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Global capital flows and strengthening investment in the Asia-Pacific region

Introduction

Investment is critical to sustain economic growth over time and increase living standards in all economies. When combined with efficient saving, high quality investment can also help to resolve global economic imbalances and ensure stable international capital flows. While substantial reform has already occurred in the Asia-Pacific region, impediments to greater investment remain.

Investment as a proportion of GDP across the APEC economies as a whole has remained relatively constant over the last decade at around 24 per cent. But this masks substantial differences in investment patterns within the region in recent years. Investment has been growing strongly in China. Investment has also been rising in a number of APEC commodity exporting economies including Australia, Canada, Chile, Mexico, New Zealand, Peru and Russia. Many of these economies have experienced strong economic growth in recent years, partially driven by the strong demand for commodities which has pushed up commodity prices, and this appears to have led to a pickup in investment since 2002. In contrast, investment in many emerging Asian economies is still well below the levels before the 1997-98 financial crisis, particularly in private investment. While pre-crisis investment levels may have been unsustainable, there is a sense that current levels are not sufficient to support the rapid growth potential of emerging East Asia.

The Asia-Pacific's investment needs

The investment needs of the Asia-Pacific region are substantial. In developing economies, greater investment in urban infrastructure and productive capacity is required to support ongoing industrialisation and urbanisation Rising incomes are also raising expectations for better social infrastructure, including hospitals, schools, and a cleaner environment. In resource-producing economies, strong global demand has increased the need to expand infrastructure to extract, transport and develop energy and mineral resources. Much of this investment will be undertaken by the private sector, and so it is important that market mechanisms to assess projects, value risk, and provide finance work as well as possible.

Efficiency in investment

Open and well-functioning markets help ensure that high-quality investment projects are identified and can attract sufficient funding. Ongoing domestic or behind-the-border structural reforms that enhance the efficiency of markets can significantly improve the quality of investment in the APEC region. These may include reforms to encourage competition, simplify government regulations, and improve public and corporate governance.

Well-functioning markets also help to direct investment towards those areas with the highest economic returns and potential social payoffs. Across the APEC region, investment in physical

infrastructure and in the services sector, particularly education and health, will be important in supporting future economic growth.

Since investors base their decisions on expected returns, policies that create more uncertainty about future returns will discourage investment. A useful framework for assessing the economic impact of impediments to markets would categorise them through their effect on cost, risk, or the level of competition.

The cost of investment may be inflated by high finance costs, inefficient taxes, overly burdensome government regulations, and inadequate infrastructure. Simplifying the regulatory framework and improving public- and private-sector governance to reduce corruption can reduce costs and improve the investment climate. A lack of competition in the financial sector can also restrict access to funds and raise borrowing rates. Further developing and deepening capital markets, including corporate bond markets, and diversifying the range of financial institutions and products can increase the availability of funds and reduce the cost of investment.

A stable policy environment, good governance, transparency, clear rules around property rights and a sound legal framework all reduce risk and encourage greater investment. Stable growth-oriented macroeconomic policies also enhance investor certainty. These policies include sustainable fiscal policies, monetary policies aimed at constraining inflation, and an exchange rate regime that supports adjustment.

Explicit restrictions or controls on investment also exist in some APEC economies. These barriers may limit the quantity and quality of investment within economies and across borders. They can take many forms including prior approval screening or licensing requirements, joint venture requirements, and limits on the share of equity held by foreign investors. Operational restrictions affecting foreign and domestic investors include those governing board membership, restrictions on employment of expatriate personnel, and performance requirements.

Foreign investment accounts for a relatively small proportion of total investment in APEC economies at around 10-12 per cent. However, foreign investment can have significant benefits for economic growth and development. The optimal mix between portfolio and foreign direct investment (FDI) will vary between economies. While FDI is less subject to capital flight and brings with it management expertise and technological spill-overs, portfolio investment can play a critical role in providing capital for banks and other financial institutions and funding and risk-management tools for firms.

