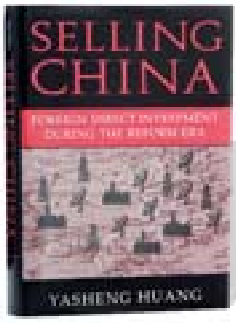


What's Behind Foreign Investment in China?

Yasheng Huang

Selling China
Foreign Direct Investment During the Reform Era
Cambridge University Press, New York, 2003, 406 pp., $50 (cloth).

CHINA'S ABILITY to attract foreign direct investment (FDI) is generally taken as a sign of its economic strength. Since launching market reforms in 1978, China has received over $400 billion in FDI. Inflows have recently averaged more than $40 billion a year and accounted for a fifth of all FDI flows to developing countries. Last year, China attracted more FDI than the United States, making it the largest FDI recipient in the world.

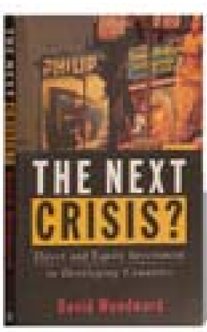
Yet Yasheng Huang of the Massachusetts Institute of Technology argues that the flood of FDI may be symptomatic of China's economic weakness. His thesis is that the business opportunities for foreign investors have been created by the inability of many domestic Chinese firms to improve their efficiency and by the constraints the country's reform strategy for state-owned enterprises (SOEs) have placed on the nascent private sector.

Although this reform strategy has been innovative in certain respects (for example, the use of experiments in incentive contracting), it has been deficient—even contradictory—in others. SOE reform has moved in fits and starts and thus has not been able to bring about a sustained improvement in corporate efficiency. As Huang notes, the strategy has been heavily oriented toward administration rather than driven by the markets. It has discriminated against domestic private firms, for instance, by providing tax benefits to foreign investors that are not available to domestic entrepreneurs. This type of discrimination promotes incentives for overseas Chinese to make foreign investments through "round tripping." Through weak market institutions that do not provide a bona fide system of checks and balances, SOE reforms have led to asset stripping, opportunistic behavior, and a misallocation of resources. In effect, China's SOE reform program has allowed for the privatization of assets and the socialization of liabilities.

Previous analysts have puzzled over China's ability to attract large amounts of FDI despite the lack of a strong tradition for abiding by the rule of law. Some have argued that this paradox can be explained by the fact that decisions made by foreign investors in China rely on the use of informal personal networks—*guanxi*—to compensate for the weaknesses in China's formal institutions. Huang's argument is complementary to this one. He notes that a substantial share of foreign investment has been in SOEs; these firms are not very efficient but are the most politically favored class of firms in China and thus enjoy certain commercial benefits unavailable to their private sector counterparts.

Huang marshals an impressive amount of data to bolster his thesis, and his study is an important contribution to the literature. There are indications, however, that the phenomenon to which he draws attention may be getting less important over time. The share of FDI flows going into joint and cooperative ventures has declined substantially since the mid-1990s: such flows accounted for 75 percent of total FDI flows in 1994, compared with less than 40 percent last year.

Harry G. Broadman
Lead Economist
Europe and Central Asia
Regional Operations
World Bank



The Perils of Foreign Capital?

David Woodward

The Next Crisis?
Direct and Equity Investment in Developing Countries
Zed Books, New York, 2001, xiv + 240 pp., $69 (cloth), $25 (paper).

THIS BOOK takes on international financial institutions for their advocacy of foreign equity capital as a way for developing countries to boost economic growth and diversify risks. David Woodward argues that this advice downplays the potential for equity capital to increase these countries' vulnerability to financial crises. He draws a parallel between the rapid rise in syndicated bank lending to developing countries in the 1970s, which subsequently led to a debt crisis, and the increase in equity flows in the 1990s, insisting that the latter could trigger the next crisis.

