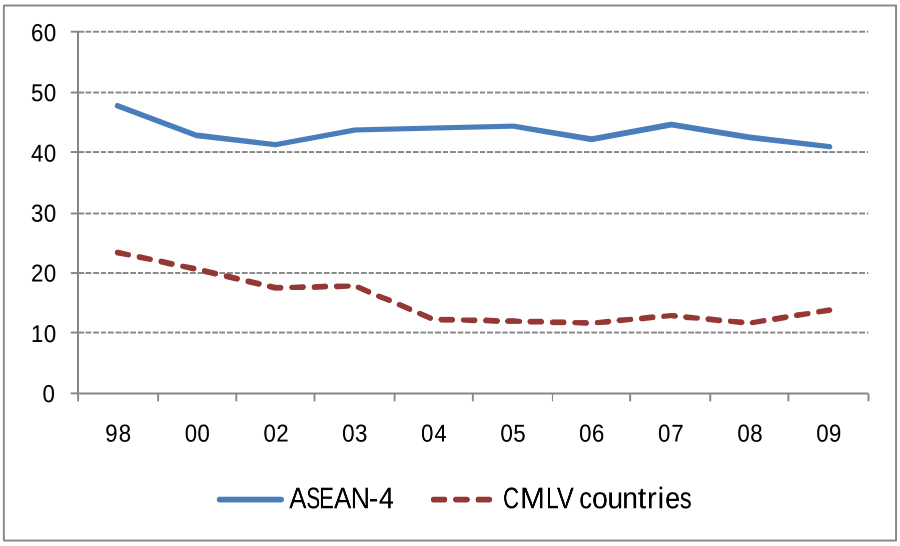
As noted earlier, Japan had shown increasingly interest in the CMLV in recent years. As aid allocation had increased substantially to the CMLV countries in 2000s, so has the FDI inflows. In order to assess the increased interest in CMLV countries, I would like to analyze the aid allocation pattern and its determinants. As pointed out by earlier literature (Alesina and Dollar, 2000), aid pattern has been allocated more to countries with a sound political institution and governance. Other than that, education has also played an important role in a country's development. I would argue later that, FDI would follow suit as the countries growth further. Besides macroeconomic determinants, a sound political institution and governance environment also would be the determinants of FDI inflows.

[15] See graph 3 and Hidemi Kimura and Yasuyuki Todo (2007)
[16]ASEAN Promotion Centre on Trade, Investment and Tourism established in 1981. http://www.asean.or.jp

***Determinants of Foreign Aid: Relationship between Independent Variables***

Moreover, as the literature[17] pointed out, good governance and sound institutional policies are important in determinants of aid allocation. This paper would analyze 3 indicators, namely the control of corruption, government effectiveness and regulatory quality.

**Graph 4: Control of Corruption: Percentile Rank**



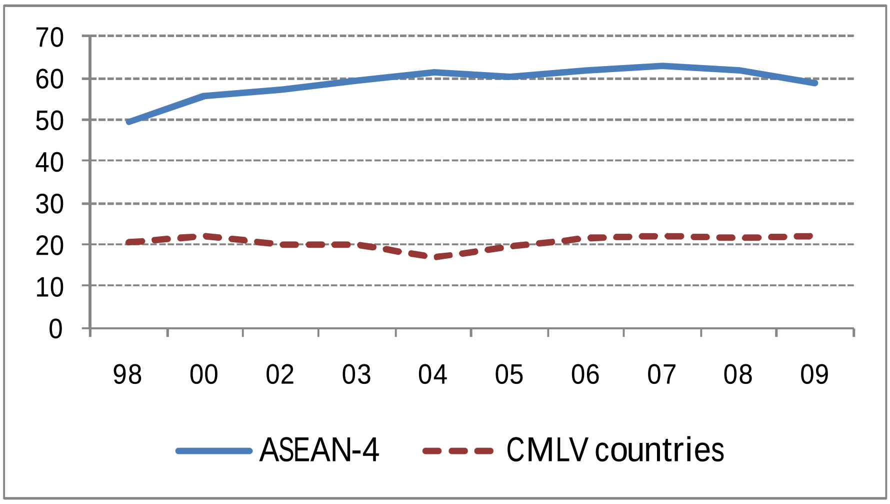

Source: World databank, World Governance Indicators (WGI)

