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# The Asian Drivers: Financial Flows into and out of Asia – Implications for Developing Countries

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## 1 Introduction

This article focuses on the impact of Asian Driver dynamism on the financial sector. It discusses the current and possible future implications of Asia's financial flows for the rest of the world. Specifically, the article's intent is to map the main types of financial flows to and from Asia, to identify their financial and macroeconomic implications for developing countries, and to suggest possible areas of future research. Much of the discussion will draw on recent financial trends in China and India. China's and India's rapid growth, size and increasing global competitiveness make these two economies major Asian Drivers, along with other countries and actors in the region (Griffith-Jones 2004; IDS 2005).

Section 2 provides an initial discussion of the Asian flows we believe have been, or may become, important for developing countries outside Asia. Section 3 discusses the role of Asia's official flows in helping sustain the US current account deficit. Section 4 examines foreign direct investment (FDI) flows into and out of China, and specifically with regards to outflows, and India's flows as well. Section 5 discusses portfolio flows, and Section 6 offers final considerations, in which global governance issues are highlighted, and research approaches are suggested.

## 2 The flows that matter

China has grown at around 8 per cent a year over the past 20 years. India has grown at a slightly lower rate (6.7 per cent) since the mid-1990s (World Bank 2004). In the case of China, this rapid and sustained

growth was accompanied by persistent and growing current account surpluses. India also exhibited surpluses in the current account during 2001–03, but this has not been observed in 2004 (see Table 1).

It increasingly seems that China is playing the role the US, the UK and a few other large European economies did in the nineteenth century, of being an engine of world growth due to its size and dynamism, and as a capital exporter (Cheong and Xiao 2003). However, the large Western economies in the nineteenth century were fully open, and therefore were mainly exporters of private capital. In contrast, China still has only a partially open capital account. As a consequence, the capital China exports to the rest of the world is mainly through the official sector. Another important difference with the large Western economies of the nineteenth century is that, although China exports capital, it is a labour-abundant economy. These two attributes have important financial implications for the rest of the world.

First, China's official sector has invested mainly in US treasury bonds, which are considered safe assets. Together with India and other Asian economies that have accumulated foreign reserves in sizeable amounts in recent years and invested these reserves in US assets, China has contributed to the financing of the US current account deficit, which has been very large – over US\$660bn or 5.6 per cent of the country's gross domestic product (GDP) in 2004 (Global Development Finance 2005). This has helped sustain US growth and therefore global dynamism. However, there is no

**Table 1: Selected macroeconomic indicators: China and India**

	1999	2000	2001	2002	2003	2004*
China						
GDP growth (annual %)	7.1	8.0	7.5	8.3	9.4	9.5
Current account surplus (US\$bn)	21.1	20.5	17.4	35.4	45.9	47.3
Inward FDI (net, current US\$bn)	38.8	38.4	44.2	49.3	53.5	56.0
FDI as proportion of GDP (%)	3.9	3.6	3.8	3.9	3.8	3.6
India						
GDP growth (annual %)	7.1	3.9	5.2	4.6	8.4	6.8
Current account surplus (US\$bn)	-3.2	-4.3	0.2	5.8	8.0	-1.1
Inward FDI (net, current US\$bn)	2.2	2.5	3.8	3.7	4.3	5.3
FDI as proportion of GDP (%)	0.5	0.6	0.7	0.7	0.7	0.9

Sources: Author's elaboration based on World Development Indicators (2004); *Global Development Finance* (World Bank 2005).

\*Estimate.

guarantee that this situation will continue in the future. There has been growing concern at the risks this poses for the world economy (Reisen *et al.* 2005; Folkerts-Landau 2004; Griffith-Jones 2004).

Second, China has attracted a lot of foreign direct investment (FDI) due to the fact the country provides a large pool of cheap labour to its broader competitive capacity. Among developing countries, it has been the largest recipient of FDI.<sup>1</sup> At the same time, China is starting to exhibit rapidly increasing outflows of FDI, linked to its sourcing of commodities from other developing countries. What opportunities does that present for these countries, and how could they maximise these opportunities?

But the story is not confined to official and FDI flows. Although China and India still have partially restricted capital accounts, particularly for short-term

capital flows, gradual liberalisation has taken place in the past few years, especially for portfolio equity inflows in the case of China. This has led to an increase in portfolio flows to these countries in recent years.