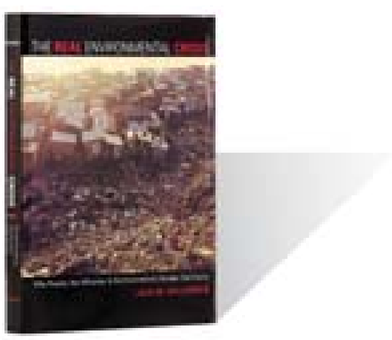
Woodward reaches a number of conclusions on the impact equity flows have on the host country, underscoring that the benefits are often overstated. Although many of his conclusions are debatable, he does rightly point to two issues of concern. First, the quality of data on foreign direct investment (FDI) and related flows to developing countries is poor, and estimates of such flows vary quite a bit from source to source. As a result, FDI's impact on a country's economy and balance of payments is often difficult to establish. Second, the poor quality of the information makes it difficult to form an accurate picture of the scale of developing countries' private sector liabilities, including companies' foreign debts and interbank liabilities, thereby increasing the countries' vulnerability.

However, Woodward's other conclusions, particularly those pertaining to FDI, are a trifle exaggerated. For example, contrary to his assertion, FDI flows do tend to be more resilient than other forms of capital flows, in part because the relatively long time horizon of FDI makes investors worry less about short-run reversals, including those that arise from host country policies. Also, unlike debt capital, on which interest payments have to be made even when the host economy is doing poorly, FDI involves risk sharing between the investors and the host country: the cost of servicing the investment falls when the recipient's economic fortunes decline.

Contrary to Woodward's fears, therefore, the increase in the share of FDI in total capital flows to developing countries, including in some systemically important ones, is a good development. This is not to downplay certain risks, however. For example, selected investors, such as banks, could conceivably reduce their investments in a country or withdraw completely at times of emerging pressures. Hedging operations by FDI investors could likewise lead to capital outflows when times are difficult.

Readers would have been well served by a discussion of how the financing and hedging of investments could affect FDI flows to developing countries, especially during a crisis.

Krishna Srinivasan
Deputy Division Chief
IMF Policy Development and Review Department



Jack Hollander

The Real Environmental Crisis
Why Poverty, Not Affluence, Is the Environment's Number One Enemy
University of California Press, Berkeley, 2003, 251 pp., $27.50 (cloth).

Lester Brown

Plan B: Rescuing a Planet Under Stress and a Civilization in Trouble
W.W. Norton & Company, New York, 2003, 285 pp., $15.95 (paper).

Food Fight!

JACK HOLLANDER and Lester Brown are soft-spoken men, but their books are a virtual shouting match between the two.

Hollander, an eminent scientist and emeritus professor at the University of California at Berkeley, accuses environmentalists of fostering "extreme pessimism" based on the mistaken notion that transition from poverty to affluence, by encouraging wasteful consumption, spells doom for the environment. As if on cue, Brown—a well-known environmentalist and president of the Earth Policy Institute—writes that the world has "built an environmental bubble economy, one where economic output is artificially inflated by overconsumption of the Earth's natural assets. . . . The destruction wrought by terrorists is likely to be small compared with the worldwide suffering if the environmental bubble economy collapses."

Hollander's thesis is that "poverty is the environmental villain; poor people are its victims." It is when people overcome poverty that they find the resources to devote to improving environmental quality. To make his case, Hollander points to the experience of the United States as it became affluent:

"In the United States the air is cleaner and the drinking water purer than at any time in five decades; the food supply is more abundant and safer than before; the forested area is the highest in three hundred years; most rivers and lakes are clean again; and . . . industry, buildings, and transportation systems are more energy- and resource-efficient than at any time in the past."

The experience of many other industrial countries is similar, Hollander says. While he admits that the resource and environmental situation is far from perfect and that many specific problems need to be addressed, "there is a big difference between advising caution on a slippery slope and crying 'fire' in a crowded theater. We've had too much of the latter, in the name of environmentalism."

Hollander thinks improvements in the environment will follow if we intensify national and international efforts to reduce poverty. While he mentions recent poverty reduction initiatives by the World Bank and the IMF, he focuses more on the efforts of the United Nations, which he notes has been "for decades, a major player in the global war on poverty. . . ." He endorses, in particular, the 2001 report by the United Nations Development Program

(UNDP), which concluded that progress in the war on poverty requires globalization—particularly the global spread of information and communications technology—and the development of genetically based biotechnologies for advances in agriculture and medicine. By contrast, Brown, saying that environmental sustainability must come first, advocates Plan B: "a massive mobilization" with "an unprecedented degree of international cooperation. . . and at wartime speed."

