

Research Focus

FDI Flows to Asia: Did the Dragon Crowd out the Tigers?

Benoît Mercereau

In recent years, China has topped the list of destinations for foreign direct investment (FDI) among developing and emerging market countries. But has its stellar performance come at the price of reduced FDI elsewhere in Asia? Generally, no, suggests a recent study done at the International Monetary Fund.

Many developing countries have been eager to attract FDI flows, which are not as volatile as other types of capital flows, tend to boost technology transfers and raise growth rates, and can spur domestic investment. China's success in attracting FDI has been impressive. Only 25 years ago, China's share of FDI in developing Asia was about 10 per cent. By 2002, China's share had risen to 70 per cent.

With this success, however, have come fears that China has diverted flows from other countries in the region. But, an increase in FDI flows to China does not have to imply a reduction in flows to other nations. First, a large share of FDI to China comes from overseas Chinese who might not have invested in other economies. (Hong Kong SAR, Taiwan Province Of China, and Singapore account for over 50 per cent of total FDI in China.) Second, China's development may have increased foreign investment in the countries that supply China with the inputs needed for its growth, such as raw materials or components that are assembled in China. China's emergence as a major magnet for FDI may therefore have increased flows to neighbouring economies, rather than reduced them.

Little work has been done on the implications for FDI flows to other countries of China's successful reform of its capital account. One simulation of the impact of China's accession to the WTO on the ASEAN group of countries finds that ASEAN economies might experience significant welfare losses if FDI were significantly redirected away from ASEAN countries

to China. One estimate of the 'crowding-out' by China for eight Asian economies from 1985 to 2001 finds that the level of China's foreign investment is positively related to the levels of the other economies' inward direct investment. Another estimate of this crowding-out by China, using a gravity model, finds that China's emergence had a positive impact on FDI flows to Asian economies, but a negative one on flows to the OECD member countries. The way these papers assess crowding-out by China is problematic, however.

For a clearer sense of what has, in fact, happened, our study, using a new methodology, analysed data for 1984-2002 for 14 Asian economies (Bangladesh, China, India, Indonesia, the Republic of Korea, Malaysia, Myanmar, Papua New Guinea, the Philippines, Singapore, Sri Lanka, Taiwan Province Of China, Thailand, and Vietnam.¹).

Did China reduce flows to other countries?

Overall, results suggest that China's success at attracting FDI did not reduce flows to other countries in Asia. The study found that China reduced flows to other countries on average. But a closer look at the data shows that this average reduction comes from two nations only: Myanmar and Singapore. Moreover, it is likely that this statistically significant relationship between China's emergence and FDI flows to Singapore and especially Myanmar is coincidental. Political developments and other factors happening at the time China opened its door to FDI probably drive the apparent negative relationship between China's rise and FDI flows to these two nations. Importantly, our study finds that increases in flows to China do not seem to have affected any other country covered by this study.

Crawford School of Economics and Government

Effective July 1, we have become the Crawford School of Economics and Government. The renaming has been driven by a wider reorganisation underway at ANU to create a college framework and coincides with the unveiling of plans for a new building for our School.

Professor MacIntyre, Director of the Crawford School said 'Sir John Crawford was a great Australian civil servant and former Chancellor of the ANU who was a key player in reorienting Australian economic policy in the mid-twentieth century and, along with a few counterparts in Japan and the United States, a pioneer in the building of an Asia Pacific economic and policy community. We think this is a wonderful legacy with which to associate ourselves and captures a central part of our mission as a graduate policy school.'

Preparing for APEC 2007

A major new research project which will study ways of improving policy processes and regional cooperation mechanisms to enhance the national policy performance of East Asian economies will be launched in Canberra on 16-17 July. The project is regional in nature, addressing priorities for the key East Asian economies and their strategies in APEC. The research will involve policy influential economists, as well as officials, in East Asia. The objective is to identify ways that will assist in strengthening national institutions and regional arrangements that are supportive of microeconomic reform as a basis for growth and prosperity. The project will seek to develop initiatives on issues that are central to core APEC priorities and policy formulation, in particular by its Economic Committee (EC).