Graph 4 is graph on control of corruption that ranks country's from 0 to 100, with 0 being the lowest and 100 being the highest. The control of corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests[18]. In the graph, the blue line represents ASEAN-4, while the red dotted line represents the CMLV countries' control of corruption. Since the last decade, the corruption level in both this subgroups has been high due to lack of transparency, good governance and accountability.

[17] Gastanaga et al. (1998)
[18] See World Governance Indicators (WGI) definition.

However, reform taken by the ASEAN-4 countries have somewhat managed to control the level of corruption slightly better compared to the CMLV countries. The important question here is whether this reform has been successful in bringing down the level of corruption. For instance, in Malaysia, the government had in recent years started to implement a more transparent system for awarding its infrastructure project. The government introduced an open system where domestic and foreign multinational companies (MNC) could participate in bidding for the project. In the past, the government would usually award these projects to their cronies and lobbies.  Through the system, the Malaysian government managed to bring down the corruption level in the construction sectors. The lowest bid would usually be picked to managed and complete the project.

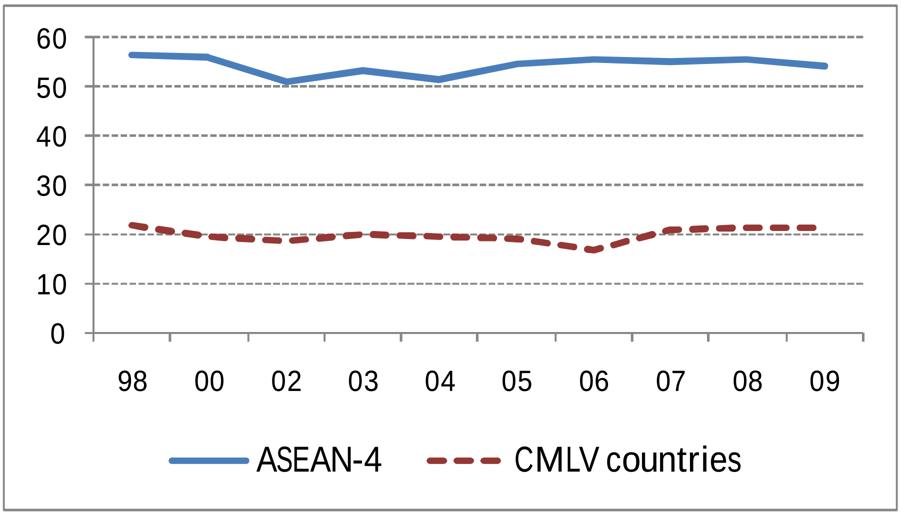
**Graph 5: Government Effectiveness: Percentile Rank**




Source: World dataBank, World Governance Indicators (WGI)

Graph 5 is a graph on government effectiveness. The government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies[19]. The blue line in the graph represents ASEAN-4 governments' effectiveness rank, while the red dotted line represents the CMLV countries. The rank for the ASEAN-4 has clearly increased throughout the years, while the CMLV countries still lacks behind. The CMLV countries have been constantly ranked at 20 for the past 10 years or so.

**Graph 6: Regulatory Quality: Percentile Rank**




Source: World dataBank, World Governance Indicators (WGI)

The last indicators, the regulatory quality also paint a somewhat similar picture. The regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.[20] In graph 6, the ASEAN-4 countries are represented by the blue line, while the CMLV countries are represented by the red dotted line. Both the government effectiveness and regulatory quality shows that ASEAN-4 countries have a higher rank compared to the CMLV countries.

