

Static and Dynamic Consequences of a **KORUS FTA**



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HOW FINANCIAL MULTILATERALISM CAN INCREASE SUSTAINABLE OUTPUT, EMPLOYMENT, AND INCOME IN THE PACIFIC REGION

** Douglas H. Brooks and David Roland-Holst*

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and Structural Adjustment
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I. Introduction

Maturing of the Asian export experience has been accompanied by structural changes that will require a new generation of multilateral financial institutions and services. Emergence of unprecedented foreign exchange reserves is one expression of this unmet need, and these reserves have reinforced interest in a reexamination of Asian exchange rate management regimes. At the same time, Asia's second generation of successful growth has made it increasingly apparent that intraregional purchasing power and savings offer essential sources of diversification from historic reliance on absorption and foreign direct investment (FDI) from Western economies that are members of the Organization for Economic Cooperation and Development (OECD). One prominent example is absorption by the People's Republic of China (hereafter China), which has emerged in the past 10 years as a primary driver of Asian regional growth, and this absorption is increasingly driven by domestic demand, not export requirements. Meanwhile, Asian domestic savings have grown to levels that justify a much larger horizon of investment opportunity. In this paper, we discuss how greater financial integration can facilitate needed adjustments to help Asian economies, and the Pacific Basin generally, transit smoothly to higher levels of sustainable output, employment, and incomes.

Economists generally agree that efficient capital allocation increases long-term growth potential, particularly when it sustains and is sustained by expanding international trade. Most recently, the post-World War II era of globalization saw rapid expansion of FDI in concert with trade, pairing relatively abundant Western savings with factors and resources relatively more abundant elsewhere. The result was a virtuous cycle of multilateral growth and prosperity that brought us to the present day. At the same time as trade and international investment expanded, financial services increased sharply in both intensity and extent, with revolutionary changes in multilateral public and private financial practices, instruments, and institutions. This dramatic evolution was not unprecedented, however. International trade, financial innovation, and growth have sharply advanced many times in the past. Most notable were two periods. During the late Middle Ages and Renaissance, Italian city-states acted as mercantile and financial intermediaries between Europe and Asia. Later, during Western colonial expansion, Bruges, Amsterdam, and London established the financial basis for modern equity, derivative, and insurance markets to mediate risks of long-distance shipping.

The difference between today's situation and historical antecedents has mainly to do with the geographic scope of financial service needs. In the past, wealth remained concentrated in relatively few trading centers and countries. During the colonial era, for example, property rights and terms of trade were disciplined by international hierarchy, concentrating the gains from trade and global investment in Western countries. The legacy of modern globalization has been quite different. Wealth creation

has been more evenly distributed around the trading system, and with this has come a sharp increase in the need for, and range of, both domestic and international financial services. The challenge today is to reconcile this new diversity in a coherent international financial system. Private agency is already very active in this area, but it is fair to say that public institutions have been slower to adapt. This is unfortunate because, today as always, economic growth cannot realize its full potential without efficient financial services.

In the past, a relatively small number of financial capitals were effective in serving the needs of trade and their own economies because international wealth was so concentrated. Private financial institutions could bridge these markets with overlapping ownership (e.g., Italian and French banking families in colonial times, OECD public and private banks during the past several decades), while sovereign interests were reconciled by alliances or spheres of influence concentrated around relatively few dominant powers. Today's world can be said to have both expanded and flattened, with much greater geographic scope and less hierarchy in economic relations. In the context of international goods and services trade, this process was recognized long ago, and the World Trade Organization (WTO) process evolved in response. Since Bretton Woods, a financial counterpart has been incubating, expressing itself in many partial forms (including the Bank for International Settlements and the European Central Bank), but a unified approach to financial multilateralism has yet to emerge. Meanwhile, the trading system bears unneeded efficiency costs as a result. This is apparent in emergent global imbalances whose magnitude portends significant adjustment risks but also significant growth opportunity costs arising from inefficient international capital allocation.

How might this situation be remedied? Clearly there is a need for more extensive, inclusive, and efficient global financial systems, combined with private financial services and the public institutions to oversee them. This paper cannot provide a manifesto for global financial reform, but it might be useful for setting out basic tenets of financial multilateralism, accompanied by thematic examples and discussion, to stimulate policy dialogue on this subject. These tenets are summarized on the following page.

Asia's economic growth and progress in real sector integration has been remarkable. What remains to complete the region's economic architecture is a complementary and coherent framework of supporting monetary, financial sector, and fiduciary institutions and standards. The remainder of this paper provides illustrations of the principles embodied in that financial multilateralism. Within the confines of a research paper, this discussion can only be indicative of the complex issues associated with this topic. The ultimate goal, however, is to stimulate the extensive reflection and discussion that this issue merits.

Three Pillars of Financial Multilateralism

1. Monetary Coherence

At its root, any multilateral financial system must address the macroeconomic objectives of governments, expressed in this context through monetary and exchange rate policy. The idea of coherence is weaker than coordination but would still require governments to adopt more harmonious standards for monetary management. For example, exchange rate regimes across the Pacific Basin need not be coordinated but they clearly lack coherence at present, as evidenced by massive reserve imbalances.

