Summary of Summaries on "The Trend of Trade, Foreign Direct Investment and Monetary Flows in East Asia, and its policy Implication"

February 2009
Lead Institute (Nomura Research Institute)

1. Increased Interregional Dependence in Trade

Much of the rise in intraregional trade is in manufactured parts and components, especially in the electronics and automotive sectors. This is a manifestation of the significant growth of production networks in the region that have made the region the hub of global manufacturing.

Inside the networks, processed materials, parts and components, and capital goods are exported from Japan, Korea and ASEAN to China and ASEAN, where final consumption and capital goods are assembled and exported to non-East Asian countries such as those in North America and Europe.

China is functioning as the assembling base of electric machineries and household electric appliances for the world market by importing parts and components from the rest of East Asia.

It suggests that East Asia cannot be "decoupled" from North America (US largely) simply because the latter is a major destination of East Asian exports. A drop in China's exports to the rest of the world, especially the US, would have a knock–on negative effect on the rest of East Asia

Regarding the trade policy, East Asian countries have substantially liberalized their trade regimes in terms of import tariffs in recent decades. This can be observed in the historical changes in the average tariff rates. Turning to the sectoral differences in the tariff rates, the tariff rates on agricultural products are higher compared to those on non-agricultural products.

2. FDI to Influence Trade

Although FDI inflows to East Asia have remarkably increased, EU is the largest recipient of gross FDI inflows as a region followed by the US. Indeed, share of FDI stock to GDP is lower in East Asia than the World. Attention shall be paid to the substance of FDI in order to clarify the importance of FDI rather than simple volume, because FDI in developed countries are inflated by M&A.

First, similar to trade patterns, intra-regional dependence in terms of FDI inflows increased from 19 percent in 1997-2000 to 25 percent in 2002-2006.

Second, FDI in the region tends to enhance intraregional trade. Countries with large FDI stock are more likely to import parts and components and are more likely to export final good. We statistically analyzed the characteristics of the trade structure in East Asian countries in comparison with other economic regions, such as EU and NAFTA. The coefficients for regional dummies clearly show that East Asian has unique performance among other regions. Asia exports more parts and components than other regions do.

3. FDI Policy

According to our analysis, inward FDI of ASEAN+3 countries are significantly affected by population, GDP per capita and Real GDP growth. In general, the determinants that matter to FDI, including such factors as the quality of infrastructure and bureaucracy, are in fact the same concerns of the domestic investors. Thus, the flow of FDI is reflective of the overall domestic investment climate.

Many East Asian countries reduced restrictions on market access by reducing the number of sectors and industries on the negative list and by relaxing the limits on foreign equity ownership. A number of countries introduced incentives such as tax breaks to attract FDI. However, a number of studies have pointed out that foreign companies face various problems such as lack of transparency in FDI policy and complicated FDI application procedures.

For all the importance being heaped on FDI, the most important source of growth and competitiveness is domestic investment. Much of the enterprises, mainly small and medium enterprises that comprise a local production network or industrial cluster are domestically owned, even if many are linked to foreign owned firms through subcontracts.

4. Financial Capital Flow

Overview of balance of payment (BOP) in ASEAN+3 indicates that increasing trend of current account surplus coupled with net financial account inflow have made overall BOP significantly rise after the Asian financial crisis, and this imbalance has resulted in a huge amount of reserve accumulation.

Among such financial account flows, the share of intra-regional flows is rising over time due to the mutual expectations of economic growth, while the inflows from the US seem to have changed little. There has been increasing focus on regional markets both as creditor and debtor, as the investors seek for higher yield. On the other hand, dependency on "other investment" highlighted in the 1997 crisis has decreased, which is attributable to improved current account balance and increased portfolio investment and direct investment.

With view to overall position of portfolio investment of East Asia in the world, East Asia comes as only third position behind the US and EU as a portfolio investor in East Asia. This may reflect two important critical points: (i) the capital markets in many of the developing East Asian countries are thin or do not have the financial depth and sophistication to allow for portfolio balancing at minimal cost for savers and portfolio holders in the region; and (ii) capital controls are still significant. Such financial instruments that allow for risk management and at the same time of maximizing returns are still not commonplace in developing East Asia.

5. Interdependence of the Regional Economy

Statistics attest to growing interdependency between ASEAN nations and Japan, China, and South Korea. Business community believes that the adoption of free trade agreement will guarantee security in trade and investment. With the implementation of a single rule of origin, the plus three nations can use ASEAN as a production base.

According to analysis focusing selected 3 countries such as Indonesia, Thailand, and South Korea, intra ASEAN+3 trade in the three countries depend on the development of economic growth in the area. Thailand and South Korea trade and FDI are more sensitive to GDP growth and real exchange rate, especially on its import. South Korea FDI depends on its economic growth. On the other hand, depreciation of real exchange rate does not increase intra ASEAN+3 trade export in Indonesia, Thailand, and South Korea. High domestic real interest rate in Indonesia will increase FDI inflow to the country. This may reflect the high rate of return of investment in Indonesia. On the other hand, a higher international interest rate will decrease FDI since it means a higher cost of fund in international market.

