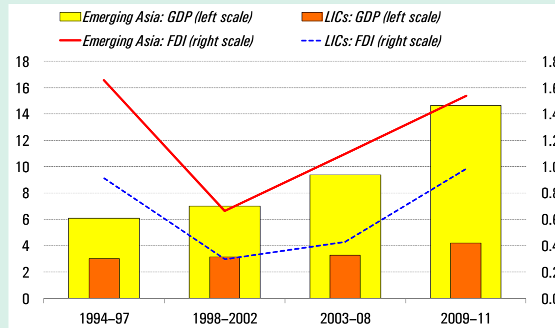
V. Asian Low-Income and Pacific Island Countries: Opportunities and Risks from Increased Regional Integration

Regional integration of Asian low-income countries (LICs) and Pacific Island countries (PICs) has increased, presenting these economies with risks and opportunities. Greater FDI inflows from advanced economies have played a key role in developing the commodity sector in resource-rich countries, and in helping economies with abundant low-skilled labor diversify into the manufacturing and tourism sectors. But it has also exposed Asian LICs and PICs to the effects of advanced economies' business cycles. Over the last decade, an increasing share of overall FDI to Asian LICs and PICs came from within the region, especially from China. As Emerging Asia gradually rebalances its growth model toward domestic demand, Asian LICs' and PICs' economic fortunes will increasingly depend on their resilience to shocks stemming from within the region.

Figure 5.1. Selected Emerging Asia: Share in Global Output and FDI[1]

(In percent)

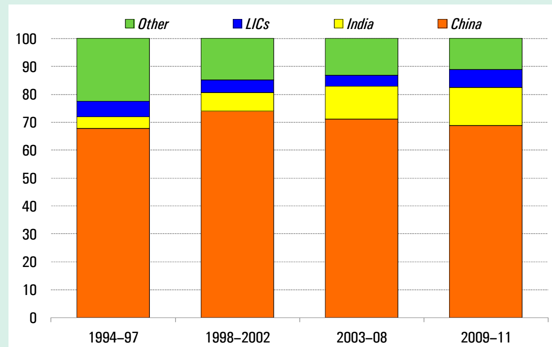


Sources: Country authorities; and IMF, WEO database and staff calculations.

[1] Emerging Asia refers to the countries considered in this chapter (see footnote 1).

Figure 5.2. Selected Emerging Asia: Share in Regional FDI

(In percent)



Sources: Country authorities; and IMF, WEO database and staff calculations.

A. Regional LICs Receive More Investment from within Asia

Over the last two decades, Emerging Asia continued to receive a high share of global FDI, commensurate with its rising share in world output, but the pattern of FDI within the region has changed (Figure 5.1).[1]

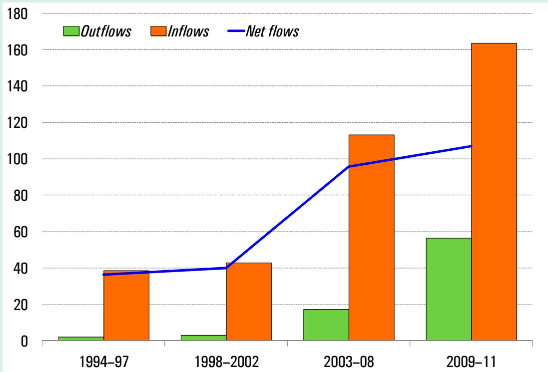
- China's large share as a recipient of inward FDI to Emerging Asia has remained relatively constant since the mid-1990s, at about 70 percent (Figure 5.2). However, in recent years, China has also increasingly invested abroad, particularly since the global financial crisis (Figure 5.3), and in neighboring countries. Some of this investment went to Asian LICs that have large natural resources (for example, the Lao People's Democratic Republic, Mongolia, and Myanmar). Some ASEAN economies, including Cambodia, Malaysia, the Philippines, and Thailand, also saw a sharp increase in FDI from China, although these flows remain small compared to those from more-advanced Asian economies, such as Japan, Korea, and Singapore.