2. Capital Market Facilitation

International capital flows have been one of the global economy's most potent growth catalysts. Foreign direct investment (FDI) has accelerated trade and growth in both destination and originating countries, and across the Pacific it has created a vast web of supply chain relationships that continues to sustain growth. At a deeper level, FDI also represents growth arbitrage. By shifting financial resources from lower- to higher-return investments, FDI can increase returns to low-priced labor and resources in poor countries, mitigating international inequality. In Asia, where per capita income levels vary dramatically, FDI can make important contributions to economic convergence. For these reasons, multilateral financial initiatives should make FDI and other capital market facilitation a high priority. At the present time, there are many obstacles to this across the Pacific region. FDI has managed to increase more in spite of capital market segmentation than because of facilitation. Again, this suggests significant growth opportunity costs.

3. Fiduciary Standards

Because of the principal-agent nature of financial intermediation, standards of responsibility are essential to institutional effectiveness.

In the public sphere, these take two forms. The first includes well established standards for independence from political influence, and this should be a central tenet of financial multilateralism. A second and less well understood public responsibility concerns financial market risk management. The private financial sector's capacity to manage risk depends critically on conditions of liquidity and access to a broad spectrum of (domestic, or overseas, or both) derivative instruments. It is the public sector's fiduciary responsibility to secure this access to responsible private intermediaries.

On the private side, fiduciary standards include well established norms for prudential management, acceptance of supervision, and transparency. All these are likewise essential to a coherent regional financial system and to efficient multilateral capital allocation. It should be emphasized that rigorous harmonization, like a single banking law or universal accounting standards, is not needed. Something more akin to OECD standards development, harmonization through regularized policy dialogue, could advance this agenda substantially.

II. Case Study in Monetary Coherence: Renminbi Appreciation and Structural Adjustment

Monetary coherence does not yet have a detailed definition, but it can be easily interpreted. Simply put, it means that monetary and financial systems in different countries interact with a minimum of intervention. While coherence may not be obvious *ex ante*, it is easy to observe its failure *ex post* in the form of distortions that emerge at the interface between markets and “incoherent” policies. One of the most common areas where its adequacy can be observed is exchange rate policy, one of the most stubborn challenges to financial multilateralism. In this section we examine one prominent case representing this issue: China’s currency. Of course, this example is only one of many. It is examined here because it exemplifies a persistent lack of coherence in the global trading system—neomercantile exchange rate policies—that has been pervasive in Asia.

Most outside observers see China’s burgeoning foreign exchange reserves as evidence of exchange rate management. In particular, it appears that the renminbi (RMB) is currently below an internationally weighted equilibrium rate that would bring reserves within a more conventional range as percentages of other macro aggregates. Within China, there may be those with strongly held opinions about exchange rate management. These include, among others, influential stakeholders with neomercantilist views regarding export competitiveness and import protection.¹ In light of this as well as relatively intense differences on this subject with some prominent trade partners, it has been difficult for China to achieve rapid RMB adjustment, even in the presence of massive reserve accumulation. This situation contributes to complex redistributive forces within Chinese society, across both social groups and generations, yet there is relatively little independent empirical analysis to elucidate this or the implications of alternative policies.

Scenarios for Real Exchange Rate Appreciation

To examine the implications of greater RMB flexibility, we consider a scenario where the Pacific regional economies maintain constant ratios of net foreign saving to real GDP. The adjusting variable in this case is the domestic GDP price index, a proxy for the real exchange rate (RER). The model employed is described in Roland-Holst, Verbiest, and Fan (2005).

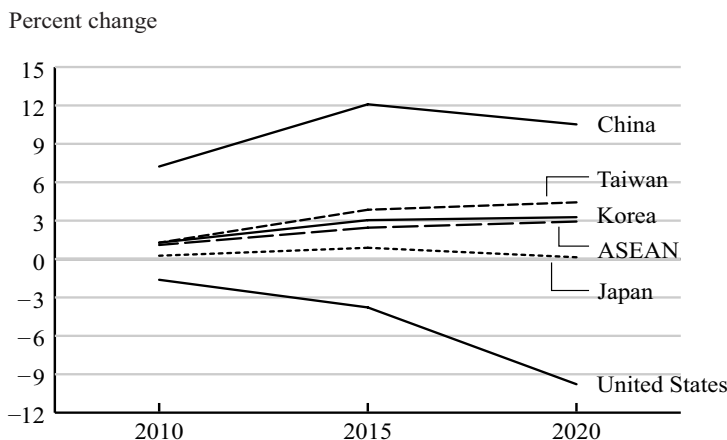
1. Among the latter, for example, are powerful advocates of China’s food self-sufficiency, who perceive RMB appreciation opening the country to an avalanche of farm products, including those from subsidized OECD producers.