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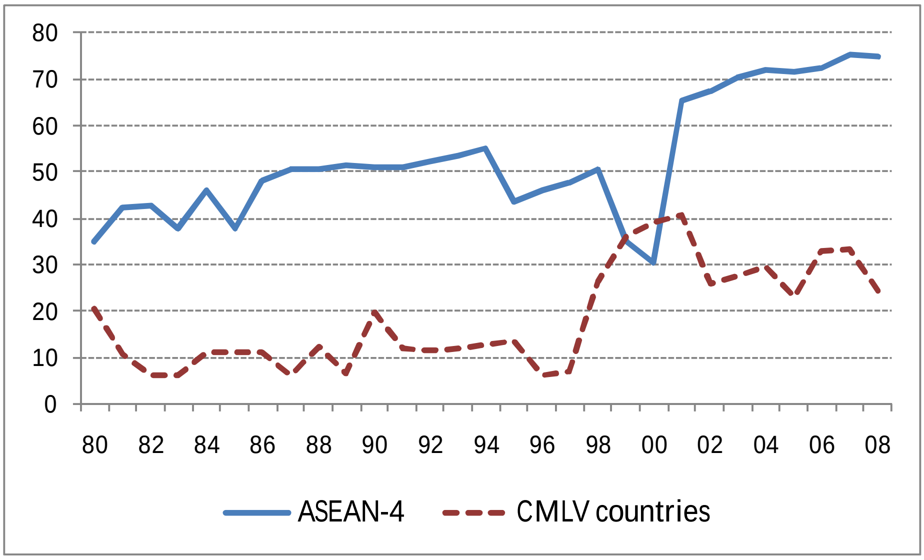
[19] See World Governance Indicators (WGI) definition.

However, effort by the CMLV countries in promoting government effectiveness and regulatory quality has been an important determinant of Japan's foreign aid allocation pattern in recent years. In 2008, the Vietnamese government through the Ministry of Planning and Investment (MPI) has committed to strengthen the attention to capacity development in the public sector. The capacity development proposed includes enhancing public services and regulatory effectiveness in line with its recent rapid economic growth[20].

Through this reform, Vietnam along with other CMLV countries not only managed to enhance their political environment and government effectiveness, but also managed to attract more FDI inflows. As shown in graph 3 above, Japan's increasing foreign aid in the 2000s had been followed suit with Japan's FDI later in 2006. This can be explained through the CMLV effort in promoting a sound political and governance environment in their country.

***Other Factors: Aid help improves Education Environment***

**Graph 7: School enrolment, Secondary (% gross)**




Source: World databank, World Development Indicators (WDI)

[20] See Vietnam's Ministry of Planning and Investment (MPI).

Other than that, Japan's foreign aid also help improves education environment. This can be explained through the infrastructure aid received in helping building more schools and universities. Graph 4 is a graph of gross secondary school enrolment. The definition of secondary school enrolment is the ratio of gross enrolment to the total enrolment. Secondary education is where one completes the provision of basic education that began at the primary level, and aims at laying the foundations for lifelong learning and human development, by offering more subject or skill-oriented instruction using more specialized teachers[21]. The blue line represents the ASEAN-4 countries and the red dotted line represents the CMLV countries enrolments.

The graph shows clearly that the percentage of secondary school enrolment in ASEAN-4 is higher that the CMLV countries. We could also see that the trend had been increasing since 1980s, while the trend for CMLV has been constant in the same period. However, the trend has increased steadily in 2000s for the CMLV. Besides the availability of more schools and universities, the respective government education policies also played an important role. The policies had focused on providing every child with a minimal amount of education through the subsidies of education by their respective government. This in turn has helped generate rapid increased in the skill labour force.

