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Foreign Investment in the Pacific Basin

Private foreign investment activity recently has experienced a tremendous upsurge among the economies in the Pacific Basin, a region which comprises North America (the United States and Canada), East Asia (Japan, China, South Korea, Taiwan, and Hong Kong), ASEAN (Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand), and Oceania (Australia, New Zealand, and South Pacific nations). Foreign trade already is a strong link among these economies. Now, the growth in both direct investment (that is, investment for the purpose of setting up production facilities and operations) and in portfolio investment (that is, the purchase of financial assets in securities markets) among these economies suggests that foreign investment also is beginning to play an important role in binding these economies together.

Coupled with the rapid growth in foreign investment, new trends in the direction and nature of investment flows also are emerging. Foreign investment in the Pacific Basin now is more diversified across industries and more multidirectional across economies than was the case in the past. This *Letter* discusses these trends, their impact on the Pacific Basin economies, and the policy issues they raise.

Foreign investment boom

The growth in private foreign investment, particularly in the more developed Pacific Basin economies, has been spectacular in the last few years. In 1986 and 1987, for example, analysts estimate that private foreign investment grew 50 percent. In the newly-industrialized East Asian economies of South Korea, Taiwan, and Hong Kong, as well as in the ASEAN economies, foreign investment growth was much higher; some countries even reported growth rates in excess of 100 percent.

In addition to its booming rate of growth, foreign investment in the Pacific Basin region also has been remarkable for its new, multidirectional flow. In the past, American and Japanese companies were the primary investors in the region, and although American investment was somewhat diversified geographically, Japanese in-

vestment tended to concentrate on portfolio investment in North America.

Today, in contrast, the East Asian, ASEAN, and Oceanian economies no longer are merely recipients of foreign investment funds, but also are engaged in foreign investment themselves. The newly industrialized economies of East Asia, for example, now have direct investment in North America, ASEAN, and Oceania, while Australia and New Zealand have direct investment in ASEAN and China.

Similarly, the nature of Japanese and North American foreign investments also has changed. Japanese investment now encompasses both direct and portfolio investment in North America, as well as direct investment in the whole region. North American foreign investment now includes portfolio investment in some countries as well as direct investment in the whole region.

Another distinction between the type of foreign investment that is taking place now as opposed to that which took place in the past is that foreign investment now is more diversified across industries in the region. In the past, foreign investment concentrated in the manufacturing and goods-producing sectors. Today, in addition to manufacturing, North American direct investment encompasses petroleum and services, including finance and insurance. Similarly, Japanese direct investment encompasses manufacturing, resource development, real estate, and services. Oceanian and East Asian foreign investment is in manufacturing.

Why the upsurge?

A number of developments in the last few years have contributed to the favorable climate for private foreign investment in the Pacific. First, all the Pacific Basin economies have experienced strong economic growth, especially in 1986 and 1987. For example, China, South Korea, Taiwan, and Hong Kong all reported double-digit or near double-digit growth in 1987. The ASEAN economies recovered in 1986, and in 1987, growth ranged from 3.5 percent for Indonesia

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and 8.6 percent for Singapore. Japan, Australia, and Canada reported growth in the four to five percent range for the year. The U.S. reported somewhat slower though still respectable, growth. The fairly optimistic medium-term outlook for growth. These growth rates have stimulated demand for foreign investment in the region, particularly, among the East Asian and ASEAN countries, likewise has made foreign investment in the Pacific Basin more attractive.

Trade imbalances

A second reason for the upsurge in foreign investment has been the emergence of substantial trade imbalances among countries in the region. For example, in 1986 and 1987, Japan recorded current account surpluses of about \$80 to \$90 billion a year, and Taiwan recorded surpluses of \$15 to \$20 billion a year. These surpluses generated substantial foreign exchange reserves for some countries that were best recycled through investment in foreign assets. High domestic saving in Japan, in particular, provided funds for foreign investment.

The currency realignments that took place after September 1985 also contributed to the rapid growth in foreign investment. The fall of the U.S. dollar and the rise in the value of the Japanese yen, coupled with the internationalization and liberalization of financial services in major markets, have made direct foreign investment in financial companies attractive. Moreover, the rises in the yen, the Taiwan NT dollar, and the Korean won (to a lesser extent) have forced firms in these countries to establish production facilities in other countries with weaker currencies as a way of remaining competitive internationally.