Note: The main authors of this chapter are Nombulelo Duma, Alexander Pitt, and Yiqun Wu.

[1] In this chapter Emerging Asia comprises seven Emerging Asian market economies (China, India, Indonesia, Malaysia, the Philippines, Sri Lanka, and Thailand) and seven Asian LICs (Bangladesh, Cambodia, the Lao People's Democratic Republic, Mongolia, Myanmar, Papua New Guinea, and Vietnam).

Figure 5.3. China: Foreign Direct Investment

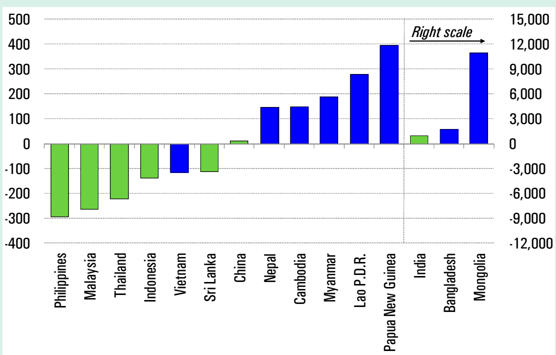
(In billions of U.S. dollars; annual averages)



Source: IMF, WEO database.

Figure 5.4. Selected Emerging Asia: Growth in FDI Relative to Regional Average

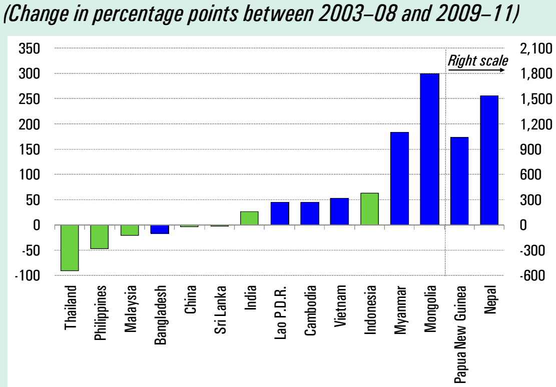
(Change in percentage points between 1994–97 and 2009–11)



Sources: Country authorities; and IMF, WEO database and staff calculations.

Figure 5.5. Selected Emerging Asia: Growth in FDI Relative to Regional Average

(Change in percentage points between 2003–08 and 2009–11)



Sources: Country authorities; and IMF, WEO database and staff calculations.

- India significantly increased its share as a recipient of FDI to the region, while the share going to middle-income ASEAN economies (Indonesia, Malaysia, the Philippines, and Thailand) has declined by more than half since the mid-1990s.

- While the share of Asian LICs in total FDI remained small, FDI growth in these economies was generally faster than in the overall sample (Figure 5.4), especially after the global financial crisis (Figure 5.5). Since FDI tends to have a positive impact on GDP growth in LICs (Dabla-Norris and others, 2010), this has helped Asian LICs buffer the impact of the crisis.

The surge in FDI to Asian LICs reflects greater investment in natural resource sectors following the spike in commodity prices since 2005. FDI inflows have increased especially rapidly in the Asian LICs with significant natural resources, such as Mongolia, and to a lesser extent, Lao People's Democratic Republic, Myanmar, and Papua New Guinea. From 1994–97 to 2009–11, FDI in these economies grew more than nine-fold in U.S. dollar terms and more than twice as rapidly as in the region as a whole. FDI is also playing a much more important role in these economies, as on average it almost tripled as a share of GDP to 22 percent.

But the increase of FDI to Asian LICs also reflects their increasing regional integration over the last two decades, through continued liberalization of trade within ASEAN economies, as well as new free trade agreements (FTAs) with other emerging and advanced economies in the region (such as Australia, China, India, Japan, Korea, and New Zealand). Indeed, trade openness appears positively associated with FDI (Figure 5.6). Baltagi, Egger, and Pfaffermayr (2007) and Ponce (2006) show that FDI is positively associated with FTAs, as freer trade flows allow the realization of multi-plant economies of scale to serve larger aggregate markets.