Going forward, there are a number of education challenges that could hinder country's growth and in generating skill labour force. Some of the challenges include lack of qualified teachers, limited experience of quality assurance processes and limited research expertise. Other than that, the government also faces substantial challenges in ensuring equitable access

[21] See World Bank Education Statistics (Edstats) definition.

of education. These challenges are important for the government to tackle in ensuring a more efficient labour force that would later be one of the major determinants of FDI.

***Investment and Trade Policies: Determinants of FDI***

ASEAN-4 countries had successful transform its economy so fast in the past 30 years. A combination of factors, particularly high saving rate and interacting with high level of human capital accumulation lead to a conducive environment for the transfer of technology[22]. This has induced capital inflows through providing sound macroeconomic management, a stable political environment and a well managed labour markets with educated workers.

Other than that, government intervention through industrial policy was also implemented that focuses on developing technological capabilities; promoting exports and building the domestic capacity to manufacture a range of intermediate goods. The government provided implicit and explicit subsidies (through cheap credit) to selective industries. In 1980s, the Malaysian government encourages foreign investors with a tax exemption of up to 10 years for investments in new industries and assurance of convertibility and repatriation of capital and profits. Other than that, with the establishment of the Promotion of Investment Act in 1986, foreign companies are allowed 100% ownership, but must export at least 50% of its product and did not compete with local industry[23].

The government also intervened systematically and through multiple channels to foster development, and in some cases the development of specific industries. Policy interventions took many forms-targeted and subsidized credit to selected industries, low deposit rates and ceilings on borrowing rates to increase profits and retained earnings, protection of

[22] Joseph E. Stiglitz, 1996 Some Lessons from the East Asian Miracle Oxford Journals Economics & Social Sciences World Bank Research Observer Volume11, Issue2Pp. 151

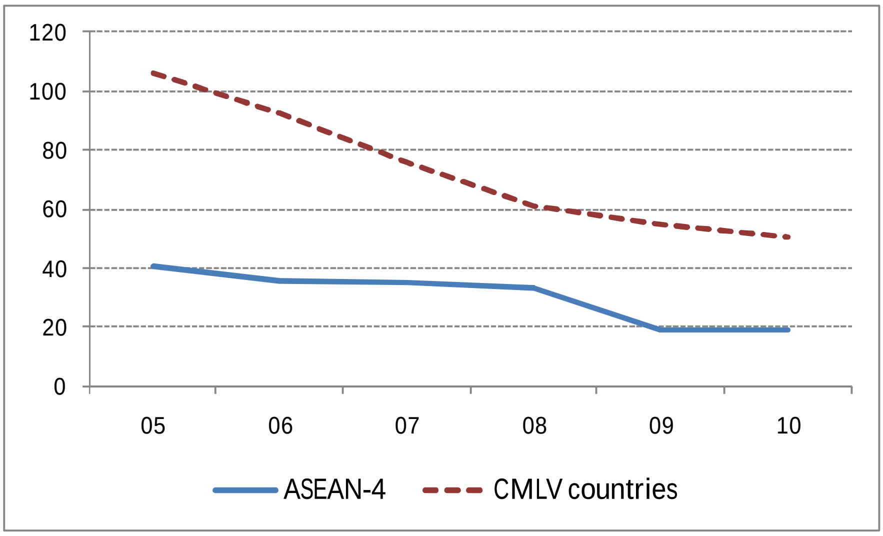
[23] Malaysian Promotion of Investment Act of 1986 (PIA 1986)

domestic import substitutes, subsidies to declining industries, the establishment and financial support of government banks, public investments in applied research, firm and industry-specific export targets, development of export marketing institutions, and wide sharing of information between public and private sectors.

Other than that, ASEAN’s trade policy also played an important role in promoting trade and attracting investment. The policy affects not only domestic but also foreign businesses; help facilitate member countries integration into global supply chains, and helpi boost productivity and rates of return on their investment. Therefore, ASEAN’s open and effective trade policy is important in promoting business climate and attracting more investments. Through the set up of the ASEAN Promotion Centre on Trade, Investment and Tourism in 1981, ASEAN countries, namely ASEAN-4 had help in increasing its exports to Japan mainly in semiconductors and raw materials such as oil, gas and timber.