Trade barriers, or threatened trade barriers, also have played a role in encouraging direct investment. Japanese and East Asian newly industrialized countries have invested in production facilities in the U.S. partly in response to rising protectionist sentiment here.

New technology and attitudes

New production technology and improvements in telecommunications and transportation systems also have encouraged foreign investment. These technological advances have made it less expensive for firms to assemble parts manufactured in many different countries and produce goods that are truly international in origin.

Investment in the electronics and automotive industries, in particular, has become internationalized, allowing firms to exploit the comparative advantages of many different countries.

Finally, foreign investment has boomed lately because the countries in the Pacific Basin have adopted much more liberal attitudes towards private foreign investment. The governments of these countries have changed rules and regulations governing foreign investment, making it easier and more attractive for foreign firms to operate. This is especially true in the case of the ASEAN countries.

Impact of investment

The upsurge in private foreign investment is having a profound impact on Pacific Basin economies. Economic and technological integration within the region is occurring at an accelerated pace partly because of foreign investment. Increasingly, it makes sense to view the Pacific Basin region as *one* economy.

Since most foreign direct investment in manufacturing has been related to international trade, trade naturally has increased among the countries in the region. This, in turn, has made each economy more open, and more subject to the fluctuations in international trade and finance. Similarly, new trends in foreign portfolio investment are leading to increased internationalization of securities markets and improved access for domestic firms to international capital markets.

Direct investment in the ASEAN and East Asian newly industrialized countries also is helping to accelerate the process of industrialization. Increasingly, the industrial sectors of all of East Asia and ASEAN are becoming integrated, with different countries specializing in different stages of production in the same industry. Moreover, because firms are choosing to invest in production facilities where the needed supplies are available, process and product technologies are being diffused at a faster rate than in the past.

Finally, the sudden rise in foreign investment is intensifying competition for local resources, including labor, and leading to rising land prices and wages in some countries. Reduced disparities among countries in these factor costs is further evidence of increasing integration within the Pacific Basin region.

Policy issues

The boom in foreign investment also highlights the need for domestic economic reforms and, as a consequence, sometimes fosters controversy. In the United States, American companies investing overseas are accused of exporting jobs, while foreign companies investing in the U.S. are accused of buying up America. New Zealand is wrestling with a conflict between the need to push forward with the liberalization and internationalization of its economy, on the one hand, and the resistance of domestic businesses to international competition, on the other hand. ASEAN countries, likewise, are attempting to balance the political implications of both the need to promote foreign investment and the consequences of the rapid growth in such investment.

Japan has had to introduce additional measures to encourage more overseas private investment as a means of reducing its current account surplus. These measures include liberalization of the Japanese capital market. Programs to insure overseas investments from fluctuations in value also are under consideration.

The newly industrialized Asian countries are finding for the first time that they must encourage domestic firms to go overseas to retain international competitiveness. Rules and regulations regarding foreign exchange transactions may need to be changed in the process.

Regional coordination

In addition to the policy dilemmas that each country faces domestically, there are issues raised by the multidirectional and diverse nature of foreign investment that are best resolved on a region-wide basis. First, trade barriers, or threatened barriers, distort investment flows. Japanese investment in the U.S. would have been lower and, according to business persons

close to the situation, investment elsewhere in the region higher, if the U.S. had not threatened higher trade barriers.

In addition to trade barriers, foreign exchange fluctuations can deter investment in many instances. Since exchange rate instabilities largely are the result of imbalances in international payments, greater policy coordination in this regard might create a more favorable environment for investment in the ASEAN region.

Third, the internationalization of production requires cooperation in the standardization of components and the quality of products. Also, rules regarding immigration and emigration need to be simplified to facilitate investment and economic integration.

In ASEAN and China, the physical and institutional infrastructure, including their tax codes and systems, needs further development. Cooperation with the more highly industrialized countries is essential in this regard to assure greater uniformity in the tax treatment of foreign investment.

Finally, assistance in the development of the securities markets of developing economies in the region would help to facilitate the flow of portfolio investment in these economies and make international capital markets more accessible.

The economic integration that has taken place to date in the Pacific Basin region is indeed remarkable. Trade and foreign investment flows among all the economies in the region are increasing in size and diversity. It is no wonder, then, that the Pacific Basin is one of the most dynamic regions in the world.

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