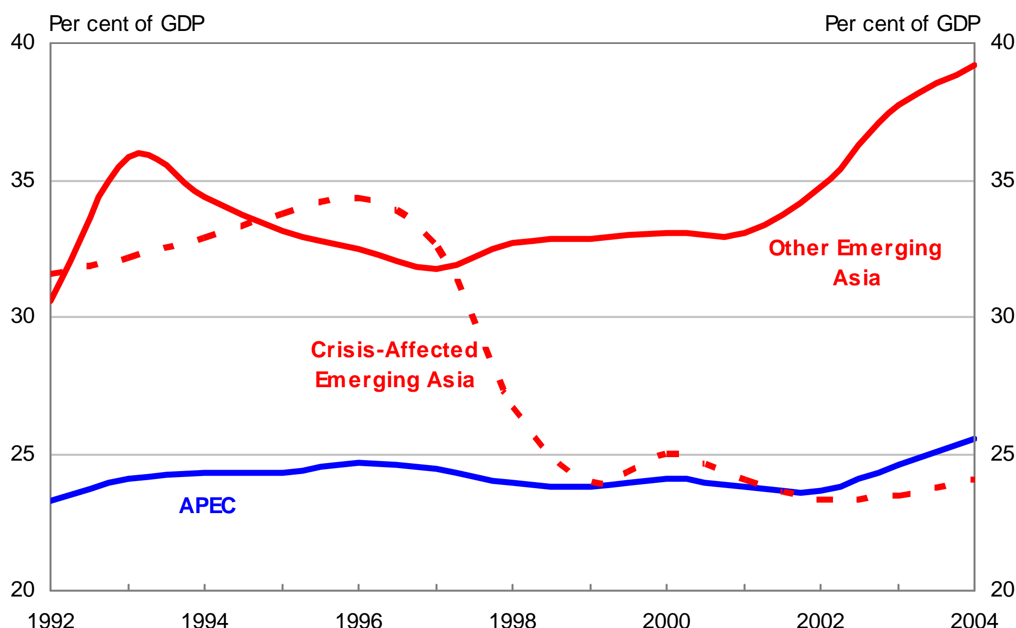
Despite the decline in investment in parts of Asia, savings rates have remained high. The resulting current account surpluses have contributed to the global financial imbalances that pose a risk to the global economic outlook. Improving the investment climate and directing the region's excess savings towards regional investment, supported by higher saving in low-saving APEC economies, will reduce the vulnerabilities arising from global imbalances.

APEC is seeking to promote further work on structural reform in the region. In 2004, APEC Leaders adopted the Leaders' Agenda to Implement Structural Reform (LAISR) that covers five key priority areas of behind-the-border structural reform: regulatory reform, economic and legal infrastructure, competition policy, corporate governance and public sector management. The APEC Economic Committee, Investment Experts Group and other forums are working to improve underlying conditions for investment in the region.

Recovery in investment

The investment levels in some APEC economies were not affected by the Asian financial crisis. For other economies, such as China, investment levels fell after the crisis but have since recovered strongly. However, in some economies, investment as a proportion of GDP fell sharply and has remained well below pre-crisis levels (Chart 1). Latin American economies also experienced a drop-off in investment following a crisis in the 1980s, but the decline in investment in some emerging Asian economies has been particularly prolonged. This is despite a strong need for investment in infrastructure, the services sector, and human capital in the region.

Chart 1: Investment in APEC



In economies where the quantity of investment has not recovered, the composition of investment has generally changed, with FDI remaining stable while portfolio investment has fallen away. Against the overall decline in investment, there has been continued strong investment, particularly FDI, in internationally exposed firms. This suggests that firms exposed to global competitive pressures have become more efficient, and are therefore more able to attract investment.

Since the crisis, many economies have undergone significant economic and financial restructuring. The crisis prompted corporations to re-examine their capital structures and consolidate their balance sheets, while governments have tightened their fiscal positions. Banks and other financial institutions have strengthened their lending practices and improved their allocation of credit.

These reforms, together with the removal of some subsidies and concessions, have introduced greater competition, improved governance and disclosure, and placed greater financial discipline on firms. These reforms may have contributed to the decline in investment in the short term, but should lay the foundation for sustained quality investment in the longer term. While significant reforms have already been achieved, ongoing efforts to encourage greater investment in the region, including in services, are required in an increasingly competitive global market.

High pre-crisis levels of investment may have led to excess capacity in some economies that is only now being absorbed. Moreover, the crisis brought about a revised perception of — and appetite for — risk. This build-up of excess capacity, combined with a demand for higher-quality and lower-risk investment, may explain some of the decline in investment.

One sector particularly affected by the decline in investment has been small- to medium-sized enterprises (SMEs). A limited range of lending products and a high reliance on bank finance may be restraining access to capital by SMEs. Additionally, lingering uncertainty about the strength of domestic demand in some economies may be limiting investment by SMEs, which are more reliant on domestic economic performance. Further development of capital markets and more diversified lending products, such as corporate bonds, could enhance the ability of SMEs to access credit.