The project will be coordinated through the East Asian Bureau of Economic Research (EABER) at the Crawford School of Economics and Government at the Australian National

Do some characteristics make economies more subject to crowding-out by China?

It is sometimes argued that low-income countries, which compete with China for low-wage investment, suffer more from competition from China, while countries that invest more in human capital and research and development are less affected. Our study investigates this issue by assessing whether low levels of GDP per capita, of education or of scientific development, are associated with increased diversion of FDI flows by China. The study finds no evidence that low-income economies have suffered more than higher-income ones. Low investment in education or in sciences is not associated with increased crowding-out by China either.

What can countries do to attract more FDI?

Governments are not helpless when it comes to attracting FDI. Some economic fundamentals help explain the allocation of FDI

flows among Asian countries, however, which suggests that countries might attract more FDI by improving these fundamentals. Results from our study suggest that healthy fiscal balances and low inflation, in particular, have a positive impact on FDI. Other studies find that corruption deters FDI, while democracy increases it. There are, therefore, measures that authorities can take to deal with such fundamental factors that will make their countries more attractive FDI destinations, regardless of competition from other nations.

Is China's emergence a threat or an opportunity?

China's emergence as a major destination for FDI flows has thus far not seemed to have had a negative impact on most of its neighbours. However, the sheer size of China and the likelihood that India may soon follow in its footsteps make it important to continue analysing the regional and global impact of these two demographic giants. Research could also corroborate how FDI flows to China

enhance regional trade, as investment in China spurs demand for capital goods from other nations.

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Reference

This article summarises a seminar presented in the Economics of Trade and Development Seminar Series at the Australian National University on 8 June 2006. The results of this research are also available as 'FDI Flows to Asia: Did the Dragon Crowd Out the Tigers?' *International Monetary Fund Working Paper* 05/189. The views expressed in this article are those of its author and should not be interpreted as the views of the International Monetary Fund.

Footnotes

¹ The study covers all Asian economies with a population greater than 4 million, except Japan. Cambodia, Hong Kong SAR, the Lao People's Democratic Republic, and Nepal are not included because of insufficient data.

University and will take advantage of the research infrastructure and networks that have been established through the ongoing program of research on advancing East Asian integration (AEAI) supported by the Australian Government (AusAID) and the Japanese Government (MOF).

The project is supported by the Australian Government's PLSP Program through AusAID, the Research Institute of Economic and Social Policy of the Japanese Cabinet Office, the Korea Institute of International Policy, and ICEAPS through the East Asian Forum.

Events

16–17 July, *Institutional Strategies within APEC for Improving the Micro Economic Policy Foundations of East Asia's Economic Performance*, workshop, Canberra

21–22 July, *East Asia a Decade after the Crisis*, conference, Canberra

31 July, *30th Anniversary of the Australia–Japan Treaty of Friendship and Cooperation*, workshop, Canberra

6–7 August, *Asia Pacific and East Asian Architecture for Economic and Political Cooperation*, conference, Canberra

29 August, *China Update*, Canberra

29–30 August, *China and East Asia Energy Issues*, conference, Canberra

School seminars**

25 July, Stephan Haggard (UC San Diego), *Famine in North Korea: Markets, Aid and Reform*

1 August, Richard McLoughlin, (Australian Fisheries Management Authority), *Turning a financially failing and environmentally struggling industry around – policy and resource management development in the Australian fishing industry*

8 August, Andrew MacIntyre (Crawford School), *East Timor: Getting it Wrong and Getting it Right*

**Seminars are held at 12.30 pm in Seminar Room 4, First Floor, Crawford Building

Publications

Asian Pacific Economic Literature (APEL) Volume 20, Number 1, May 2006

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