6. External Impact of Economy and Capital Flow

Our observation reveals significant positive correlations between growth of stock index and yield ratio in the panel data constructed with US and ASEAN+3 panel data. Also, calculated coefficient implies that higher credit extension of US coincides with larger capital inflow to ASEA+3 countries by means of portfolio investment and direct investment. Estimated fixed effects of the ASEAN+3 countries show Hong Kong and Singapore are subject to non-US credit factors, which may reflect highlight those two markets as regional financial hubs.

According to VAR analysis, impacts of financial inflows on domestic market and economy may have volatile impact for a shorter period, but these effects would stabilize in several quarters. Thus, the assessment of impacts of capital flow shock towards domestic credit, stock price, and economic growth reveals existence of certain influence patterns. However, influence patterns would be different depending on the degree of openness. In many Asian countries, the authorities are generally considered to be cautious on fully lifting the restrictions on financial flows.

Another VAR model analysis reveals that fluctuations of GDP and export of East Asia countries are significantly accounted for by shocks of the regional factors and US imports, and ASEAN GDP is strongly affected by China. This may reflect trade structure of East Asia mentioned earlier.

7. Signals of Financial Crisis

Preceding financial crisis, several aspects of the buildup to the crisis might be considered. Preceding assessments often mention the factors such as huge overall capital inflow (especially short-term finance), inflexible exchange rate which sometimes encourage capital inflows and may deteriorate trade position, declining export growth, expanding domestic credit extension, etc.

In order to provide insights related to above based on data analysis, we conduct a probit model analysis to identify the early-warning indicators that precede capital outflow shocks. The estimation results show debt liabilities do positively affect the probability of shocks as expected. Similarly, foreign reserve stock affects negatively. Thus, we may be able to conclude that financial openness is relevant to the probability of crisis. Significantly higher or lower growth of stock prices also tends to precede the capital outflow shocks. Contrary to our expectations, impacts of domestic credit and CPI on the probability of shocks are negative or not significantly detected according to our analysis.

8. Global imbalance

According to assessment of global economic shocks on the dynamics of consumption and real exchange rate, a country with relatively large net foreign assets as percentage of its GDP tends to accumulate more assets in the presence of positive global real economic shocks, thereby adding to the 'global saving glut.' In the medium to long run, however, we observe the declining dispersion across countries from the distribution of net foreign assets/GDP.

The debate over 'global imbalances' has intensified in the early 2000s, when the world witnessed stronger economic growth, lower financial market volatility, and the 'global saving glut.' Triggered by the subprime mortgage crisis in the US, the global economy has recently entered into the period of a sharp slow down. The issues of how a country should tap on its foreign exchange reserves, manage the net foreign assets, or pool them as a part of economic cooperation, taking into account the macroeconomic objectives, have become ever more a challenging task.

9. Policy Recommendation

Interdependence in the region increased in terms of trade, FDI and financial capital flow, which have brought positive effects such as mutually-beneficial and organic trade relationship and relatively stable capital flow to macro economy.

Trade Policy

1) East Asian countries have liberalized their trade regimes in terms of import tariffs substantially in recent decades. However, it is very important for policy makers to be reminded that there still exist a lot of room for tariff reduction and furthermore that the number of non-tariff barriers including quantity restrictions and technical standards appears to be increasing although it is difficult to obtain the accurate picture of the current situation.

FDI Policy

2) Similar to the situation for foreign trade regime, our analysis of FDI regimes has found that FDI policies have been liberalized but there still is an ample room for improvement. This is especially the case concerning FDI facilitation measures such as FDI application and approval procedures, protection of investors, enhancement of governance, and overall investment climate.

Policy on Financial Flow

3) East Asian countries have increased financial openness in terms of “de facto” measures which are calculated as the total stock of inflow/outflow of FDI, equity and debt stocks in gross terms. Impacts of financial inflows on domestic market and economy may have volatile impact for a shorter period, but these effects would stabilize in several quarters. Excessive dependence on external capital inflow shall be avoided, as global market fluctuation and/or unstable capital flow might affect in both positive and negative ways.

4) Financial openness shall be pursued as it could enhance flexibly-available financial resources, which contribute to economic growth. Meanwhile, policy makers may utilize certain warning signals in order to avoid/prepare for hard adverse impacts. The useful combination of those signals includes dependence on debt position, domestic stock market, and foreign reserves according to our analysis.

5) On top of such monitoring scheme, (i) preparatory policy measures to control excessive market movement in a carefully accountable manner, as well as (ii) policy coordination such as CMI, would be useful.

Regional cooperation framework

6) Since the interdependence in the region has increased, economic or/and financial turbulences of one country might significantly affect others. Thus, it has become more important to implement regional surveillance coordination, which shall then be utilized and reflected into coordinated policy measures in the region.

7) There is need for new schemes, as well as ASEAN+3 cooperation, to reform and strengthening the economic and financial market. Starting from United States, the crisis has affected ASEAN+3 nations. Strengthening economic cooperation in ASEAN+3 is becoming more important

In order to achieve the policy objectives noted above, ASEAN+3 countries may consider the formation of region-wide frameworks such as a region-wide comprehensive FTA, which include trade and FDI liberalization, facilitation, and various kinds of cooperation including financial and macro economic cooperation and coordination.