Discussion of “Regional monitoring of capital flows and coordination of financial regulation: S takes and options for Asia”

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Summary

• Capital flows are necessary but need monitoring
  - Capital flow reversal => externalities
  - Double mismatch
  - Financial regulation needs to be improved, including that of hedge funds and credit rating agencies.

• Asia needs better financial markets
  - High savings and high investment needs
  - But financial intermediation is outsourced
  - Problems with capital flows accompany the outsourcing of financial intermediation.
Comments

• This is a comprehensive discussion of capital flow monitoring and financial regulation coordination in Asia.
• Many good recommendations.


Comments

• The role of foreign direct investment
  - Mitigating the double mismatch problem
  - Mitigating the capital reversal problem
  - Cooperation and trust building
    • Investment climate
    • Is loss of sovereignty a real concern?
Comments

- Asia, or some economies in Asia, as exporters of capital
  - High savings: “growth prospects, demographics, institutional characteristics, and savings behavior”
  - Savings may exceed investment needs
  - Infrastructure for outward investment needs to be improved
  - Facilitating outward direct investment
    - Political obstacles to direct investment
    - Capabilities to manage outward direct investment
**Comments**

• *Incentives for improving financial regulation*
  - *Cooperation in Asia may help create incentives*

• *Credit rating agencies: to few to fail*
  - *Cooperation in Asia to help the formation of credible alternatives*
Thank You!
FDI to China
Questions:

• Why does China attract so much FDI and at the same time export capital by purchasing government bonds abroad?

• Return differential between FDI and foreign government bonds.
The Reasons for FDI

- FDI brings in know-how that is lacking in China.
- The domestic financial system does not do a good job intermediating investment, and FDI is equivalent to contracting out of financial intermediation.
- Poor protection of domestic investors but better protection of foreign investors.
- Brings in capital.
- Discrimination against domestic private investors.
Our Questions

• Consider the roles played by the foreign partners in joint ventures.
• Do they bring in know-how?
• What kinds of know-how do they bring in?
• Do they bring in capital to relax the liquidity constraints of the domestic firms?
• Is there any evidence supporting the discrimination theory?
Why is the answer important?

• If foreign investors do not bring in any know-how (including the know-how to choose investment target and reduce incentive costs), then their only role is to relax the liquidity constraint of domestic firms.

• They may choose wrong investment targets, increase the incentive costs, and gain too much control of the economy.

• Huang’s argument: The reason for the large flow of FDI to China is because domestic firms face unnecessary liquidity constraints, and it is harmful for the Chinese economy.

• Liquidity constraints should be relaxed through other means.
Why is the answer important?

• If foreign partners in JVs do bring in know-how, what kind?

• Some know-how has spillover effects and its transfer should be particularly encouraged.

• Some know-how can be learned or developed by domestic firms. If foreign ownership has its costs, then such learning and development of such know-how should be encouraged.
Why is the answer important?

- We can also find out what roles domestic partners play in the JVs.
- To attract more FDI, the enhancement of the ability for domestic firms to play their roles is important.
Why is the answer important?

- In the process of our research, we also test the empirical relevance of theories of the firm, in particular theories about the joint venture.
Our method

• According to the incentive theory of team production, the partner who plays a more important role should be given more equity shares.

• By estimating the determinants of the foreign partner’s equity share, we can infer what roles are played by the foreign partner and the domestic partner respectively.
Data used (Almanac of China’s Foreign Economic Relations and Trade)

• 5217 joint ventures in manufacturing industries in China between 1985 and 1996
• Equity shares of the foreign and domestic partners
• Location of the JV: 28 provinces are represented
• Country of the foreign partner: 51 countries and regions
• 29 two-digit manufacturing industries are represented
The role of the foreign partner

• Providing technology
  - R&D intensity: the average value of the ratio R&D expenditure/sales in the industry

• Improving the access to the international market
  - Foreign/China RCA: the foreign country’s strength in exporting in the industry relative to China’s.
  - Advertising intensity: the average value of the ratio advertising expenditure/sales in the industry (if the joint venture sells to the international market, or is “vertical”)

• Training of staff
  - ETR: the share of engineers and technicians in the
The role of the foreign partner

• Providing capital only
  - Capital-labor ratio of the industry (+)
  - Per capita savings in the province
    - Supply of capital (-)
    - Demand of capital (+)
  - Investment size (+)

• Providing capital and reduce incentive costs
  Agency cost high -> less likely to get bank loan -> foreign investors are needed -> foreign investors get more equity shares.
  - Profit margin (-)
  - Capital-labor ratio (collateral) (-)
The role of the domestic partner

• Dealing with bureaucracy
  - The average time needed to register the JV after signing the contract in the province
  - The share of SOEs in the province and in the industry in terms of output

• Marketing
  - Advertising intensity: the average value of the ratio advertising expenditure/sales in the industry (if the joint venture sells to the domestic market, or is “horizontal”)

• Recruiting skilled local staff
  - ETR: the share of engineers and technicians in the labor force of the province
Other factors behind equity shares

- Managing the daily operations of the JV
  - Distance to China of the foreign country (-)

- Policy restrictions
  - In less competitive industries, foreign ownership is often restricted by government regulation (-)
  - Many capital intensity industries are considered strategic and foreign ownership is restricted there (-)
The determinants of foreign shares

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Conclusions about FDI

- FDI brings in know-how that is lacking in China.
  - Technology
  - Access to international markets
  - Employee training

- The evidence is consistent with the view that FDI helps with financial intermediation.

- There is no evidence that FDI plays an important role relaxing liquidity constraint.

- The evidence is not consistent with the view that FDI is the result of discrimination against domestic private investors.