Because of this fundamental difference in perspective, Hollander and Brown are on opposite sides on virtually every major issue:

- Overpopulation? Hollander thinks affluence is the solution to maintaining a sustainable population because the evidence shows that "throughout the world as people begin to live better (and longer), they are producing smaller families." But, for Brown, many developing countries cannot wait for affluence to come first: they should reduce the size of families quickly and stabilize their populations, perhaps by imitating the family planning program undertaken by Iran in the 1990s. "The time has come for world leaders. . . to publicly recognize that the Earth cannot easily support more than two children per family."
- Global warming? Hollander says that "media coverage of the issue has been so alarmist that it fails to convey how flimsy the evidence really is." It's a formidable scientific challenge to detect a very small amount of warming caused by human activity against a "much larger background of naturally occurring climate change." To Brown, the evidence of global warming is everywhere, reflected in heat waves and melting ice caps and glaciers. He cites predictions that, in the next 15 years, most South American glaciers will disappear, as will the snowcap of Mount Kilimanjaro in Africa.

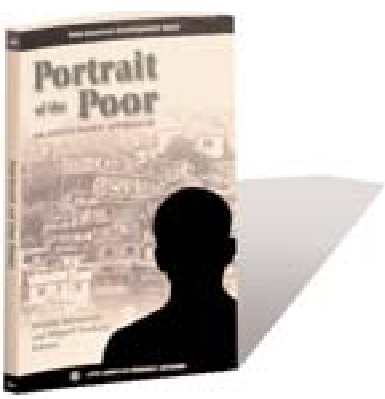
But we won't have to wait 15 years to see stark evidence of environmental degradation, according to Brown. He believes that the "most vulnerable economic sector may be food, where the bubble is most obvious." Overpumping of aquifers to boost food production in the short run causes a drop in long-run production, a development that Brown says is already apparent in many smaller countries and is now occurring in one of the biggest, China. The drop in China's grain harvest over the past five years has equaled the entire grain harvest of Canada in magnitude. While China has thus far been able to cope with this drop by drawing down its vast stocks, Brown says "it can do so for only another year or two. When China enters the world grain markets for massive imports . . . we will see the effects at the supermarket checkout counter." Rising food prices within the next couple of years will be the "first global economic indicator" to suggest that the bubble is about to burst.

Hollander foresees no such denouement. On the contrary, he notes that, if biotechnology research in Hunan Province succeeds, Chinese rice productivity may jump 15–20 percent in coming years. Elsewhere as well, the biotechnology revolution—the Second Green Revolution—could ensure that the battle against hunger is won, according to Hollander.

Who's right? Food prices will tell. If they don't rise in the next couple of years, Brown will have some explaining to do.

Prakash Loungani
Assistant to the Director
IMF External Relations Department

Probing Poverty



Orazio Attanasio and Miguel Szekely (editors)

Portrait of the Poor
An Assets-Based Approach
Inter-American Development Bank, Washington, 2001, 272 pp., $24.95 (paper).

"THE RICH are very different from you and me," F. Scott Fitzgerald once reportedly said to Ernest Hemingway. "Yes," Hemingway replied, "they have more money." It should come as no surprise that the poor have less money, that is, less capital of all sorts—human, physical, and social. That's one of the facts documented in this study of the socioeconomic characteristics of households in six Latin American countries.

The book goes on to tackle a more challenging question: Do the poor lack capital simply because they are poor (and hence cannot afford to save) or because of constraints imposed by various market and government failures? In the former case, antipoverty programs should consist simply of direct transfers of income to the poor, whereas the latter argues for removing structural constraints that impede capital accumulation by the poor.

The authors argue strongly that the latter is the case and note that imperfect and underdeveloped capital markets impede the poor's ability to save, borrow, and invest; that inefficient public education and health services disproportionately hurt the poor; that unequal access to public utilities, such as water and electricity, makes household chores more time-consuming for the poor; and that inflexible labor laws discourage part-time work, disproportionately hurting the poor, especially women.