Figure 1 (details in **Table 1**) depicts the aggregate results of this alternative macro closure rule, including significant RER appreciation for China. Because of sustained export surpluses, all the Asian economies experience RER appreciation in varying degrees. China is in the lead for analogous reasons, yet the total adjustment is less than might be expected because China is also experiencing bilateral deficits with respect to its neighbors. Appreciation with respect to the U.S. RER, by contrast, is more than 20 percent during the period under consideration, a figure generally in line with current public discussion.

Trade Adjustments

Consideration of more detailed structural adjustments can improve understanding of the policy setting for exchange rate management. In the context of trade adjustment,

Figure 1: Real Exchange Rate Adjustments, 2010–20 (est.)



Source: Authors' estimates.

Table 1: Real Exchange Rate Adjustments, percentage

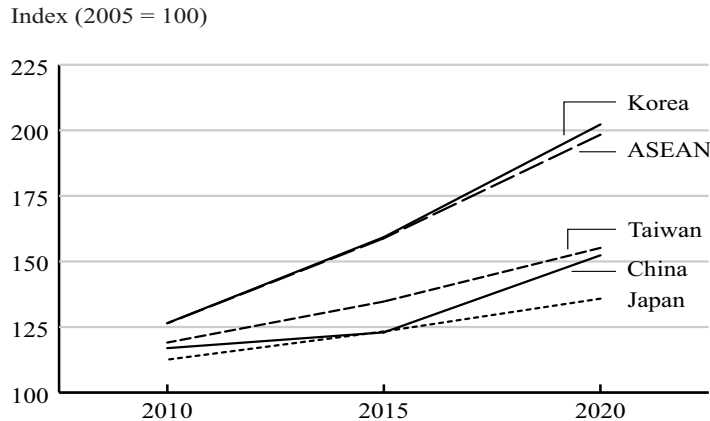
Country	2005	2010	2015	2020
China	1.29	7.23	12.09	10.52
Japan	0.00	0.26	0.88	0.14
Korea	0.13	1.28	3.04	3.27
Taiwan	-0.01	1.28	3.85	4.43
ASEAN	0.15	1.10	2.45	2.93
United States	-0.21	-1.62	-3.78	-9.78

Source: Authors' estimates.

Note: ASEAN = Association of Southeast Asian Nations.

a few salient effects emerge in the RER appreciation scenario. On the export side (*Figure 2*), Chinese exports are adversely affected with respect to the baseline scenario but still rise above steady growth in baseline values. Growth of China's exports is slower than for its non-Japanese trading partners, largely because China's RER "opening" has sharply stimulated their export opportunities.

Figure 2: Asian Export Trends, 2010–20 (est.)



Source: Authors' estimates.

Note: Indexed to 2005 exports = 100.

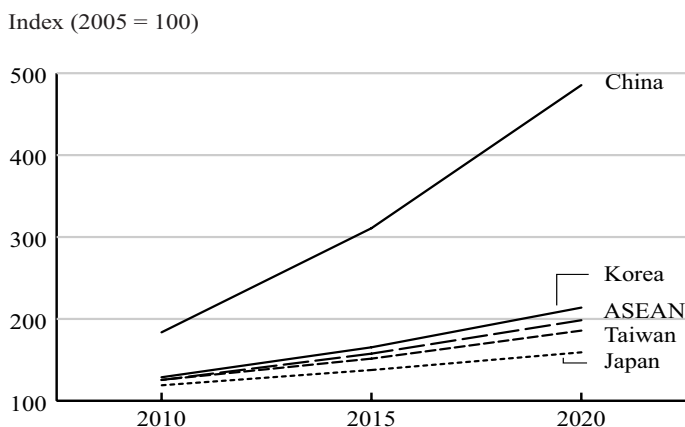
On the other side of regional trade flows, we see the converse effect of exchange rate changes, with China experiencing dramatic import expansion while its neighbors lag behind (*Figure 3*). All countries expand trade, but this important (multilateral) component of China's absorption nearly triples across the decade 2010–20. To this extent, we are seeing China and the United States exchanging places from the Asian regional perspective. Indeed, in light of these dynamics it is reasonable to ask whether a strong-RMB consensus might emerge in the wake of the long-held strong-dollar consensus. Certainly, trade reorientation on the part of China's neighbors gives them two important growth advantages. Export expansion toward China offers important diversification away from traditional, North-South patterns of trade. It also represents a commitment to the world's most dynamic consumer market.

Beneath the veneer of macro shifts, dramatic patterns of trade diversion emerge, both between countries and within sectors. The simulation model we use has a significant amount of sector detail, but space constraints prevent detailed discussion of these in this chapter. Even so, a few salient features merit emphasis:

- China's import dependence accelerates across a wide spectrum of products, but especially energy and food.

- Asian exports to China will reflect traditional comparative advantages, with high-income Asia exporting technology and education-intensive products and capital goods, while the rest of Asia ships more diverse consumer goods, intermediates, and raw materials.
- Other Asian exports accelerate despite RER appreciation (because China is experiencing significantly higher appreciation), sharply increasing the domestic purchasing power of other Asian countries.