Through these policies, ASEAN-4 countries had managed to lower its cost of doing business and also improved its logistic performance. As these policies help in facilitating their trade, it also helped these countries in promoting investment to their country. Therefore, to proof my point, I would like to analyze three indicators from the Doing Business (DB) and the Logistic Performance Index (LPI) that were taken from the World Bank database. The two business environment indicators are namely the cost to start a business and the ease of doing business index. The cost to register a business is the cost to start a business normalized by presenting it as a percentage of gross national income (GNI) per capita.

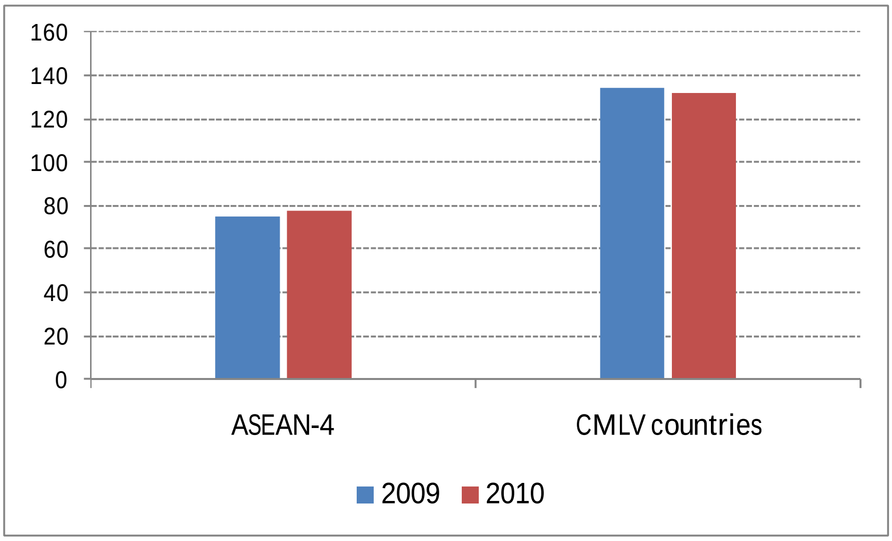
**Graph 8: Cost to start a business (% of income per capita)**




Source: World databank, Doing Business

Graph 8 as shown above is a graph on the cost to start a business. The blue line represents the ASEAN-4 countries and the red dotted line represents the CMLV countries' cost. From the graph, we could see that the cost to start up a business in ASEAN-4 countries has seen a substantial decrease, while CMLV countries are still lagging behind. However, efforts by their government that includes subsidizing certain sectors have been successful in reducing the cost from 38% to a mere 20% of income per capita in 2009.

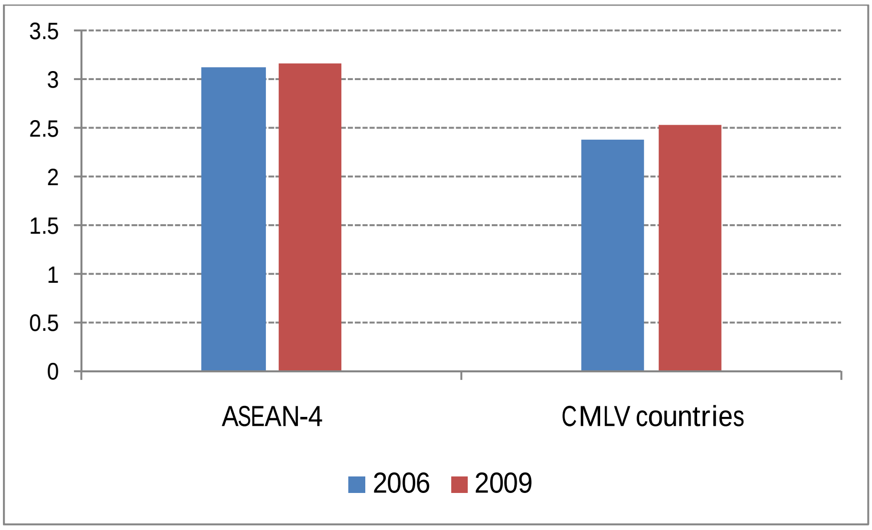
**Graph 9: Ease of doing business index (1=easiest to 183=most difficult)**




