

Discussion of:

# “The Chinese Approach to Capital Flows”

by

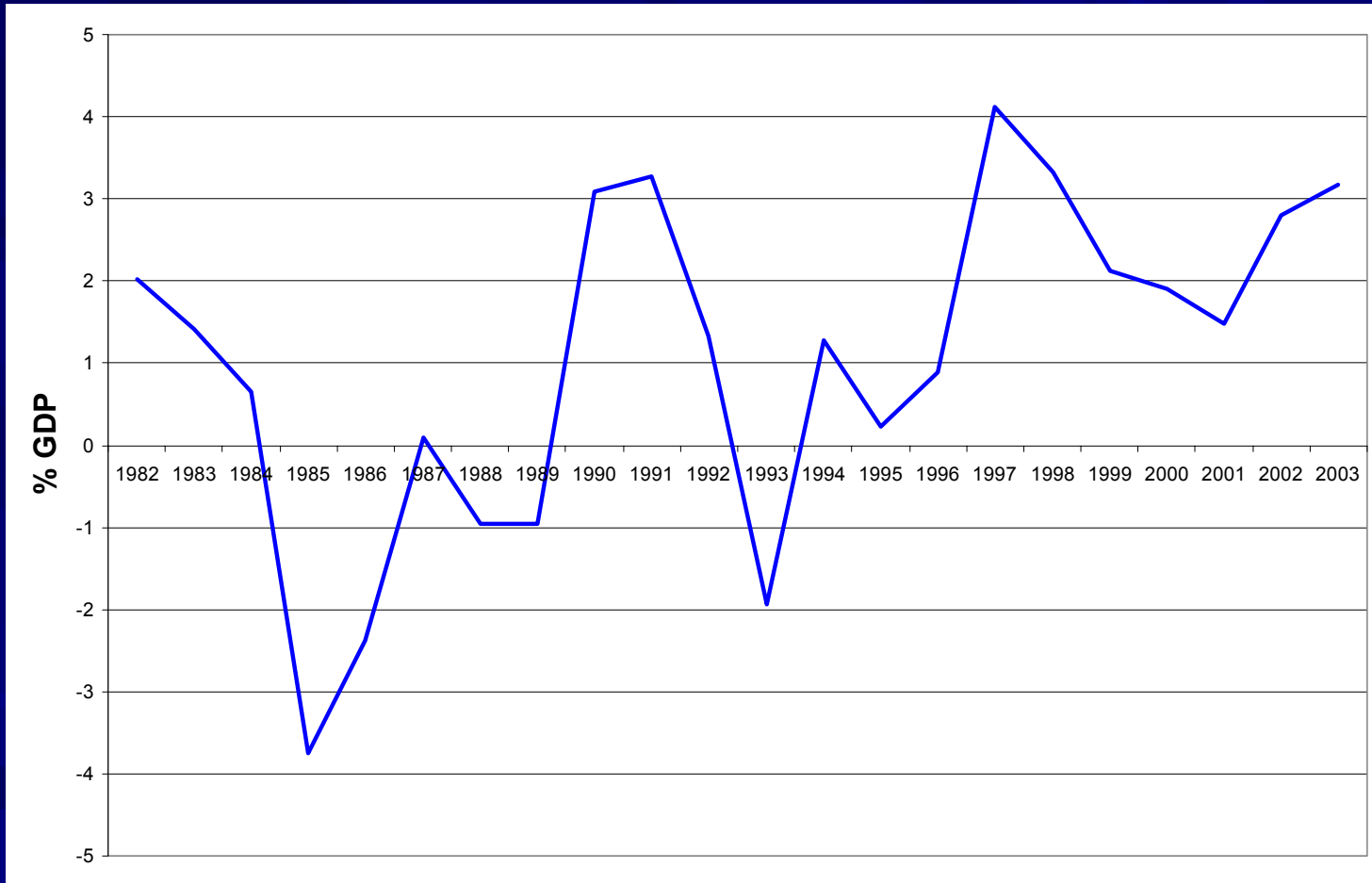
Eswar Prasad and Shang-Jin Wei

Mark L. J. Wright  
Stanford University

SCID China Conference

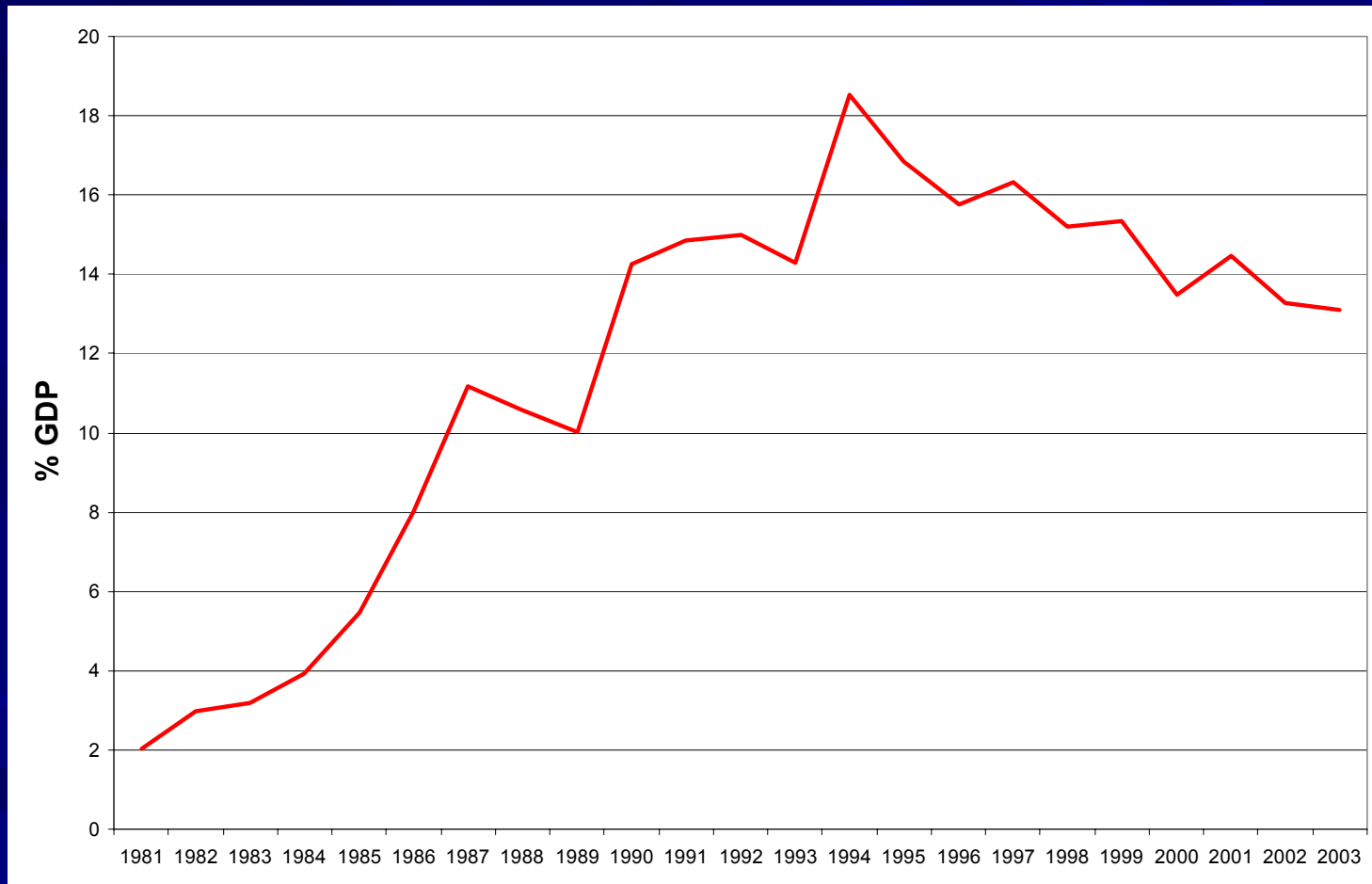
15<sup>th</sup> October 2004

# Net Capital Flows: Surplus



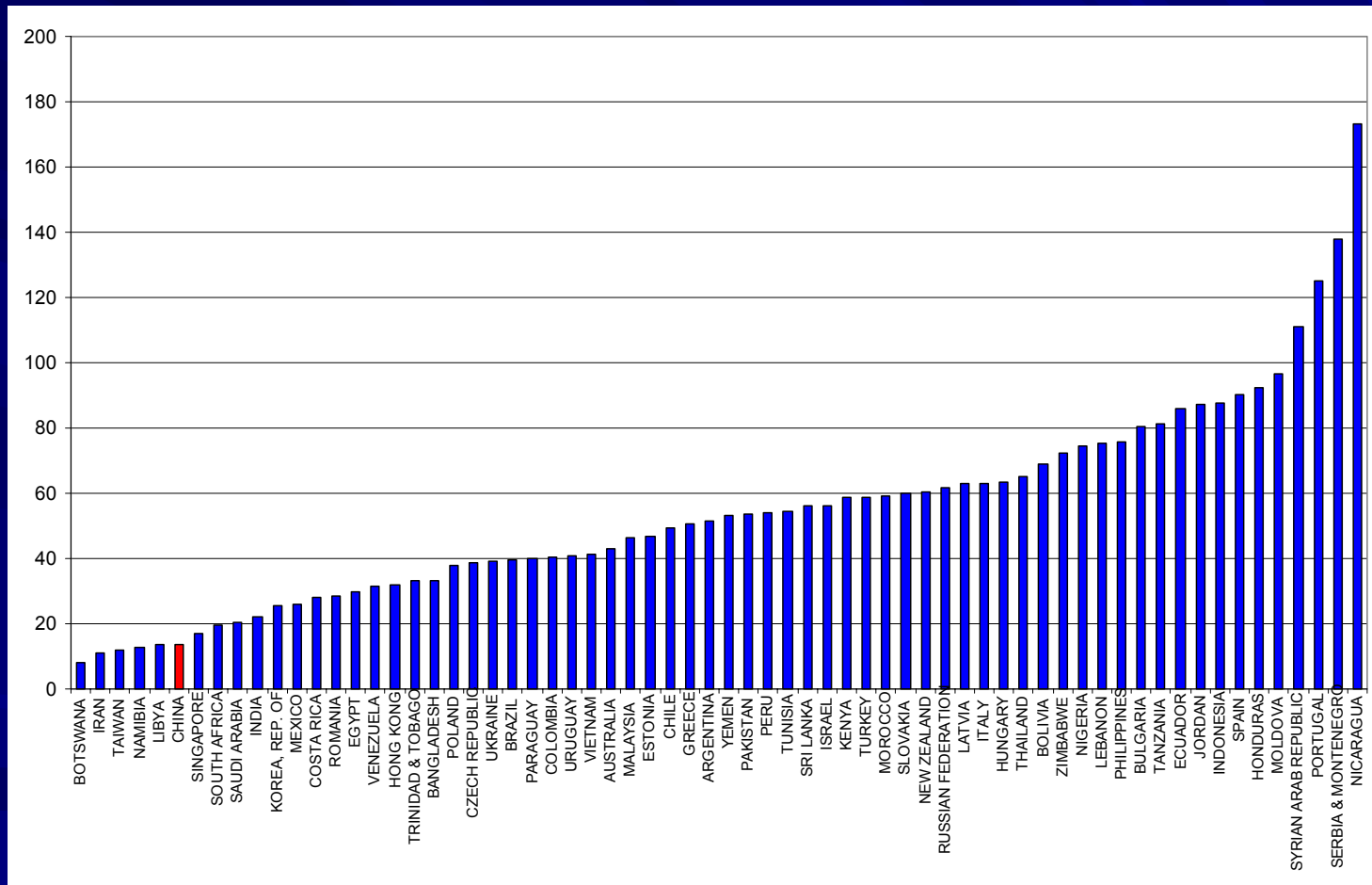
Source: EIU

# External Debt Declining ...



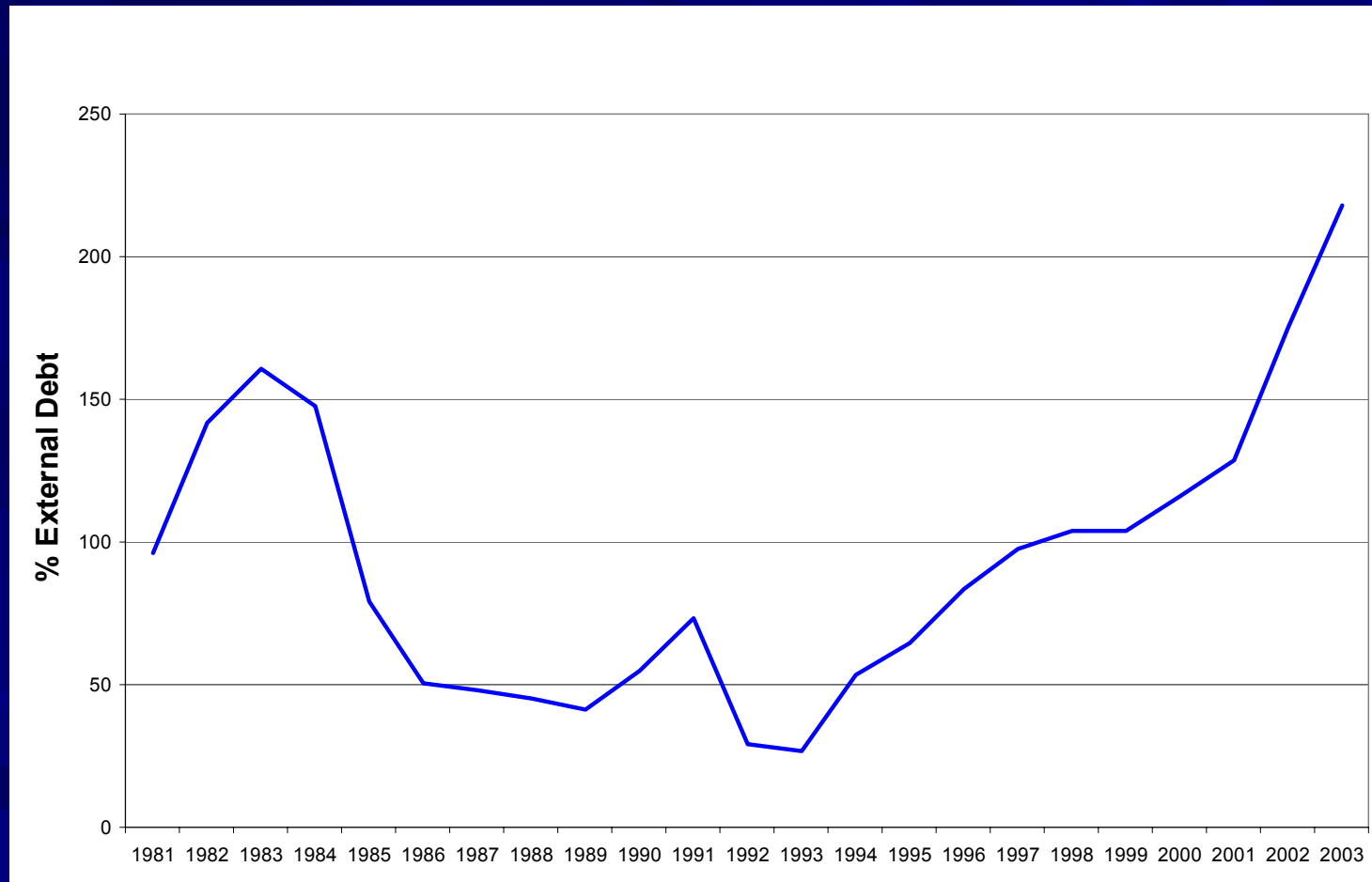
Source: EIU; medium and long-term debt