Tables 2 and 3 show that portfolio equity flows to, and the issuing of bonds in, the international capital markets by both China and India grew strongly in 2003 and 2004, in both cases to levels above those observed before the East Asian crisis. Much of this recent increase reflects renewed interest by international investors in developing country assets as a whole.

The fact that China and India are increasingly attracting portfolio flows poses a competitive challenge for other emerging economies willing to attract portfolio flows. But perhaps the biggest impact on other developing countries will not occur

**Table 2: Net portfolio equity flows to China and India (US\$bn)**

	1996	1997	1999	2000	2001	2002	2003	2004
China + India	5.9	8.3	2.9	9.4	3.8	3.3	15.9	18.0
China	1.9	5.7	0.6	6.9	0.8	2.2	7.7	10.5
India	4.0	2.6	2.3	2.5	3.0	1.1	8.2	7.5
As a proportion of net portfolio equity flows to developing countries (%)								
China + India	18.0	36.7	22.8	75.8	63.3	56.9	64.0	67.2
India	12.2	11.5	18.1	20.2	50.0	19.0	33.0	28.0

Source: Author's elaboration based on *Global Development Finance* (World Bank 2005: Statistical Appendix).

**Table 3: Gross issuing of international bonds by China and India (US\$bn)**

	1996	1997	1999	2000	2001	2002	2003	2004
China + India	5.0	7.0	1.4	1.3	2.7	1.1	3.9	10.8
China	3.9	5.0	1.4	1.3	2.6	0.9	3.4	6.4
India	1.1	2.0	0.0	0.0	0.1	0.2	0.5	4.4
As a proportion of total developing country bond issuing (%)								
China	5.5	5.5	2.1	1.9	4.0	1.5	3.9	5.8
India	1.5	2.2	0.0	0.0	0.2	0.3	0.6	4.0

Source: Author's elaboration based on *Global Development Finance* (World Bank 2005: Statistical Appendix).

through diversion of flows towards China and India. Instead, it may occur when these two countries take the step of allowing residents to invest abroad on a large scale. The liberalisation of portfolio outflows is already under way in India, although at a slow pace. Although full liberalisation is not likely to take place in the near future, it nonetheless poses important questions. Will major liberalisation for private portfolio outflows have an impact on these countries' capacity to accumulate foreign reserves? Will their capital surplus be mainly directed to developed countries, or will developing countries also be able to attract part of these flows? To what sectors might these flows be directed?

A further important trend with implications for developing countries concerns aid flows. Although most of the world's poor live in India and China, India is starting to impose restrictive conditions on the aid flows it receives from traditional donor countries. Also, together with China it is starting to donate aid to other developing countries. To the extent that rapid growth continues, it is possible that these countries become important players in the aid system as net aid donors, and even in the shaping of a new development aid architecture. Will China's and India's aid be donated on compassionate grounds, or will geo-economic interests drive their aid policies? Will aid be mainly directed to neighbouring countries? Will it follow the geography of FDI outflows, as happened to Japan in the past?

Some of these flows will have both competitive and complementary effects on other developing countries. For example, while China competes with other developing countries for FDI, it is becoming an increasingly important source of this type of