Source: World databank, Doing Business

Meanwhile, Graph 9 is a graph of ease of doing business index. The index ranks economies from 1 to 183, with first place being the best. A high ranking means that the regulatory environment is conducive to business operation. The index ranks the simple average of the country's percentile rankings on 10 topics covered in the World Bank's Doing Business. The ranking on each topic is the simple average of the percentile rankings on its component indicators[24]. From the graph, it is clearly shown that the CMLV countries still ranks high at 130 both in 2009 and 2010.

**Graph 10: Logistics performance index: Overall (1=low to 5=high)**




Source: World databank, World Development Indicators (WDI)

On the other hand, Graph 10 is a graph on logistic performance index of ASEAN-4 and CMLV countries. The data compares performance between 2006 and 2009 for both subgroups. Based on the World Bank definition, the Logistics Performance Index overall score reflects perceptions of a country's logistics based on efficiency of customs clearance process, quality of trade and transport-related infrastructure, ease of arranging competitively

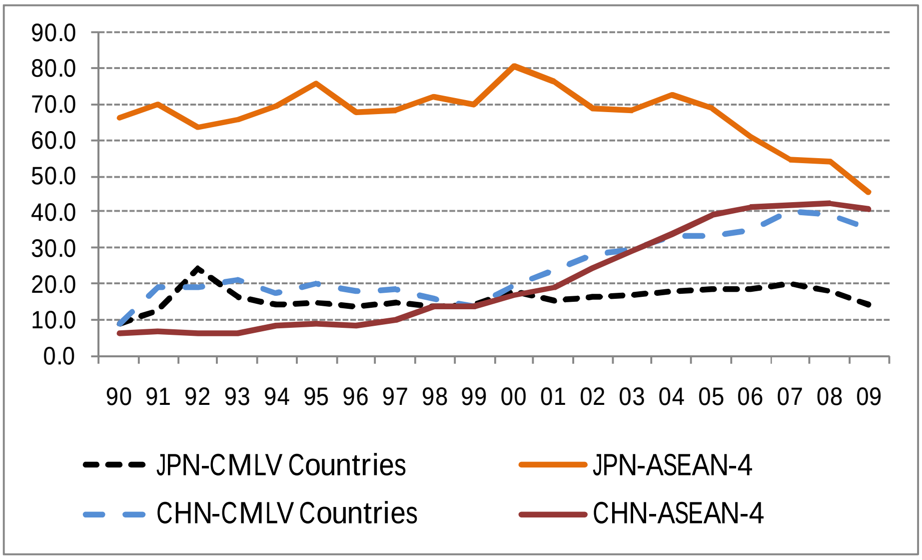
[24] See World Bank Doing Business (DB) definition.

priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time.

The index ranges from 1 to 5, with a higher score representing better performance. Data are from Logistics Performance Index surveys conducted by the World Bank in partnership with academic and international institutions and private companies and individuals engaged in international logistics. 2009 round of surveys covered more than 5,000 country assessments by nearly 1,000 international freight forwarders. Respondents evaluate eight markets on six core dimensions on a scale from 1 (worst) to 5 (best). The markets are chosen based on the most important export and import markets of the respondent's country, random selection, and, for landlocked countries, neighbouring countries that connect them with international markets. From the graph, we could see clearly that the ASEAN-4 countries have a higher overall scale compared to the CMLV countries.