# ... and Relatively Low



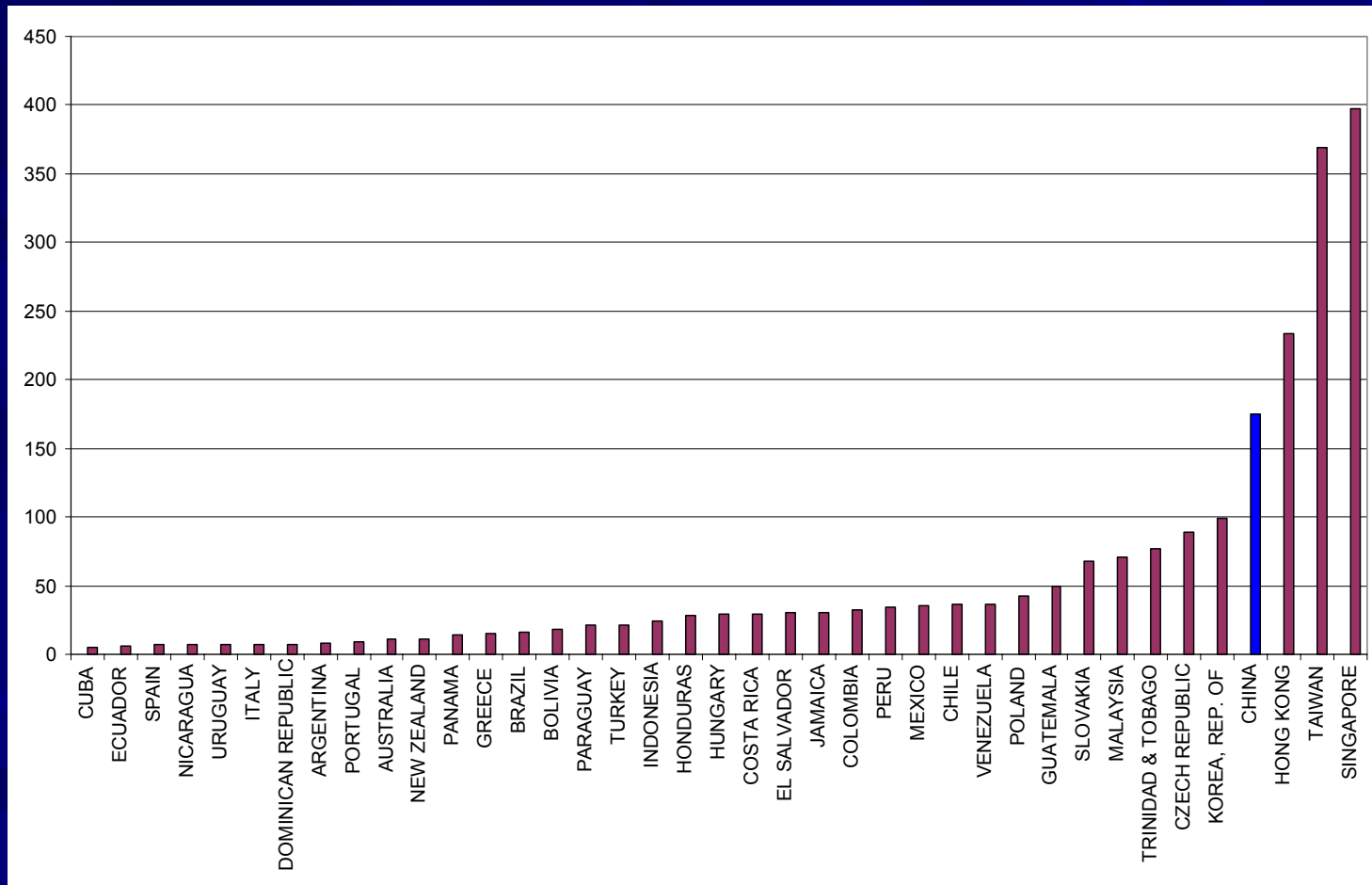
Source: EIU; medium and long-term debt as % GDP, 2002

# Int'l Reserves/Debt rising ...



Source: EIU; medium and long-term debt as %GDP

# ... and relatively high



Source: EIU, 2002; reserves to medium and long-term debt

# Are there any reasons for concern?

- China does *not* seem vulnerable to debt or liquidity crisis
- But ... this does not imply capital flows are efficient or optimal
  - Might expect China, like most high growth countries in history, to be a large net borrower
  - Is composition of capital inflows a cause for concern?
    - Bias towards FDI
    - Recent increases in short-term debt
- Major contribution of paper is to point to issues of concern with composition of capital flows
- My discussion will focus on FDI

# A Closer Look at FDI

- A common view is that foreign direct investment (FDI) is a better form of capital ...
  - Brings with it technology, managerial skills and market access
  - It is less mobile, and hence less prone to capital flight
  - Easier to enforce repayment (combined with necessary inputs)
- ... while debt (especially short-term debt) is bad ...
  - Driven by speculative considerations (“hot money”)
  - Distorted by moral hazard (implicit exchange rate guarantees or implied government bailouts of the banking system)
- Indeed, volume of FDI has been largest to/from developed world

# FDI Volumes by Region

Table 1. Regional Allocation of FDI Inflows, 1990–2001  
(Billions of U.S. dollars)