To remedy these conditions, the authors thus suggest what they term a "fourth generation" antipoverty program for Latin America: increased investment in the poor's human capital, promotion of small-scale financial institutions, movement to performance-based budgeting in public health and education, more flexible labor laws, and an expansion of unemployment insurance.

Of course, many of these proposals are not novel, and some are not especially convincing. More attention should have been given to marshaling evidence on the potential effectiveness of the book's specific policy proposals and less to detailing largely well-known correlations between income and assets. Nonetheless, *Portrait of the Poor* provides some illuminating reflections, statistics, and proposals on poverty reduction, particularly in the Latin American context.

Kevin Fletcher
Economist
IMF Fiscal Affairs Department

Mitigating Monetary Tensions

David M. Andrews, C. Randall Henning, and Louis W. Pauly (editors)

Governing the World's Money
Cornell University Press, Ithaca, New York, 2002, 222 pp., $35.00 (cloth).

"WALL STREET BANKERS and the New York Federal Reserve were at the core of opposition to the [creation of the] IMF; the Bank of England was equally skeptical," writes Miles Kahler in one of the 10 essays that make up this interesting book. In addition to essays on the evolution of the Bretton Woods institutions, the book tackles two other topics: the extent and benefits of regional monetary integration and changes in institutions in response to the globalization of financial markets.

The birth of the Bretton Woods institutions in the 1940s marked a delegation of power from national to international monetary institutions "that would not be matched until the construction of European monetary institutions four decades later," Kahler writes. It was not an easy birth. Wall Street was opposed to the transfer of power from a few conservative national monetary institutions to a multilateral body like the IMF, which, it feared, would end up as "a hotbed of left-wing activism."

Keynes, too, "adamantly resisted intrusion by the new organization in national economic policy," according to Kahler. Keynes favored a technocratic model of the IMF rather than a political model; he pressed for an IMF that would award to national monetary authorities alone "the right of initiative." The United States, in contrast, was more amenable to the idea of delegating powers to the IMF "as it became clear that the United States was unlikely to approach the Fund for resources."

These tensions continue to this day, as Thomas Willett notes in his paper, which discusses the IMF's use of conditionality to foster changes in national economic policies. He notes that some favor limited conditionality in IMF programs and want policy measures to pass strict criteria, including whether such a policy would be forced on a major industrial economy if it applied for an IMF program.

Willett writes that such views are, in part, a response to the widespread perception "that Japan and the United States took advantage of Korean weakness during the Asian financial crisis of 1997–98 to use the IMF as a lever to force liberalization in areas that were unrelated to either the cause of or the solutions to the crisis." Willett feels that "such perceptions undermine the political legitimacy of Fund programs and can substantially weaken their effectiveness." He says the solution lies in more ownership by country governments and "more political-economy analysis" by IMF staff.

The papers on regional monetary integration include Peter Kenen's review of the literature on optimal currency areas, followed by case studies, one by Pier Carlo Padoan on the evolution of the European Monetary Union and the other by Kathleen McNamara on the move to a national currency in the United States in the aftermath of its civil war in the 1860s. Eric Helleiner's paper discusses why many countries, particularly smaller ones, are abandoning their territorial currencies in favor of such arrangements as dollarization or monetary union. Their reasons, he says, include lowered expectations of the benefits of an independent monetary policy and increased weight being placed on monetary credibility and stability.

Philip Cerny says that increasing globalization of financial markets is leading to "webs of governance" not limited to the nation-state but based instead on "transnational structures" and "cross-cutting affiliations among agents." Mitigation of the instability of global financial markets requires new forms of cooperation and governance, such as the adoption of standards and codes under the auspices of the IMF, the World Bank, and standard-setting institutions.

Rounding off the book are a helpful overview chapter by the three editors and two methodological papers by Robert Gilpin and John Odell on the application of political economy to the analysis of developments in international finance and institutions. To its credit, the book takes a multidisciplinary approach, bringing together leading scholars in economics, political science, and international relations. The essays are highly readable, but many of the issues tackled are so complex that they not do lend themselves to clear-cut answers.

George Iden
Senior Economist
IMF Monetary and Financial Systems Department