***Trade Pattern***

**Graph 11: Trade Openness (Export + Import, % GDP)**




Source: Asian Development Bank (ADB), Key Economic Indicators

Based on graph 11, we could observe that the trade orientation of ASEAN-4 countries to Japan has been high in the 1990-00s. The direction of ASEAN's trade with Japan has been influenced by the latter's need for petroleum and raw materials and the former's need for capital goods. This is, of course, the typical trade pattern that has for long existed between the developed, industrialized countries with the developing countries. Thus, Indonesia and Malaysia, which are both rich in petroleum and other natural resources, have found Japan to be their biggest trading partner. Likewise, as a supplier of machinery and other capital goods, Japan has been ASEAN's biggest and most important trading partner also.

However in late 2000s, with the rapid growth of China and its needs for raw materials, trade orientation had increased tremendously between ASEAN-4 with China. Despite the diversifying trend to China, ASEAN-4 trade with Japan still remain at elevated levels. On the other hand, trade orientation of CMLV countries with Japan has been low throughout the past 20 years. Therefore, one might question the importance of ASEAN-4 countries to Japan and why the trade orientation towards ASEAN-4 has been high since the past 20 years. Therefore, it is important to look at the relation that has been established between Japan and ASEAN community namely the ASEAN-4 member countries.

***Japan-ASEAN Economic Relations***

ASEAN and Japan first established informal relations in 1973. The ties were later formalized with the establishment of the ASEAN-Japan Forum in March 1977. The meeting marked the formalization of the ASEAN-Japan Forum, entrusted with the task of reviewing, monitoring and recommending measures to strengthen and expand cooperation between ASEAN and Japan, particularly in the field of industrial development, trade, and food and agriculture.

**Table 2: Japan's bilateral agreement**

| FTAs in force | Year | Participants |
|---|---|---|
| ASEAN-Japan Framework Agreement for Comprehensive Economic Partnership (AJCEP) | signed in October 2003 | ASEAN |
| Japan- Brunei Darussalam Economic Partnership Agreement | signed in 2007 | Brunei |
| Japan-Indonesia Economic Partnership Agreement | signed in 2008 | Indonesia |
| Japan-Malaysia Economic Partnership Agreement | signed in 2005 | Malaysia |
| Japan-Philippines Economic Partnership Agreement | signed in 2006 | Philippines |
| Japan-Thailand Economic Partnership Agreement | signed in 2007 | Thailand |
| Japan-Singapore Economic Partnership Agreement | signed in 2002 | Singapore |
| Japan-Viet Nam Economic Partnership Agreement | signed in 2009 | Vietnam |

Source: Japan Ministry of Foreign Affairs (MOFA)

Japan adopted a two-track approach, involving a comprehensive economic partnership agreement with ASEAN as a group, and bilateral pacts with individual ASEAN countries. In table 2, we can see that the ASEAN-Japan Framework Agreement for Comprehensive Economic Partnership (AJCEP) was signed at the ASEAN-Japan Summit in October 2003[25].

The objectives of the AJCEP is to strengthen the ASEAN-Japan economic integration; enhance their mutual competitiveness in the world market; progressively liberalize and facilitate trade in goods and services and a transparent and liberal investment regime; explore new areas and develop appropriate measures for further cooperation and integration; and facilitate the more effective economic integration of CLMV countries and bridge the development gap in ASEAN.

[25] Japan's Ministry of Foreign Affairs (MOFA)

## SECTION 4

### *Conclusion*

Through the analysis, Japan's foreign aid has been directed more towards building political and economic relation. Since the past, Asia namely developing ASEAN countries has been the top recipient of Japan's foreign aid. Their relation can be traced back since the 1970-80s. However, the aid allocation pattern has changed dramatically throughout the years. In the past, the top recipient were the ASEAN-4 countries but, this trend has somewhat changed and directed to the CMLV countries. The change in trend can be explained through the rising importance of the CMLV countries in the past century.