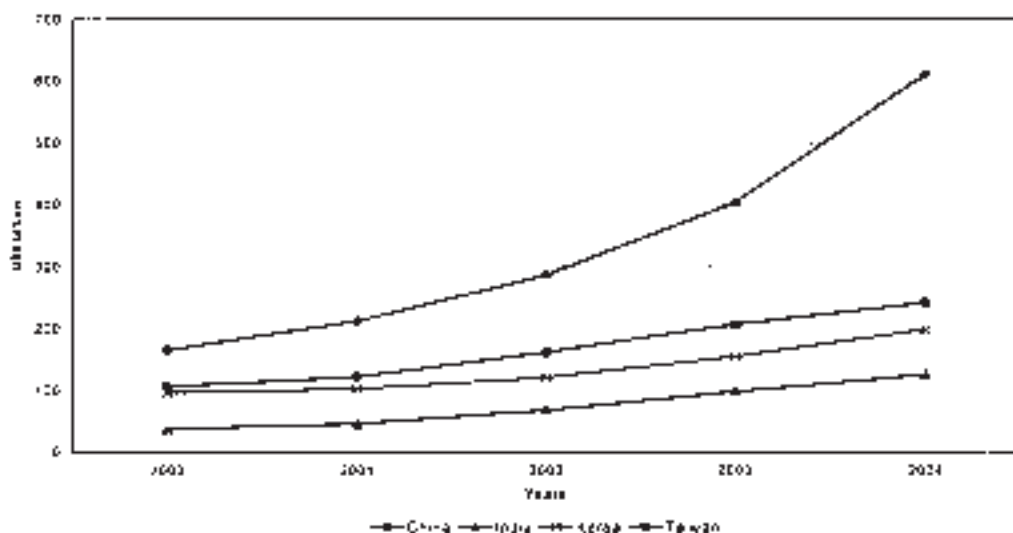
flows for this category of countries. But will this trend continue? How important will these types of flows be for other developing countries in the future? Also, can China's and India's portfolio flows have a complementary role as well? What is the likelihood that this will happen? As regards official flows, how harmful can Asia's disengagement from US assets be to other developing countries? What about potential benefits? Can developing countries appropriate the benefits of this disengagement in the longer term, as the locus of new investment opportunities? What countries could benefit – mainly Asian developing countries, or countries outside Asia as well?

### 3 The role of Asia's official flows in sustaining the US current account deficit<sup>2</sup>

One of the key aspects of the Asian dynamism is the large trade surpluses many of the region's countries have been generating over the past years. In most cases, the trade surpluses have resulted in current account surpluses as well. In the context of fixed or at least heavily managed exchange rate regimes, the result has been that Asian governments have accumulated large stocks of foreign exchange reserves (see Figure 1). This has served the purpose of insuring against instability in the international financial markets, and avoiding undesirable appreciation of their currencies, which could undermine their international competitiveness.

As mentioned above, most of these reserves have been invested in US assets, and have helped finance its large and growing current account deficit. For example, three-quarters of China's US\$600bn foreign reserves have been invested in the US. This

**Figure 1: Foreign exchange reserves of selected Asian countries**



Sources: Author's elaboration based on Global Development Finance, 2005; BIS, 74th Annual Report, June, 2004.

has helped sustained US growth, and has been good to Asia, as it has provided a dynamic market for the region's exports. But there are already indications that some Asian central banks are starting to reassess their portfolio investment strategies. After all, holding such amounts of reserves is becoming both costly for many countries (these are quasi-fiscal costs related to sterilisation operations) and risky, in face of the prospect of capital losses associated with the dollar devaluation and rise in the US interest rates (*Global Development Report 2005*, Ch. 3). Indeed, a number of Asian governments have announced they intend to reduce the percentage of the reserve flows they invest in US assets. This implies diversifying their portfolio gradually towards assets in other currencies, such as the euro and the pound, and even towards non-government assets that had not been considered before among their investment choices.

This new investment strategy by Asia's central banks may accelerate the decline in the dollar. The major risk is not so much the decline in itself, seen as necessary for the adjustment of the US economy, but that it happens in a disorganised way. There is a growing consensus that a coordinated strategy is required to avoid a sharp dollar decline, requiring

*inter alia* a gradual adjustment of the US fiscal deficit, efforts to stimulate growth in the euro area, and a revaluation of the Chinese currency, within a broader re-alignment of Asian currencies (which has already started, but very timidly following China's recent adoption of a band system for its exchange rate).

What macroeconomic policy responses will too rapid a decline in the dollar cause? A sharp increase in the US interest rates? Could the latter also happen independently of the behaviour of the dollar? What will be the costs of a sharp increase in the US interest rates for developing countries? What about the broader effects, for example in the form of a sharp slowdown of the US and thus the entire world economy? What impact will that have on developing countries? What will be the consequences for developing countries of the increased macroeconomic and financial volatility as a result of these adjustments?