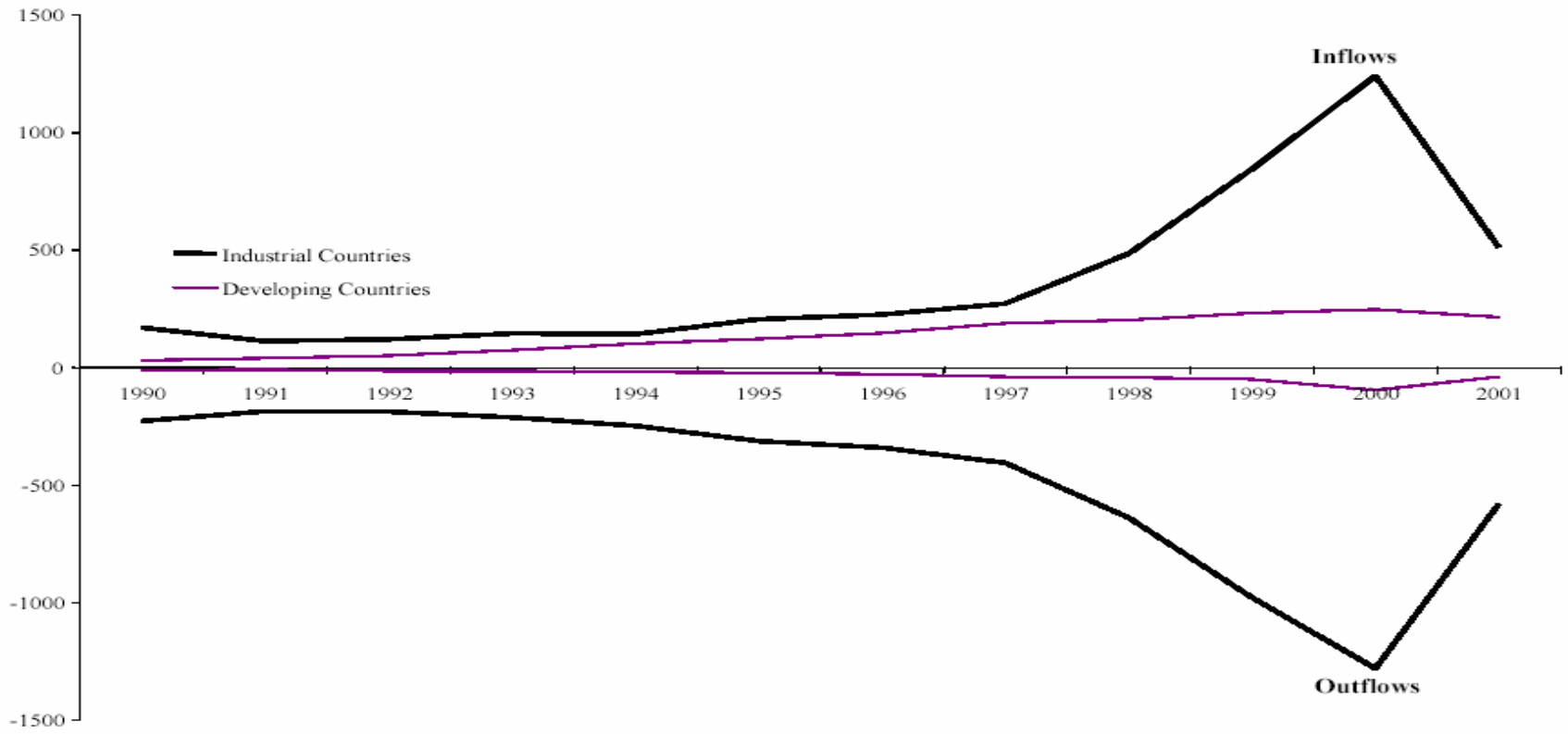
	1990–94 (Average)	1995	1996	1997	1998	1999	2000	2001
<b>Total</b>	197.7	327.9	372.9	461.4	690.4	1076.6	1489.8	729.2
<b>Industrial countries</b>	137.7	205.5	226.4	272.3	486.5	844.8	1241.5	513.8
<b>Developing countries <sup>1/</sup></b>	59.9	122.4	146.5	189.1	203.9	231.8	248.3	215.4
<b>Africa</b>	2.7	5.0	5.3	9.8	7.5	9.7	7.5	17.7
<b>Asia</b>	33.5	66.3	74.4	82.8	87.0	99.9	128.2	91.4
<i>o/w China P.R.</i>	16.1	35.8	40.2	44.2	43.8	38.8	38.4	44.2
<i>Hong Kong SAR</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	14.8	24.6	61.9*	22.8
<b>Europe</b>	4.4	17.4	16.7	22.3	26.6	29.3	30.1	31.2
<b>Middle East</b>	3.6	3.2	5.8	8.0	9.3	4.9	6.5	5.7
<b>Western Hemisphere</b>	15.7	30.5	44.4	66.2	73.5	88.0	76.0	69.5
<i>o/w Argentina</i>	3.0	5.6	6.9	9.2	7.3	24.0	11.7	3.2
<i>Brazil</i>	1.7	4.9	11.2	19.7	31.9	28.6	32.8	22.6
<i>Mexico</i>	5.4	9.5	9.2	12.8	11.9	12.5	14.2	24.7

<sup>1/</sup> The FDI data for industrial and developing countries used in this section relate to the balance of payments statistics published in the *Balance of Payments Statistics Yearbook (BOPSY)*. The coverage of “developing countries” is broader than the *WEO* classification of the group of developing countries as it includes Cyprus, Hong Kong SAR, Israel, Korea, Singapore, and the countries in transition.

\* Reflects mergers and acquisitions transactions in the telecommunications sector. Source: *External Direct Investment Statistics of Hong Kong 2001*.