Figure 3: Asian Import Trends, 2010–20 (est.)



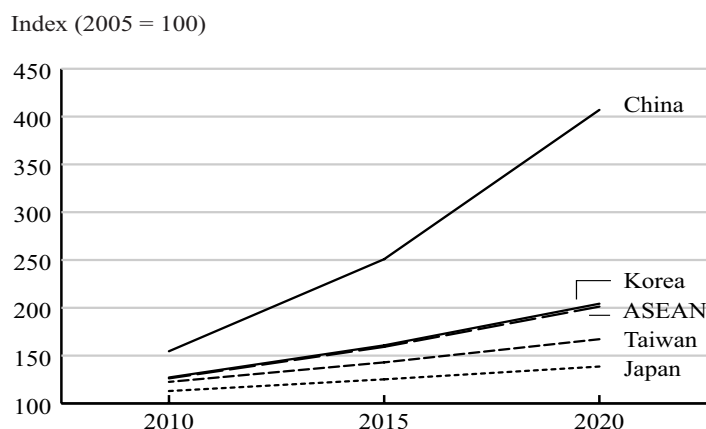
Source: Authors' estimates.

Note: Indexed to 2005 imports = 100.

Domestic Growth

Perhaps the most interesting result of the RER experiment is that, contrary to neomercantile or other protectionist arguments, China's aggregate real economic growth accelerates with currency appreciation. In particular, the attenuation of export growth is more than offset by domestic demand expansion, implying that historic exchange rate rigidity may have actually retarded domestic structural transition as well as aggregate growth.

Figure 4 shows how China's growth (well above the baseline trend) accelerates ahead of other regional economies. The primary driver of this is increased domestic purchasing power, in particular for essential components of the national balance sheet like raw materials, basic consumer goods, and a wide spectrum of intermediate and capital goods. The result is a dramatic shift from external to domestic demand as the engine of real economic growth. In this context, consumer final demand has higher tertiary and employment-intensive content and thus longer multiplier chains across the domestic economy.

Figure 4: Real GDP Trends, 2010–20 (est.)

Source: Authors' estimates.

Note: Indexed to 2005 = 100.

Capital Market Implications

Obviously, all these current account adjustments will be reflected in the capital account, especially at the bilateral level. Such shifts are notoriously difficult to generalize, yet a few observations are relevant. Foreign savings are constrained by real GDP under the assumed macroeconomic closure, and growth of the trade surplus is slowing. This means FDI is increasing in both absolute and relative terms, with two main effects. First, to the extent that foreign investors are more selective and able to add value to domestic assets, China will experience rising average quality of domestic investment and asset holdings. This has important implications for productivity growth and competitive discipline, particularly as export discipline recedes. Second, RER appreciation will induce accelerated (and discounted) technology transfer. The cost of embodied foreign technology is falling, which will also contribute to accelerated substitution, adoption, or modernization, or some combination of these three.

As the RER appreciates and FDI accelerates, an extensive sectoral rotation will be set in motion across the economy. Nontradable prices will rise relative to tradables, and domestic resources will be drawn toward these activities. This can be very beneficial to development of the internal market, but there are two potential pitfalls. The first is a variant of classic Dutch disease: disengagement from external competitive discipline.

A second source of risk comes from labor intensity of emergent demand. The net employment characteristics of the sectoral rotation will be very important to long-term employment levels and composition. If, for example, property leads the growth of nontradable demand rather than services, it could be difficult to maintain employment rates or to limit the growth of inequality.

Labor Markets

We have assumed full employment across all scenarios. Clearly, however, compositional features of the employment question will determine how much economic potential is realized and how the benefits of higher growth rates are distributed across each economy. For the Asian region, detailed analysis of sectoral adjustments is needed to assess this question. For China, elastic supplies of unskilled workers are probably less of an issue than recruitment of skilled labor. In any case, observations from three perspectives on labor markets are relevant:

1. How high?
 - a. Skilled labor demand may be rising faster than supply. This trend is being accelerated by FDI, for which skilled labor appears to be a complement.
 - b. What is the real capacity of formal and informal education and training to deliver higher productivity?
2. How long?
 - a. Demographic transition and rising dependency. Aging and family policy may intensify the pressure on the working labor force.
 - b. The only way out is ever-increasing labor productivity.
3. How wide?
 - a. Migratory pressure will continue as the opportunity cost of labor in the rural sector declines monotonically.
 - b. Actual migration must continue to be demand driven.
 - c. Regional growth rates will increasingly determine aggregate growth (median vs. average growth).

Regional Issues

On the current account, tempering China's export competitiveness and accelerating absorption looks good to regional neighbors. However, there will certainly be intensified regional competition for primary products and intermediate goods. This will squeeze regional balance sheets as a broad shift from export competition to competition for imports ensues. RER appreciation will help China in this purchasing power competition, but intensify the underlying regional (and global) challenges of resource sustainability. Under such conditions, major trends that are already in evidence can be expected to persist and even intensify.