As the literature pointed out, there is considerable evidence that that political and strategic consideration plays an important part in foreign aid allocation pattern[26]. The argument of donor allocating aid more towards countries with sound political and governance also are being supported by the three governance indicators I've discussed earlier. The indicators were taken from the World Bank Governance Indicators (WGI) namely the control of corruption, government effectiveness and regulatory quality[27]. Japan's foreign aid also has been allocated mainly towards infrastructure and building trade capacity. This preference can also explain Japan's policy towards building political and economic relation. .

The importance of infrastructure in attracting FDI deserves special notice in the context of this paper. Specifically, transport and communication should be important predictors of investment. A well developed transportation infrastructure reduces the costs of importing inputs and exporting or distributing output as well as a good communication infrastructure

[26] Alsenia and Dollar (2000)

[27] See graph 4 to 6 on the World Governance Indicators (WGI)

facilitate and reduce the cost of communication of affiliates.” This suggests a broad consensus in the literature that FDI is attracted to states with more infrastructures, controlling for other factors.

Further, foreign investors are attracted or deterred by government policies, perceptions of corruption, trade barriers, and political institution. Thus, many FDI-seeking governments offer incentives in the form of tax breaks and special policies that improve their appeal in the eyes of investors. Prudent macroeconomic management is required to provide a stable and predictable commercial policy environment, and to ensure that exchange rate outcomes do not impair competitiveness. Above all, political stability and policy certainty figure prominently among prerequisites for profitable long-term investment, particularly for multinational enterprises (MNEs).

Favourable labour markets in the form of relatively low wages and an educated workforce can also be very attractive to foreign corporations. Others attract more by favourable investment and trade policies. Through liberalizing their market and engaging in FTAs, country could attract more FDI. This commitment to free trade and to certain international standards increases foreign and domestic firms’ confidence in investing in a host country, thereby increasing trade flows, growth, and investment opportunities.

### *Limitation and Recommendation*

When writing this paper, I've encountered some limitation. I've noticed that the percentage of ODA disbursement over commitment range from 45% to 90%. The data was gathered through the OECD-DAC[28] aid online database. The data imply that the total aid committed by a particular donor differ from the actually total aid disbursement. Therefore, the trends and estimated analysis may deviate from true ones. Results from the analysis can be improved further through having an alternative agencies gathering the data. Although there are a number of international agencies such as the World Bank and OECD as well as donor agency such as JICA, it is worth noting also of a possibility of setting up an agency handled by the recipient country.

Through the establishment of this agency, the recipient not only could be as an alternative in providing inaccessible data, but also could act as a one stop agency where the donor as well as companies could access information ranging from economic situation and political environment of the country. As I pointed out earlier, Japan's foreign aid has a vanguard effect as the government provided inaccessible information to these companies for them to make their business decision.

Therefore, there is a diffusion of information on the recipient country to private firms of the donor country. Business rules and standards specific to the recipient country could also be access through this agency. Therefore, recipient country that is FDI-seeker could promote their country through this agency.

[28]Organization for Economic Cooperation and Development (OECD), International Development Statistics (IDS), aid and other flows online database. http://stats.oecd.org

Other than that, strong cooperation between donors and recipients country also could help improve the disbursement. Cooperation such as monitoring, monthly or quarterly meetings between the donor and recipient country could be conducted that could help to improve the disbursement.

Stronger partnerships between the donor countries with the private sector also could be establish in helping to develop trade facilitation, trade and investment that would benefit both the donor and recipient. Partnership with the private sector such as the Public, Private Partnership (PPP) could also be employed to recipient country in helping to promote development in their country.

## *Appendix*

CRS Purpose Coda and Categories

| 2. ECONOMIC INFRASTRUCTURE | |
|---|---|
| 21010 to 21081 | Transport and storage |
| 22010 to 22040 | Communications |
| 23010 to 23082 | Energy supply and generation |

Source: OECD – DAC, www.oecd.org/dac/stats

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