Foreign Direct

INVESTMENT

The Key to Asia's Future Economic Growth?

by Dennis J. Encarnation

GLENN PIERCE

THROUGHOUT 1997, East Asia's unfolding financial crises provoked scathing critiques of the role of foreign investors in the region's downward spiral. According to the critics, the same foreign investment that had helped spawn the East Asian economic miracle had come to exacerbate, if not cause, the current problems. And for many Asians, as well as for analysts elsewhere, foreign investment remains a debatable part of

Dennis J. Encarnation is director of the Asia-Pacific Policy Program at the Center for Business and Government, Kennedy School of Government, Harvard

any proposed solution.

But before rushing to judgment about foreign investors in East Asia, it is important to remember that foreign investors come in many varieties. Foreign debt must be distinguished from foreign equity. Among debt instruments, short-term borrowings must be distinguished from long-term lending. Among private lenders, commercial banks must be distinguished from nonbank creditors, including bondholders and trade financiers. And of course private lenders must be distinguished from official lenders, which can be multilateral institutions or individual foreign governments. Among the forms of foreign equity, foreign portfolio investments in local stock markets by mutual funds and other institutional investors differ from foreign direct investments (FDI), typically by multinational corporations that consciously combine equity ownership with managerial control. Even FDI must be further dissected—into new cross-border flows and local earnings reinvested in the host economy where they were generated.

Each of these forms of foreign investment has responded differently to East Asia's ever-changing opportunities and risks. Discerning these differences is critical to understanding both the likely causes of, and the potential solutions to, the region's current financial crises. Among potential solutions, foreign direct investment figures prominently. Indeed, throughout the crises, FDI has remained one of the few private sources of foreign investment for much of East Asia. And because foreign direct investment often facilitates the cross-border transfer of foreign technology as well as better access to foreign markets, a credible case can be made that it will become even more critical to East Asia's future economic growth.

> With increased exports critical to recovery, East Asian governments are competing fiercely for foreign direct investment in export-

FDI IN THE CRISIS ECONOMIES

The external financing of East Asia's five most afflicted economies—Indonesia, Korea, Malaysia, the Philippines, and Thailand—illustrates foreign investors' varied responses to the financial crises (see table 1). Before 1997 these five economies financed their current account deficits and increased their foreign exchange reserves principally through private commercial borrowings, largely short-term debt regularly rolled over year after year. They supplemented these borrowings with additional foreign loans from bondholders, trade creditors, and other nonbank lenders, as well as with foreign portfolio investments by mutual funds and other institutional investors interested in these "emerging markets."

During 1997 the pattern changed dramatically. As multiple crises unfolded, foreign direct investment and nonbank credit quickly became the only remaining private sources of foreign investment in all five economies. Foreign commercial banks withdrew large sums, as did foreign portfolio investors. To finance these new foreign investment outflows as well as ongoing current account deficits, the five countries had to turn to official, especially multilateral, sources of external financing. But securing access to such funding necessitated individual negotiations with the IMF—except in the case of Malaysia, which has to date held the IMF at bay.

The Institute for International Finance predicts that this year foreign direct investment will be the sole private source of net foreign capital inflows; the *only* alternative will be funding from official sources, principally the IMF, the World Bank, and other multilateral institutions that impose major conditions on their lending. Not surprisingly, as other sources of foreign investment dry up, governments in the region have sharply escalated their competition for foreign direct investment.

COMPETITION FOR FOREIGN EXCHANGE

With increased exports critical to recovery, all five governments are competing fiercely for foreign direct investment in export-oriented projects. The Institute for International Finance estimates that the five will collectively record current account surpluses during 1998, thanks both to a contraction in domestic demand and related imports and to an increase in merchandise exports, including those linked to foreign direct investment. Foreign direct investment has thus emerged as an important source of foreign exchange for crisis-afflicted economies not only on their capital account, but also on their current account (through exports).

The role of foreign direct investment varies widely across the region's economies and industries. Much of it is concentrated in manufacturing, where government competition is most intense, especially in Southeast Asia. There, Indonesia, Malaysia, and Thailand have become destinations for foreign direct investment and are likely to remain so, as reinvested earnings grow along with economic recovery. Korea has long sought to limit foreign direct investment in manufacturing though elaborate capital controls. Although Korea has begun to dismantle those controls, the economic impact of Korea's liberalization remains in doubt given the uneven experiences of prospective foreign investors there.