First, there will an expansion of resources-seeking multilateral partnerships. China is already heavily engaged in this, including mining in South America and pursuing energy in Central Asia and Africa. India is following rapidly, and both have been increasing

investments in OECD economies. On the private-sector side of the same trend, China and perhaps others will have strong incentives to pursue global vertical integration, investing to secure sources of upstream products and factor services. This will have the secondary effect of strengthening downstream market power and will probably accelerate downstream consolidation. Within more highly articulated international supply chains, there will be strong incentives to shift value by transfer pricing, bargaining, and technology diffusion across national boundaries. Who benefits nationally from this process of supply chain integration is today a matter of pure speculation. Japan's experience, with its extensive networks of overlapping foreign ownership, overseas facilities, and equity listings, makes it apparent that the benefits of "network" globalization are widely dispersed, serving the interests of not only parent company shareholders but many others as well.

III. Capital Market Facilitation: Growth Arbitrage and the Role of FDI

Also in the context of international financial integration, international capital allocation has been a primary driver of modern growth, particularly for emerging economies, and this relationship has nowhere been more fortuitous than in Asia.² Together with disciplined commitments to domestic and external economic reform, the region's economies have leveraged foreign savings to achieve growth and modernization well beyond the imagining of prior generations. Given the nearly universal appeal of FDI as a growth catalyst, however, it would clearly be desirable for policymakers to strengthen the capacity of capital markets to facilitate these flows in advancing economic progress. As Asia transits from a loose federation of emerging economies to a more fully integrated and mature economic region, the need to facilitate multilateral investment dynamics will only increase.

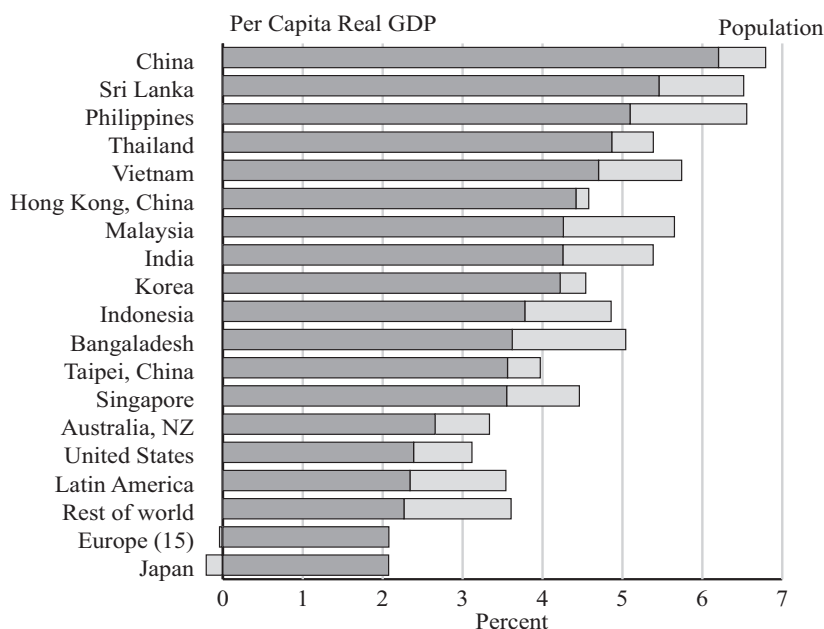
In addition to its role as a pure growth driver, FDI is an important mechanism of growth arbitrage. By moving capital from lower- to higher-return environments, FDI can increase returns to lower-priced labor and resources, making possible greater percentage income gains for low-income countries. This process can mitigate international inequality in both growth rates and, in the right institutional settings, overall living standards. In the Asian region, this aspect of FDI is particularly attractive for two reasons. First, Asia has progressed dramatically over the past two generations, yet the benefits of growth have still been concentrated in a minority of the population, and per capita income across Asian economies remains highly unequal. Because

2. See, for example, Markusen and Venables (1999) and Frenkel and Menkhoff (2004) for samples of a large literature on these issues.

sustainable growth in Asia will ultimately rely on its internal markets, this makes economic convergence a high priority for the region.

Second, wider capital allocation across the Asian region would represent international financial diversification in the direction of superior growth rates. As the “league table” (*Figure 5*) indicates, Asian economies are expected to lead in both absolute and per capita real GDP growth over the next decade.

Figure 5: Baseline Real GDP Growth Rate, Including Population Growth average percentage change during 2005–25 (est.)



Sources: DRI, Cambridge Econometrics, EIU.

Note: EU (15) = Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, Germany, Netherlands, Portugal, Spain, Sweden, United Kingdom.

Historical Overview of Asian FDI Trends

Flows of FDI have seen a dramatic rise in recent years owing to increasing openness of host economies.³ This trend is likely to continue. From only \$53.7 billion in 1980, annual FDI outflows reached \$1.2 trillion in 2000. (The global recession after that considerably reduced outflows, however; outflows dropped by 39 percent in 2001, 17 percent in 2002, and 15 percent in 2003, before picking up again since 2004).

