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The Chinese Approach to Capital Inflows
(a proposed outline)

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1. Introduction

2. The Chinese Pattern versus International Norm

a. The total volume has risen from a very low (virtually non-existent) base at the beginning of the economic reform program in 1978 to a very high level (in absolute dollar amount) by now.

However, relative to its GDP, per capita GDP (and perhaps other natural determinants), the size of the inflow is not far from the mean or median of the cross-country distribution

[Show tables/figures on where China fits in the cross-country distributions].

b. The most unusual feature of the Chinese capital inflows is its composition: the share of FDI in the inflows is substantially higher than other countries (xxx standard deviations away from the median/mean???]

Earlier work by Wei suggests that the size of FDI relative to its GDP size and other "natural" determinants is not unusually high. If anything, China seems to be an underperformer as a host of FDI from the world's five major source countries. In more recent years, with the continued rise in FDI, China may have become a "normal" country [Verify it if there is time before the deadline.]

Therefore, the usually high share of FDI in capital inflows must reflect a simultaneous policy mix of discouraging foreign debt and foreign portfolio inflows and policy incentives for FDI.

c. China has been steadily accumulating foreign exchange reserve in the last ten years, becoming the world's second (???) highest reserve holder after Japan since ???. Relative to its GDP and total trade (exports+imports), China's FX reserve is xxx standard deviations away from worldwide mean/median.

[Note: it would be nice if we include a discussion on the FX reserve issue given the policy interest in the issue worldwide. We could skip it in this round if we run out of time to do anything serious.]

3. Sense and Sensibility: Understanding China in Light of the Relevant Literature

a. While in theory there are many ways through which capital inflows could help to raise the economic growth rate in developing countries, it is very hard to find a strong and robust causal link empirically. [Prasad, Rogoff, Wei, and Kose]

If anything, there is some evidence that a rise in financial integration from a low to a medium level could be associated with a rise in the relative consumption/GDP volatility (reflecting mostly currency crisis experience). [Prasad, Rogoff, Wei, and Kose]

On the other hand, FDI is likely to be the most beneficial type of capital inflows for developing countries (quote Box 3.1 in OP 220, p18).

In light of this literature, China's pattern of capital inflows seems appropriate.

b. The literature on fx reserve (Nancy Marion, Flood, Aisenman, etc). What are the bottom lines? Do they suggest that China's reserve/GDP is too high?

[Again, it would be nice to comment on this even if preliminary.]

4. How Does China Get Where It is: Inertia, Foresight, Luck, or Something Else?

a. three possibilities:

- a part of a mercantilist strategy
- a consequence of weak public governance
- a combination of inertia and the scare of the Asian financial crisis

[anything else?]

b. details

This is part of a mercantilist approach that seeks to dump exports on the world market (for which FDI is more useful than debt or ptf inflows, and reserve accumulation is the price to pay to buy the acquiescence of the importing countries like the US). Dooley-Folkslandau-Garber (DFG).

Some evidence that DFG hypothesis (the mercantilist view) cannot be the entire explanation of the Chinese approach: (i) China chose not to devalue in 1997-98 even though that would have increased its exports, and (ii) the massive fx reserve buildup is a relatively recent phenomenon, and (iii) for much of the last two decade up to 2001, the Chinese currency was

likely to be over-valued rather than under-valued according to the black market premium (is it possible to demonstrate it? Through Picks' currency book?]

Recent literature has also looked into the role of weak institutions (high level of corruption, lack of transparency, weak judicial system) in affecting the volume and patterns of capital inflows. Low transparency tends to substantially discourage international portfolio investment (Gelos and Wei, forthcoming, Journal of Finance). Weak public governance especially rampant insider trading tends to exacerbate stock market volatility, further discouraging foreign portfolio inflows (Du and Wei, forthcoming in Economic Journal). High corruption also tends to discourage FDI (Wei, RESTAT). However, taken together, these factors are unlikely to explain the particular composition of the Chinese capital inflows as weak public governance by itself tends to tilt the composition away from FDI and towards to foreign debt (Wei, International Finance).

Alternatively, this is a coherent approach consistently pursued since the beginning of the reform program in 78. Rather, it is the result of a trial-and-error, pragmatic reform strategy. [Deng Xiaoping: "crossing the river by feeling the stones," and "no need to differentiate a black or white cat, as long as it catches the mouse."] The pattern in the 1980s and early 1990s reflected a combination of inertia and luck. The pattern post 1997 reflected the scare of the Asian financial crisis.

At the start of the reform, there was no capital inflow of any kind. The early stage of reform sought to import only the type of foreign capital that was thought to help transmit technical and marketing know-how, thus "welcome to FDI, but no thank-you to foreign debt and portfolio flows," and export performance and foreign exchange balance requirement on FDI.

[Show a table and a figure on the evolution of the restrictions on capital account from the AREAER database.]

The restrictions on FDI were relaxed step by step, together with certain "super-national treatment" of (incentives for) for foreign owned enterprises and joint ventures.

Over time, the government had also started relax restrictions on foreign borrowing by corporations (and expand B-, H-, and N-shares market). The government declared (and informed the Fund?) in 199x (???) that it intended to implement capital account convertibility by 2000.

The psychological impact of the Asian financial crisis is profound (and perhaps more than the real economic impact). Several countries that China had regarded as a role model (esp Korea) went into a deep crisis in an instant. It is perceived in China that the swings in the non-FDI part of the international capital flows had played a crucial role in the process. In this sense, the Asian financial crisis has caused a re-thinking in the Chinese approach to capital

inflows. Gone is the talk of capital account liberalization by 2000. In vogue is the notion that the higher the foreign exchange reserve the better.

Eswar: Any other ways to empirically test these and other competing explanations?

5. Conclusion

summary of results

potential for further rationalization of the composition is there, especially if the country can make progress on strengthening the rule of law and public governance.