We know developing countries are not a homogeneous bloc. They hold different levels of private debt, and have different financing needs, institutional arrangements (e.g. insurance mechanisms, social protection, exchange rate regimes) and export structures. Thus, the impact will be differentiated across the developing world. Which countries will be most affected? What factors

**Table 4: Net FDI flows to developing countries and largest recipients 1996–2004, annual averages (US\$bn)\***

	1996–1998	1999–2001	2002	2003	2004†
Developing countries	156.1	174.5	154.0	151.8	165.5
China	42.7	40.5	49.3	53.5	56.0
Brazil	20.9	28.0	16.6	10.1	15.3
Mexico	11.5	18.9	14.8	10.8	14.1
Russia	3.4	2.8	3.5	8.0	7.8

Source: Author's elaboration based on *Global Development Finance* (World Bank 2005).

\*Current annual values are used to calculate the annual averages; †estimate.

will be the most harmful – the decline in the dollar, the increase in interest rates, and for what countries? Which sectors and population segments will be hit hardest? By how much? Through what mechanisms?

#### 4 FDI into and out of China

Table 1 shows that FDI to China was on the increase between 1999 and 2004, although FDI as a proportion of the country's GDP looked fairly stable. This proportion is not very high – it has been within the range 3.5–4.0 per cent over the period but the absolute FDI value at US\$56bn for 2004 is significant. In that year, it was equivalent to 34 per cent of total FDI to all developing countries. Also, it placed China as the largest recipient of FDI among developing countries, far ahead other large recipients such as Brazil, Mexico and Russia (see Table 4). These figures should be tempered by the fact that part of FDI to China is round-tripping Chinese capital, that is, capital that leaves China unregistered and officially re-enters the country as capital from Hong Kong.

As is well known, China's position as a major pole of attraction of FDI is not a recent phenomenon. It has attracted this type of flows

since the early 1980s, following its open-door policies initiated in the late 1970s. Table 5 shows how much China's FDI stock increased between 1980 and 2003, both in absolute terms and as a proportion of the country's GDP.

As can be seen from Table 5, China's FDI stock grew dramatically from around US\$1bn in 1980 to US\$500bn in 2003, or from 0.5 per cent to over 35 per cent of the country's total GDP.

Most of the FDI to China has been directed to the manufacturing sector; 66 per cent of the total flows in 2001, thereby contributing to China becoming a centre of regional and global production networks, and a major export platform. Indeed, multinational corporations (MNCs) in China are responsible for more than half of China's exports (Cheong and Xiao 2003).

China's position in regional and global production networks implies that at the same time it competes with other countries for third markets (and to a lesser extent their own markets), it also plays an important complementary role. The patterns of origin of FDI to China indicate that this is certainly the case at the regional level. During the period 1995–2001, FDI from neighbouring

**Table 5: FDI stock in China: selected years**

	1980	1985	1990	1995	2000	2002	2003
US\$bn	1.1	6.1	20.7	134.9	348.4	448.0	501.5†
GDP (%)	0.5	2.0	5.8	19.3	32.2	35.4	35.6

Source: Author's elaboration based on *World Investment Development Report* (UNCTAD 2004).

†Estimate.

**Table 6: China's and India's FDI outflows (US\$m)**

	1980–9	1992–7	1998	1999	2000	2001	2002	2003
China	450.0	2846.0	2634.0	1775.0	916.0	6884.0	2518.0	1800
India	NA	96.0	47.0	80.0	509.0	1397.0	1107.0	913.0

Source: Author's elaboration based on UNCTAD *World Investment Report* (2004).

countries accounted for nearly 70 per cent of total FDI flowing to China. It is true that the main FDI source was Hong Kong, whose share in the total was at 44 per cent, and that a significant portion of this amount – 25 per cent according to the *World Investment Report 2003* (UNCTAD 2003) – is just round-tripping Chinese capital. But Japan, Taiwan, Singapore and Korea together also contributed to nearly 25 per cent of FDI flows to China (Cheong and Xiao 2003).

#### 4.1 FDI outflows

China and India's FDI outflows are a relatively new phenomenon that, according to preliminary indications, is growing in importance and that can have far-reaching implications for other developing countries. The questions to ask are: how much FDI is flowing from China and India, and to which countries and sectors? What is driving these flows? What do these new trends imply for developing countries?

Table 6 shows that China's FDI outflows more than quintupled from the 1980s to the 1990s, from around US\$450m annually to over US\$2,846m over the 1992–7 period. From 1999 onwards, these flows started to oscillate. The accumulated flows resulted in a FDI stock abroad totalling US\$37bn in 2003 against a stock of US\$2.5bn in 1990 (see Table 7).