3. This section draws on Roland-Holst, Verbiest, and Zhai (2005).

Moreover, FDI flows have risen tremendously relative to world output and trade since the early 1990s. World FDI outflows increased almost five times from 1990 to 2000, while world output and exports grew at more modest paces. This swift expansion in FDI was most pronounced during 1986–90, when many host countries began to relax regulations in order to attract FDI, and 1996–2000, when many mergers and acquisitions (M&As) followed in the wake of the 1997–98 Asian economic crisis and privatization programs in Latin America.

Economies in developing Asia generally received increasingly larger shares of world FDI inflows, particularly during the 1990s. From an average of 6.4 percent in the 1970s, developing Asia's share in total FDI inflows increased to 21.8 percent in 2005. FDI inflows to developing Asia grew from only \$694 million in 1970 to \$200 billion in 2005, an average growth rate of 24.4 percent per year.

Within FDI flows to Asia, M&As have become important, particularly following the financial crisis, as sharp local currency depreciations and liquidity constraints increased the availability of target firms. M&As in developing Asia rose more than 129 times by value between 1987 and 2001, from only \$256.1 million to \$33.1 billion. The preferences of foreign investors for individual country destinations have shifted over time. While Europe and North America continue to be major recipients of FDI, China has emerged as another favored destination.

In developing Asia, the top 10 recipients of FDI inflows in 2003–05 accounted for about 90 percent of total FDI in the region, with the top three recipients alone accounting for 73 percent (*Table 2*). Azerbaijan, while being only number seven in the list of top developing Asian FDI recipients, had the highest ratio of FDI to GDP, reflecting the importance of new FDI in its hydrocarbons sector, the primary driver of domestic economic growth.

As the total value of FDI inflows to the top 10 Asian destinations surged during the past 15 years, developing Asia's share in the world total increased from 19.5 percent in 1991–93 to 21.2 percent in 2003–05. The largest recipients at the aggregate level may not be those with the greatest economic impacts from FDI (*Table 3*). As a percentage of domestic economic activity, average FDI inflows have shown remarkable increases in some Asian economies. Per capita inflows are generally largest in smaller countries (*Table 4*). In Singapore and Hong Kong (China), for instance, per capita inflows more than doubled between 1991–93 and 2001–03. The choice of time period matters, as some years show more remarkable increases than others. In Hong Kong (China), for example, per capita FDI inflows increased from only \$574 in 1990 to \$9,232 in 2000—an expansion of 16.2 times. In Azerbaijan, total annual inflows reached 66 percent of gross fixed capital formation in 2003–05 (*Table 5*).

Table 2: FDI Inflows in Selected Developing Asian Economies, 2003–05

Economy	Percentage of total FDI in developing Asia	Ratio to GDP
China, People's Republic of	43.2	3.6
Hong Kong, China	19.3	16.6
Singapore	10.5	14.1
Korea, Republic of	4.4	0.9
India	3.9	0.8
Malaysia	2.6	3.1
Azerbaijan	2.0	33.2
Kazakhstan	1.8	6.5
Thailand	1.6	1.4
Indonesia	1.5	0.8

Source: UNCTAD (various years).

Table 3: Top 10 Destinations for FDI in Developing Asia, 2003–05, in millions of dollars

Rank	Country	Annual FDI Inflows 2003–05
1	China, People's Republic of	62,180
2	Hong Kong, China	27,851
3	Singapore	15,093
4	Korea, Rep of	6,272
5	India	5,552
6	Malaysia	3,688
7	Azerbaijan	2,840
8	Kazakhstan	2,648
9	Thailand	2,351
10	Indonesia	2,192

UNCTAD (various years).

It is increasingly difficult to characterize and typify FDI.⁴ In most economies, it enters practically all sectors. It originates from both industrial and developing economies. It may take the form of long-term greenfield investment or short-term, opportunistic M&As. It ranges from the global investments of the world's largest corporations to smaller cross-border investments. The distinction between foreign investment and domestic investment is increasingly blurred, especially when a country's diaspora is

4. Compare Wheeler and Mody (1992) and Xu (2000).

Table 4: FDI Inflows per Capita, 2003–05, in dollars

Rank	Country	Inflows
1	Marshall Islands	4,027
2	Hong Kong, China	3,978
3	Brunei Darussalam	3,584
4	Singapore	3,522
5	Azerbaijan	342
6	Tuvalu	268
7	Palau	198
8	Kiribati	192
9	Kazakhstan	175
10	Malaysia	146

Source: UNCTAD (various years).

Table 5: FDI Flows as a Percentage of Gross Fixed Capital Formation, 2003–05 Rankings of Selected Countries

Rank	Country	Percentage
1	Hong Kong, China	78.0
2	Azerbaijan	65.7
3	Tajikistan	62.7
4	Singapore	61.1
5	Jordan	32.5
6	Kazakhstan	30.7
7	Vanuatu	28.4
8	Mongolia	27.2
9	Cambodia	17.3
10	Vietnam	10.9

Source: UNCTAD (various years).

actively involved. A world of increasingly seamless national boundaries is also amenable to highly fluid capital whose national characteristics are often difficult to discern.