While FDI has been critical in raising productivity and economic growth, it has increased Asian LICs' exposure to advanced economies' business cycles. An escalation of the euro area debt crisis and sharply lower global growth would severely hit Asian LICs. Of course, pressure points would differ depending on country circumstances. For economies with a rapidly growing industrial sector, direct export exposures to Europe and other advanced economies are substantial, exceeding 20 percent of GDP in the case of Cambodia and Vietnam (Figure 5.7). By contrast, commodity exporters are mainly exposed to export demand from China and other economies in Emerging Asia, and would suffer mainly indirectly from a decline in commodity prices. A third group of economies would be mainly hit as a result of a decline in tourism (Bhutan, Cambodia, Maldives, and Vietnam). Increased global volatility could also expose weaknesses that are already evident in some of the region's banking systems and, in some cases, provide a catalyst for greater financial pressures (for example, Nepal).

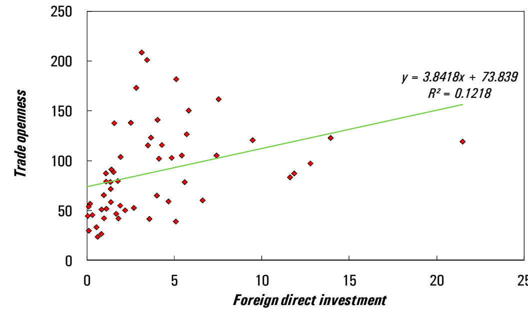
Greater FDI from within the region offers Asian LICs the potential for insurance against these risks. Fast-growing economies—in particular China—are moving up the production ladder and rebalancing internally and externally. China's increasing investment abroad is an indication that this process is already underway. As multinational companies are also diversifying their production within the region, this should help boost FDI to Asian LICs. Further regional integration should support this process, although policymakers should ensure that the proliferation of FTAs does not lead to distortions, such as from different rules on local content, FDI incentives, or competition policies, as well as increased costs for businesses to comply with them.

B. Pacific Island Countries: Links to Regional Economies Already Matter More

PICs have also increased their integration with regional economies over the last two decades.

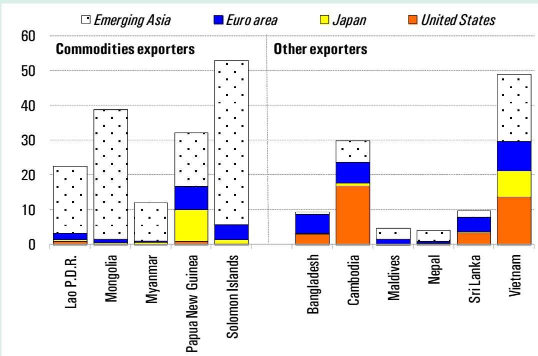
- The stronger linkages are with Australia and New Zealand. Australia is by far the largest provider of aid and FDI to the PICs (Figure 5.8). Trade with Australia and New Zealand accounts on average for one-third of total PICs trade, while remittances

Figure 5.6. Selected Emerging Asia: Trade Openness and FDI[1]
(In percent of GDP)



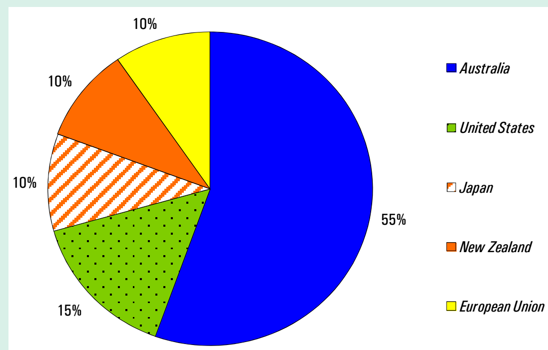
Sources: IMF, WEO database and staff calculations.
[1] Trade openness is defined in terms of sum of exports and imports in goods and services. The chart uses the annual averages for the periods 1994–97, 1998–2002, 2003–08, and 2009–11.