As regards India, Tables 6 and 7 show that the country's FDI outflows also grew very rapidly, from

just US\$96m in the 1992–7 period to nearly US\$1bn in 2003. The result was a FDI stock held abroad of over US\$5bn in 2003.

China and India are not the main sources of FDI among developing countries. China accounted for only 5 per cent of total developing country outflows during 2000–03, and for 4.3 per cent of the total developing country FDI stock held abroad in 2003 (UNCTAD 2004). But the figures above also show that these two countries are becoming increasingly important FDI sources. Where are these flows going? Mainly to developed or developing countries?

In the case of China, the largest recipients are Hong Kong and the US. These two countries alone accounted for over 50 per cent of the value of approved FDI projects abroad in 2002. At the same time, the following developing countries are listed among the top 15 destinations of Chinese FDI (measured by cumulative FDI value over the 1979–2002 period): Peru, Mexico, Zambia, Cambodia, Brazil, South Africa and Vietnam.

Thus, although most flows are going to developed countries, a number of developing countries are also capturing some of these flows, which in some cases are significant when measured as a proportion of their GDPs. Moreover, the flows' destination patterns seem to be changing very rapidly. Between January and November 2004, Latin America received 49.3 per cent of China's total outward investment, with 29 per cent of the remaining flows going to Asia and 16.4 per cent to

**Table 7: China's and India's FDI stock abroad (US\$bn)**

	1990	1995	2000	2002	2003
China	2.5	15.8	25.8	35.2	37.0
India	0.1	0.3	1.9	4.0	5.1

Source: Author's elaboration based on *World Investment Report* (UNCTAD 2004).

Europe (*People's Daily Online*, 7 January 2005).

In the case of India, developing and emerging countries figure more prominently in the country's list of FDI destination, accounting for nearly 70 per cent of approved cumulative FDI values for the 1996–2003 period. The largest recipients have been Russia, Mauritius, Sudan and Vietnam. If Russia is excluded, over 50 per cent of the country's FDI have been directed to developing countries (UNCTAD 2004).

#### 4.2 What is driving China's and India's FDI towards other developing countries?

In the case of China, the main factors are willingness to acquire foreign technology, desire to establish distribution networks abroad and to relocate mature industries to countries with lower wages (UNCTAD 2004: 25–7). More recently, their need for natural resources to sustain their high growth path has been a key factor.

Between 2000 and 2004, exports from Latin America to China witnessed rapid growth. Brazil's exports to China grew by 400 per cent over the period,<sup>3</sup> and Chile's exports grew by 59 per cent in 2003 alone (ECLAC 2004). Latin America has exported mainly mineral and agricultural commodities. That makes the region a natural port for China's FDI.

China has invested in the steel, iron, agriculture and forestry in Brazil; and signed accords with Venezuela to invest in the oil industry. China's appetite for raw materials from Latin America led it to aim for large infrastructure investments in the region. It reportedly promised US\$50bn investment in roads, ports and other infrastructure projects (*Financial Times*, 9 March 2005). Much of the promised investments are as yet largely unconfirmed, however.

In the case of India, the country's companies and firms' aim for new markets, establishment of distribution networks, foreign technologies and the build-up of brand names seems to be the major driving force behind its investment abroad (UNCTAD 2004, Ch. 1: 27). The leading companies and firms in this process have been those that provide IT services, and those of the pharmaceutical industry. As regards developing countries, India's growing needs for natural resources seems to be a major force behind investments in this group of countries, as its investment in Russia (which has been mainly in oil) attests. India, which at present imports 70 per cent of its oil needs and has an oil consumption *per*

*capita* of only one-third of the world's average, faces the critical challenge of expanding its foreign sources of energy abroad, especially in view of its limited domestic natural resources.

Given these recent trends, will China and India, and developing Asia more broadly, become an important source of FDI to developing countries? What will be the beneficiary sectors – only natural resource-intensive sectors? Will the poor be able to benefit from these developments, or will they remain outside any benefits, especially if most FDI goes to resource-intensive industries? What room will host governments have to pursue redistributive policies? Will that be possible to be done through fiscal channels, particularly in Latin America, where they face high debt-service and thus budgetary constraints? These are questions that future research could aim to address.