Impact of Foreign Direct Investment

Supporters of FDI contend that, in addition to helping overcome local capital constraints, foreign investors introduce a combination of other highly productive resources into

the host economy. These include production and process technology; managerial expertise; accounting and auditing standards; and knowledge of international markets, advertising, and marketing techniques. The challenge for the host economy is to benefit from foreign economic presence and to appropriate as much as possible of the increased income accruing from the resulting productivity growth without deterring further investment. Host economy benefits are quite uneven, both across and within countries, suggesting that host country policies are important in the distribution of these benefits. Of particular relevance are monetary and fiscal policies; financial institutions to support access to credit and risk management; and policy influences on the commercial environment, broader institutional quality, and productive capabilities.

Distinguishing characteristics of FDI are its stability and ease of service relative to other forms of external finance, such as commercial debt or portfolio investment, as well as its nonfinancial contributions to procurement, production, and sales processes. Aside from increasing output and income, potential benefits to host countries from FDI inflows include the following (Brooks et al. 2004):

1. Foreign firms bring superior technology and management practices. The extent of benefits to host countries depends on the technological and knowledge spillovers to domestic and other foreign-invested firms, as well as the extent to which domestic consumers or owners of the factors of production reap the gains from greater productivity. In addition, the potential benefits from adopting or adapting to new technology or techniques encourage human capital development to more fully exploit those benefits.
2. Foreign investment engenders increased competition in the host economy. The entry of a new firm in a nontradable sector increases industry output and may thereby reduce the domestic price, leading to a net improvement in welfare. Marketing locally and learning by doing spur additional domestic market development and welfare improvements.
3. Foreign investment typically stimulates increased domestic investment. Bosworth and Collins (1999) found that on average about half of each dollar of a capital inflow translates into an equal increase in domestic investment. When the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and increased domestic investment.
4. Foreign investment yields advantages in terms of export market access arising from foreign firms' economies of scale in marketing or ability to gain market access abroad. Besides their contributions through joint ventures, foreign firms serve as catalysts for domestic exporters. The probability that a domestic plant will export is positively correlated with proximity to multinational firms (Aitken,

Hanson, and Harrison 1997). By creating export processing zones and promoting clusters, or by conferring special benefits such as duty-free imports of inputs, subsidized infrastructure, or tax holidays, governments may encourage potential exporters to locate near each other and thereby reduce costs for domestic firms to break into foreign markets.

5. Foreign investment can contribute scarce foreign exchange. Often investment requires imported production inputs for which domestic savings are insufficient, or investment faces barriers in converting local currency to foreign exchange to acquire imports. Then domestic savings alone may be insufficient to guarantee growth, while capital inflows can help ensure that foreign exchange will be available to purchase imports for investment and production.

Even for countries with relatively easy access to international capital markets (such as Korea) or with substantial holdings of foreign reserves (such as China or India), the nonmonetary benefits of FDI, such as those listed in 1 through 4 above, still make it an attractive source of investment.

The general conclusion in the empirical literature is that FDI confers net benefits on the host economy. The capital stock is augmented, productivity rises, and some (often much) of the increase is appropriated by domestic consumers and factors of production. These benefits appear to be especially important in connecting the host country to the global economy and in the area of technology transfer. They are greater when supported by sound monetary, fiscal, and fiduciary policies.

As trade has been liberalized, there has been a switch in the motivation for supplying FDI: from rent seeking to efficiency seeking. The contemporary challenge for developing countries is to capitalize on FDI's efficiency gains. Competition for FDI among host countries focuses on the establishment of an enabling, business-friendly commercial environment, consistent with national development objectives. In this context, a useful paradigm is the so-called four Is: incentives, institutions, infrastructure, and information. As economies open up, these four factors (which encompass monetary coherence and fiduciary standards) are key determinants not only of the overall rate of economic growth but also of the magnitudes and productivity of capital flows.

A carrot-and-stick approach has long been a feature of the regulatory framework governing FDI in host countries (McCulloch 1991). Most countries offer incentives to attract FDI. These often include tax concessions, tax holidays, tax credits, accelerated depreciation on plants and machinery, and export subsidies and import entitlements. Such incentives aim to attract FDI and channel foreign firms to desired locations, sectors, and activities. At the same time, most countries have also regulated and limited the economic activities of foreign firms operating within their borders. Such

regulations have often included enforcing private-sector fiduciary standards, limitations on foreign equity ownership, local content requirements, local employment requirements, and minimum export requirements. These measures are designed to optimize benefits arising from the presence of foreign firms in the local economy.