> Asia's financial crises have brought the United States back into East Asia as a renewed economic and political actor —with broad security implications.

In financial services, Korea has much in common with Indonesia, Malaysia, the Philippines, and Thailand. In all five, foreign direct investment in banking and other financial services has long been severely restricted by capital controls that largely relegated foreign investors to niche markets. But these controls have probably limited cross-border transfers of foreign technology. In manufacturing, Korea and other countries have long preferred to unbundle technology from foreign direct investment whenever possible through licensing agreements. But in financial services, technology licensing tends to be much less common, making foreign direct investment more critical to the cross-border transfer of financial processes and products, as well as managerial skills, from more advanced markets. Foreign direct investment may thus be crucial to the long-term restructuring of financial services in afflicted East Asian economies.

INTRA-ASIAN FOREIGN DIRECT INVESTMENT

While the troubled economies of East Asia seek foreign direct investment from abroad, most of it comes from elsewhere in the region. Japan has long been Asia's largest source of foreign direct investment. And Asia has for years been second only to the United States as a destination for Japanese foreign direct investment. But during the 1990s fresh outflows of Japanese foreign direct investment began to slow. At home the popping of Japan's bubble economy early in the decade combined with subsequent recessions to limit the value of fresh outflows; while financial crises in Indonesia, Malaysia, and Thailand—all host to sizable shares of Japanese foreign direct investment—limited the value of reinvested earnings. These problems at home and abroad are likely to diminish Japan's relative importance as a source of foreign direct investment flows to other Asian economies, especially those in financial crisis.

Meanwhile, other Asian economies have become more important sources of intra-regional foreign direct investment. Indeed, the intra-regional bias of foreign direct investment from these other Asian investors has become more pronounced. According to a recent study by the Japan External Trade Organization, by 1996 Hong Kong had become East Asia's chief source of annual foreign direct investment inflows. Estimates of Hong Kong's FDI outflows are no doubt boosted by its intermediation of capital flows originating elsewhere (typically Taiwan and mainland China). But Hong Kong is likely to maintain its status as a major foreign investor in its own right, as well as a key center for capital intermediation in Asia, as long as it can continue to weather Asia's financial crises. Should these crises spread, Hong Kong's status as a principal source of foreign direct investment and other capital outflows to the rest of Asia increases the risk that it will suffer from this contagion.

According to official statistics, the region's other newly industrialized economies—Korea, Singapore, and Taiwan—are the next largest sources of foreign direct investment. The offi-

Table 1. Total External Financing for Indonesia, Korea, Malaysia, the Philippines, and Thailand (Billions of U.S. dollars)

	1996	1997	1998
Current account balance	-54.9	-26.0	17.6
External financing (net)			
Foreign direct investment	7.0	7.2	9.8
Portfolio investment	12.1	-11.6	-1.9
Commercial bank debt	55.5	-21.3	-14.1
Nonbank private creditors	18.4	13.7	-3.2
Multilateral financial institutions	18.5	-1.0	23.0
Bilateral creditors	0.7	4.3	6.1
All other (net, including errors and omissions)	-19.6	-11.9	-5.7
Reserves (excluding gold) (- = increase; + = decrease)	-18.3	22.7	-27.1

Source: Institute for International Finance, "Capital Flows in

cial statistics underestimate the relative value of their FDI, especially that of Korea and Taiwan, where home-government policies have often conflicted with corporate strategies. At any rate, Korea's relative importance as a regional source of foreign direct investment is likely to decline as it adjusts to its own financial crisis and to related crises in other Asian economies, such as Indonesia, that host sizable shares of Korean FDI. By comparison, Singapore and Taiwan, having been largely spared the current crises, may see their relative importance as Asian sources of intra-regional foreign direct investment grow. Dampening this prospect, however, is the heavy concentration of their FDI in Indonesia, Malaysia, the Philippines, and Thailand. Regardless, the newfound status of Singapore and especially Taiwan has already begun to produce subtle but important changes in the political economy of East Asia, as evidenced recently by Taiwan's diplomatic forays across the region.