#### 5 Portfolio flows

As seen earlier, private portfolio flows to China and India have increased in the recent past, as a result of renewed interest by international investors in emerging market assets and as a result of gradual capital account liberalisation. As liberalisation continues, and private capital outflows become important, where will these flows go to? And what about the official flows, currently invested in the US and other developed countries?

Recently, a number of initiatives have taken place in Asia to promote regional financial integration, including among others the issuance of local currency bonds by the Asian Development Bank and other foreign issuers to promote financial integration in Asia.<sup>4</sup> Park and Bea (2003) argue that this will be good for the region. Greater regional financial integration in Asia could lead to a regional currency, which in turn could facilitate the creation of a regional denominated securities market, thereby reducing currency mismatch, a key issue facing financial systems in developing countries. It could furthermore contribute to the channelling of Asian savings towards financing investment and growth inside the region. Could these developments mean a greater share of both official and private Asian flows being invested inside Asia rather than outside as is currently the case? How much of Asia's capital will stop going to the West, and be invested instead in Asia? Will other developing countries be able to tap these resources as well? What instruments and mechanisms could these countries develop to have

access to these flows? As regards the current challenges facing the world, what will be the implications for the resolution of today's world macroeconomic imbalances?

These developments could also have important implications for Asia's exchange rate regimes, their investment priorities and, linked to that, their policy choices of whether to target exports or domestic demand as the main engine of growth. This, too, could have far-reaching implications for the rest of the world.

As regards Asian official flows, it is well known that large reserves are becoming increasingly costly for a number of Asian developing countries. Aiming for lower levels of individual reserves, and having in place a regional pooling of reserves, is seen by many Asian analysts as a more cost-effective arrangement. The Chiang Mai initiative, which has been so far the main step towards a regional arrangement, could be strengthened. Again, what implications will that have for the world and for developing countries outside Asia?

## 6 Final considerations

All the possible developments mentioned in this article, as a result of continued dynamism of Asian countries, particularly China and India, involve a number of political economy issues that future research could also aim to address.

For example, what will be the implications of the unfolding of different scenarios for the adjustment of the US macroeconomic imbalances, for global governance? What will be the implications of a successfully strengthened Chiang Mai initiative

for the power position of multilateral institutions such as the International Monetary Fund (IMF) in relation to Asian countries? Specifically in relation to China's and India's growing economic power, will that be translated into efforts to have a greater voice in multilateral institutions such as the IMF and the World Bank? Will they build alliances with other developing countries in a consistent fashion, so that developing countries can pursue common platforms in international fora, or will alliances be forged on a case-by-case basis? Will the overall results be net positive for other developing countries? What strategies could these countries build to maximise benefits (and minimise costs) through allying with China and India?

The issues and questions raised in this article will have to be addressed through a number of disciplines and methods, including both quantitative and qualitative analyses. Research in this area will also have to take into account the fact that the issues and questions may vary significantly across regions and countries (and even within countries). For example, for different categories of countries, what flows will be the most important? Will the competitive or complementary effects dominate? What will be the intensity of the impacts and how manageable will these be? What arsenal of instruments and mechanisms (individual, regional) will be available to respond to shocks and changing circumstances caused by the Asian Drivers? These questions imply that regional and country-specific issues and questions should be clearly identified to guide future research and policy design.

## Notes

\* This is a shortened version of a background paper prepared for the Asian Drivers Workshop held on 9–10 May 2005 at the Institute of Development Studies. I would like to thank the workshop participants for their comments and Atsuo Mori for research assistance. The usual caveats apply.

1. It should be remarked that part of this FDI is just round-tripping Chinese capital.
2. For a thorough analysis of the US current account deficit and the unfolding of alternative adjustment scenarios, see Griffith-Jones (2004).

3. Figure from Brazil's Ministry of Development, Industry and Trade. But as Fleury and Fleury (in this *IDS Bulletin*) show, Brazil has moved from a trade surplus to a trade deficit with China in a very short period of time.
4. See *Financial Times*, 'Asian bank will issue bonds in local currencies to help markets', by Victor Mallet, 15 April, (2005); also Hoschka (2005).



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