# Absolute values of FDI

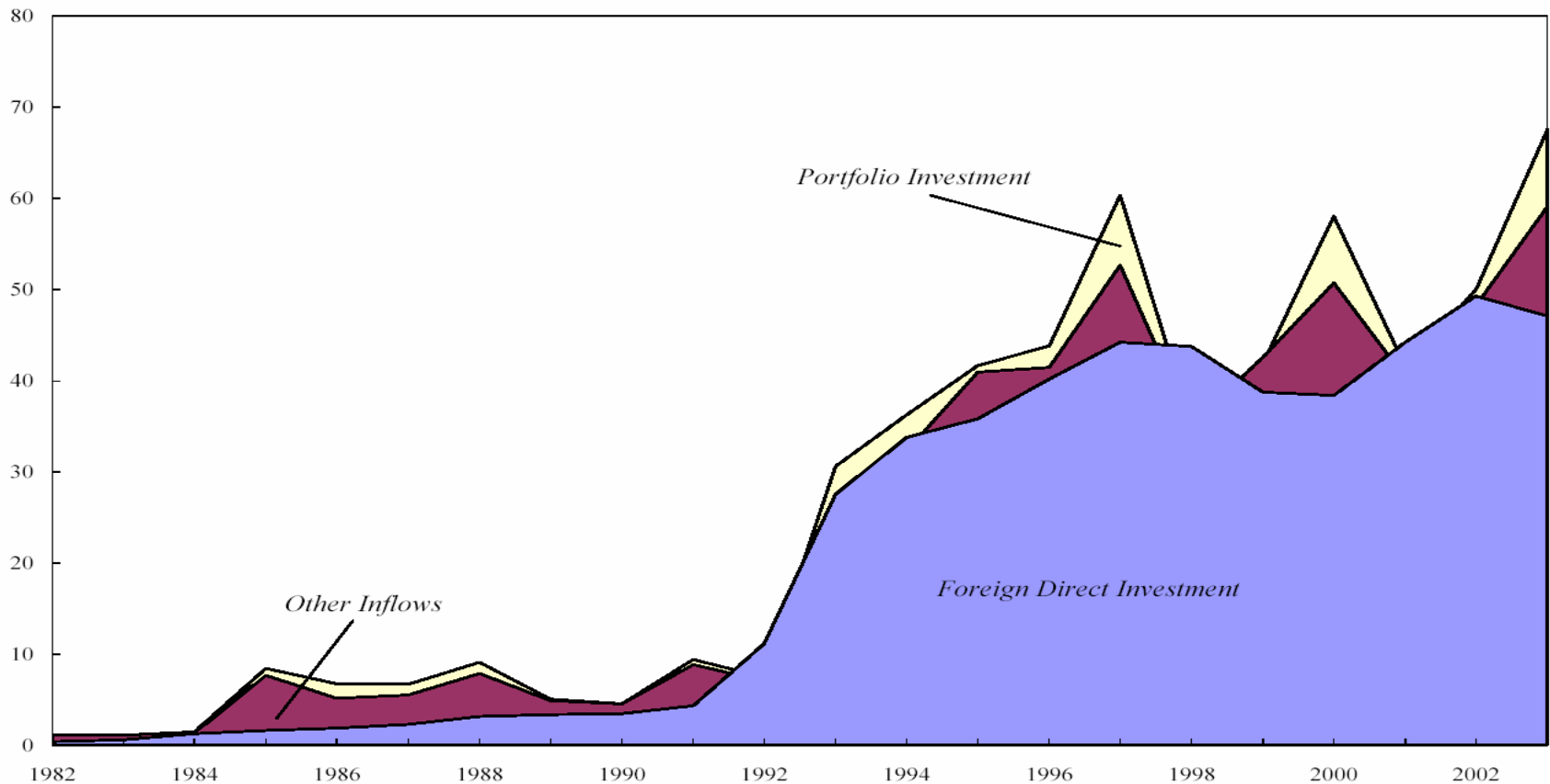
Figure 1. Direct Investment Capital Flows, 1990–2001  
(Billions of U.S. dollars)



Source: IMF "FDI Trends and Statistics" 2003

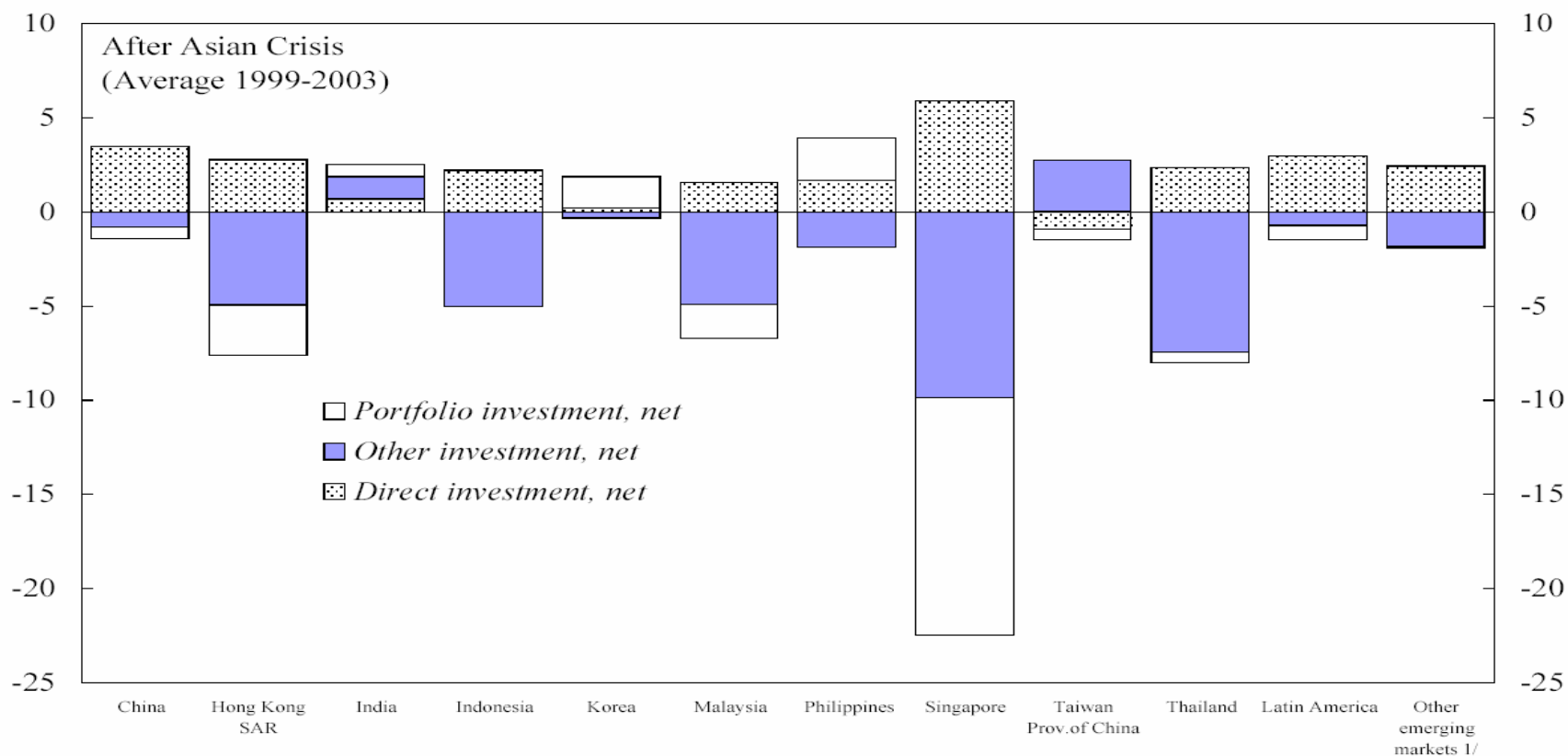
# China looks in good shape ...?