CHINA AND BEYOND

Much of this intra-Asian foreign direct investment, especially that from Hong Kong and Taiwan, is concentrated in mainland China. According to World Bank estimates, last year China attracted more than half of the projected $70 billion in foreign direct investment flowing into Asia. This status is quite new: as recently as 1990, China was second to Singapore as a recipient of new FDI inflows. Any estimates of China's FDI inflows must be corrected for the circular flow ("roundtripping") of foreign direct investment from, and then back to, China—nearly all via Hong Kong. But after correcting for roundtripping that may make up as much as a quarter of all FDI officially recorded in China, China still accounts for well over two-fifths of FDI flows into Asia.

The roundtripping of Chinese investors is one sign that government competition for FDI extends well beyond the troubled economies of Southeast Asia. China's discriminatory application of investment incentives so strongly favors Hong Kong and other foreign investors that domestic Chinese investors feel compelled to roundtrip through Hong Kong to qualify for Chinese government concessions when they return to China. But intra-regional, inter-governmental competition does not end here. China and other Asian governments, for example, may also compete in devaluing their currencies to boost exports from existing (foreign and domestic) producers, as well as to attract new investments from prospective (again, foreign and domestic) producers. By this logic, currency devaluations outside of China, across much of the rest of East Asia, have intensified pressure on Chinese policymakers to respond by devaluing their own fixed-rate currency, thus raising the specter of a downward spiral of exchange rates across the region, as governments and speculators alike respond to competitive pressures.

Because China and other East Asian economies are increasingly integrated, not so much through trade but through foreign direct investment and other capital flows, government policies and corporate strategies in one economy inevitably shape policies and strategies elsewhere in the region. Thus, the financial crises afflicting Indonesia, Korea, Malaysia, the Philippines, and Thailand quickly can spill beyond their national borders, as the case of Charoen Pokphand (CP) shows. A Sino-Thai conglomerate with FDI spread across the afflicted economies of Southeast Asia, CP is also one of the oldest and largest foreign investors in China. But according to recent press reports, CP's regional investments in China and elsewhere are now threatened by its difficulties in rescheduling its mounting debt both at home and abroad. CP's case, hardly unique, illustrates how intra-Asian FDI contributes to a larger contagion effect threatening to spread financial crises across the region, back and forth between Asia's home and host economies.

IMPLICATIONS FOR THE UNITED STATES

The United States runs a much smaller risk of importing Asia's financial contagion through foreign direct investment. Outside of Japan, Asia has typically accounted for only about 10 percent both of the cumulative stocks of U.S. foreign direct investment abroad and of annual U.S. FDI outflows—only slightly more than U.S. FDI in South America. And more than three-fifths of the cumulative stock of U.S. foreign direct investment in East Asia is in Singapore and Hong Kong, both largely unaffected to date by the region's financial crises. According to the JETRO study cited above, during 1996 both Japan and Hong Kong had FDI inflows into East Asia with a dollar value double that of inflows from the United States. U.S. inflows even lagged those of the 12-member European Union.

But the East Asian financial crises are likely to increase both the importance of East Asia to American multinationals and the relative importance of U.S. foreign direct investment to that region's economies. Helping to fund this expansion is the robust profitability recorded by American multinationals at home. Indeed the U.S. press is replete with news of American multinationals seeking to exploit new opportunities in East Asia resulting from sharp declines in local share prices and a sharp rise in the relative value of the U.S. dollar. Exploiting these new Asian opportunities are a "Who's Who" of American multinationals—General Motors in Korea and China, Ford in the Philippines, Citibank and GE Capital in Japan, to name but a few. Such U.S. foreign direct investment is likely to figure prominently in the future growth and structural adjustment of a growing number of East Asian economies.

Viewed more broadly, the anticipated increase in U.S. foreign direct investment across East Asia heralds a much larger set of important changes in that region's political economy. Asia's financial crises have brought the United States back into the region as a renewed economic and political actor—with broad security implications. Not that long ago, America's withdrawal from Asia was a hot topic widely debated on both sides of the Pacific.The response of the U.S. government and American multinationals to Asia's financial crises has largely ended that debate. ■