Tax breaks and subsidies are common, but they generally influence investment location decisions only at the margin. More important to most potential investors are the size and expected growth rate of the market to be served, the long-term macroeconomic and political stability of the host country, the supply of skilled or trainable workers, and the presence of modern transportation and communications infrastructure. All of these are indirectly supported by monetary coherence, capital market facilitation, and fiduciary standards. Once these criteria are satisfied, then financial incentives may influence the investor's choice of suitable sites. Government action can also enhance a host country's success in attracting FDI by significantly reducing the uncertainty, asymmetric information, and related search costs faced by foreign investors, as well as transaction costs—especially the amount of time and number of steps involved in acquiring approval.

Too often in the past, policies ostensibly designed to maximize the net benefits of FDI for recipient economies resulted in subscale manufacturing plants, frequently through mandated joint ventures that were not permitted to source inputs freely and that contributed little to the technological, social, or economic development of the country. A host country benefits less when foreign investment is directed toward serving small and protected domestic markets. The benefits to the host economy are greatest when international companies can exploit economies of scale, both locally and globally, and are continually driven by competition to update their technology and managerial practices.

A central issue is whether investment promotion measures alter the allocation of resources in production and trade, or just influence the distribution of rents between firms and host countries. Both suppliers and recipients of FDI may gain from the liberalization of investment measures. Foreign investors may benefit from new investment opportunities resulting from liberalized investment regulations, while host countries may benefit from increased FDI inflows and the resulting greater market discipline. Because many developing countries compete with one another to offer foreign investors generous tax, infrastructure, and financial incentives, it is important to note that the scaling down of investment incentives in a coherent manner could avoid harmful tax competition and yield additional revenue for host country governments.

Notwithstanding their diversity, almost all developing Asian economies have adopted progressively more open policies toward FDI during the past decade or two, and this

trend appears likely to continue. This more open posture has been accompanied by the adoption of more liberal trade regimes and more coherent exchange rate and capital account policies. This process has had profound implications for the motives for, and impacts of, foreign investment.

The upsurge in FDI to developing countries from the 1990s on was largely caused by the unilateral liberalization of developing countries' FDI policies and regulatory regimes. Theoretical and empirical evidence provides strong support for the proposition that neutral policies designed to enhance the efficiency of investment and monetary coherence are better suited to attracting foreign investment and enhancing its contributions to development than interventionist methods.

Thus, there appears to be increasing acceptance that liberal policy regimes for most industries, supported by monetary coherence and prudent fiduciary standards, bring the highest benefits to host countries. FDI policies can be put in place at both the national and international level. At present, however, they are predominantly national rather than international. There is still much disagreement on forming and implementing a multilateral framework on investment, in part owing to the lack of coherence in the supporting policy and institutional environment.

IV. Conclusions

This paper sets forth a tentative proposal for financial multilateralism, beginning in the Asia-Pacific region where emergent macro distortions indicate it is most needed. After motivating the idea with a discussion of the many growth dividends associated with more efficient capital allocation, we examined two contextual examples, the potential consequences of RMB appreciation and historical developments in Asian FDI.

If the RMB were to appreciate as needed to resolve emergent reserve imbalances, a complex set of adjustments would ensue. Most of these are consistent with prior intuition, but the magnitudes are important for policy reasons. For China, the overall RER would adjust only moderately, but bilateral adjustments could be larger (11 percent globally, against 20 percent vis-à-vis the United States). As a part of a sustained appreciation, China's trade balance would move in the expected direction. Total export growth would slow but would continue, while imports would accelerate rapidly. Aggregate regional trade would not change in trend, but the composition would shift dramatically, with exports switching from Western OECD markets to China. As part of this geographic shift, a strong RMB could be expected to assume part of the burden of global demand sustainability long carried by a strong dollar. Indeed, how the policy environment and financial markets might adapt to this is an interesting open question.

Perhaps most important, this research indicates that the Chinese economy would experience significant additional growth with RER appreciation, mainly owing to accelerated growth of the internal economy. It is apparent from this research that undervaluation of the exchange rate is restricting China's access to essential resources, commodities, and intermediate goods, undermining enterprise expansion and household real incomes. Like most distortionary policies, managed exchange rate regimes entail welfare transfers between social groups (and generations). These results suggest there is also an aggregate (growth) opportunity cost to foreign exchange accumulation.

Our review of Asia-Pacific FDI trends only strengthens the argument for facilitating this mechanism's many contributions to economic progress and prosperity. International capital mobility, supported by strong fiduciary standards, has been an essential component of modern globalization and a strong catalyst for growth in many emerging-market economies. For the Asian region in particular, FDI has played a prominent role in the majority of dynamic and sustained success stories, supplementing domestic savings and transferring a variety of technical and market externalities to accelerate modernization and outward orientation. The development process across this region is only partially complete, however, and the next phase of regional growth will need to propagate successful experiences across a more diverse set of initial conditions. To take full advantage of the transformative role that FDI can play in this process, governments need to affirm their collective commitment to capital market facilitation.

More generally, we have seen that financial expansion and innovation have been inseparable companions of globalization and essential contributors to its economic successes. Without more comprehensive multilateral efforts to enlarge the scope and improve the efficiency of financial services, the Pacific region will be slower to realize its vast economic potential.

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