Figure 1. Level and Composition of Gross Capital Inflows  
(billions of U.S. Dollars)



Source: Prasad and Wei (2004)

# China looks in good shape ...?

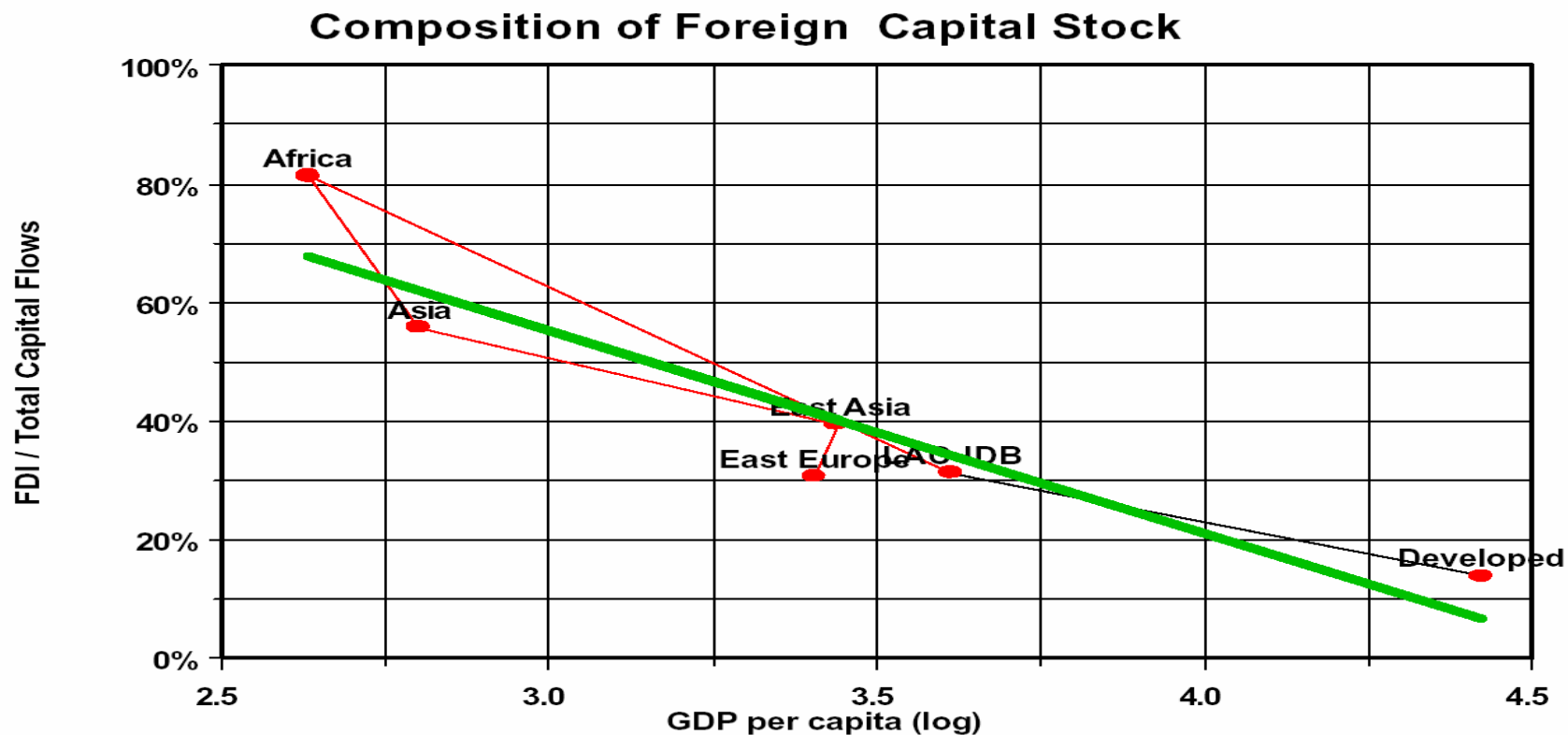


Source: World Economic Outlook database.

1/ Average for emerging markets in EMBI+ index, excluding Latin America and Asian countries.

Source: Prasad and Wei (2004), as % GDP

# But relative to other countries ...

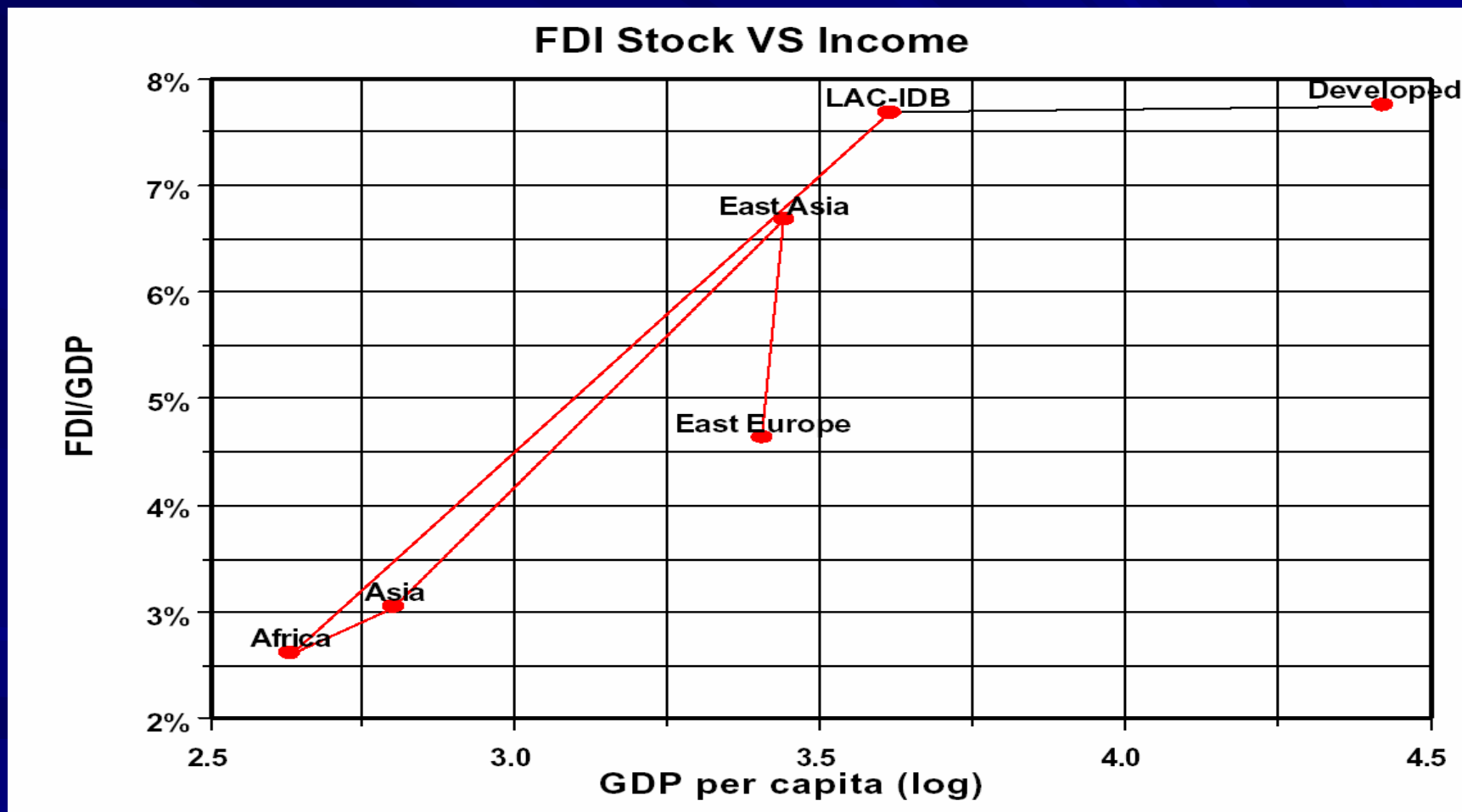


\*Data refers to stocks of 1997 in current dollars and GDP in PPP current dollars. The GDP per capita is a weighted average of countries for the same year.

Source: IFS, WB and RES-IDB.

Source: Hausmann and Fernandez-Arias (2000)

# But relative to other countries ...



Source: Hausmann and Fernandez-Arias (2000)

# Pro's and Con's: FDI

- The composition of China's capital inflows looks like composition of a low income country
  - Capital flows are still at low levels
  - Capital flows biased in favor of FDI
- What determines compositional choice?
  - Cross-country evidence suggests that ownership is a substitute for “bad institutions” in sub-Saharan Africa
- If this suggested lack of faith in Chinese institutions, this would be cause for concern ...
- Instead, this seems to reflect
  - Tax distortions
  - May be cause for concern in its own right

# Pro's and Con's: FDI

- However, it may be that this distortion is not very costly if FDI is a veil for other capital flows
- Questions of Measurement. Recall definition of FDI:
  - category of international investment that reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and a significant degree of influence by the investor on the management of the enterprise. (The fifth edition of the IMF's *Balance of Payments Manual*)
  - Allows for inter-company debt
- From 1998-2000 more than one quarter of world FDI was inter-company debt
  - How much FDI in China is really a substitute for debt?

# Pro's and Con's: Sources of FDI

- Additionally, FDI bias may be overstated by domestic investment masquerading as foreign investment for tax purposes
  - Share from Hong Kong SAR + Virgin Islands + Samoa often >45%
- But if so, external capital flows even smaller than measured ...
- US and EU account for only 15%. Is this consistent with
  - Cheap finance?
  - Technology transfer?

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total	100	100	100	100	100	100	100	100	100	100
Hong Kong SAR	58.2	53.4	49.6	45.6	40.7	40.6	38.1	35.7	33.9	33.1
Virgin Islands	...	...	...	...	8.9	6.6	9.4	10.8	11.6	10.8
Japan	6.1	8.2	8.8	9.6	7.5	7.4	7.2	9.3	7.9	9.4
Korea	2.1	2.8	3.3	4.7	4.0	3.2	3.7	4.6	5.2	8.4
United States	7.4	8.2	8.2	7.2	8.6	10.5	10.8	9.5	10.3	7.8
European Union	...	...	...	...	...	11.1	11.0	8.9	7.0	7.3
Taiwan Province of China	10.0	8.4	8.3	7.3	6.4	6.4	5.6	6.4	7.5	6.3
Singapore	3.5	4.9	5.4	5.8	7.5	6.6	5.3	4.6	4.4	3.8
Western Samoa	...	...	...	...	0.3	0.5	0.7	1.1	1.7	1.8
Macau	...	...	...	...	0.9	0.8	0.9	0.7	0.9	0.7
Others	12.6	14.0	16.4	20.0	15.3	6.5	7.4	8.6	9.6	10.4

Source: Prasad and Wei (2004), as % total

# Conclusions

- China's current account surplus, high reserves and low external debt suggest chances of liquidity or debt crisis small
  - Although asset revaluation risks ...
- But level and composition of capital flows arguably far from efficient
  - We should expect high growth countries to borrow, not lend ... think of the history of USA, Canada, Australia, New Zealand
  - And FDI seems like last resort, not first choice ...
- Compositional bias may be overstated, but ...
  - Little evidence this is the “good” form of capital flow (in terms of technology transfer and low cost finance)
  - Costs of FDI ...?(Razin, Sadka & Yuen 2001 show FDI can reduce welfare if foreigners can float lemons on local stock market)