Figure 5.7. Selected Emerging Asia: Exports Exposure
(In percent of GDP)



Sources: IMF, *Direction of Trade Statistics* and staff calculations.

Figure 5.8. PICs: Official Development Aid by OECD Donors
(In percent of total aid, 2010)

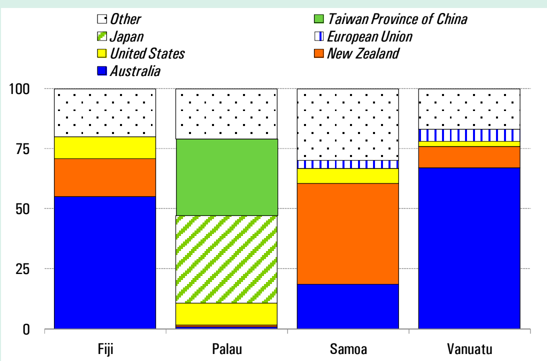


Source: Organization for Economic Cooperation and Development.

from these two economies account for about 60 percent of total remittances in Fiji and Samoa. Tourist arrivals from Australia and New Zealand represent about 60–70 percent of total arrivals in Fiji, Vanuatu, and Samoa (Figure 5.9). Also, the financial sector mainly consists of Australian banks.

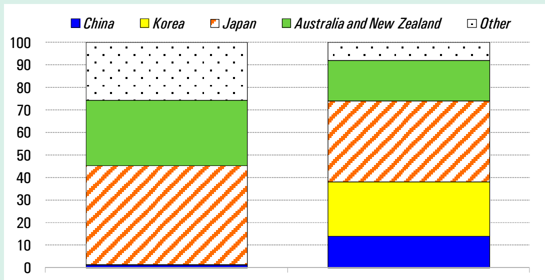
- But linkages with Emerging Asia have grown substantially, especially over the last 10 years. In particular, trade with China has increased by seven times on average for PICs since the early 2000s, with China even becoming the first trading partner for some (for example, the Solomon Islands). Similarly, FDI patterns have become more diverse, with the share of inward FDI from China and other East Asian trading partners, notably Korea, growing at the expense of traditional investors from Australia and New Zealand, and, to a lesser extent, Japan (Figure 5.10).

Figure 5.9. Selected PICs: Tourist Arrivals by Country of Residence
(In percent of total arrivals, 2010)



Sources: Country authorities; and IMF staff calculations.

Figure 5.10. PICs: FDI by Country of Origin[1]
(In percent of total FDI)



Sources: Organization for Economic Cooperation and Development; and United Nations Conference on Trade and Development.
[1] Includes Australia, China, France, Germany, Italy, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Sweden, the United Kingdom, and the United States.

Not surprisingly, spillovers from regional economies are more important for PICs than those from advanced economies outside Asia.[2] Australia is by far the main source of direct and indirect spillovers, both in the short and long term, with the exception of the compact countries (Marshall Islands, the Federated States of Micronesia, and Palau), for which the United States appears to be the most important partner (consistent with the large size of U.S. aid). Spillovers from New Zealand are also highly relevant for several PICs, such as Samoa and Tonga. Over the last decade, shocks from Emerging Asia have had a greater impact on PICs' business cycles, while the role of more traditional partners, such as Japan, has declined. In the short run, the elasticity of output with respect to regional partners is higher than one for a number of PICs.

Notwithstanding greater regional linkages, PICs remain particularly vulnerable to global commodity price shocks. The impact on PIC growth from an adverse oil shock scenario (wherein oil prices are 50 percent higher than in the baseline, consistent with Chapter 1) would be substantial, averaging about three-quarters of a percentage point of GDP, and in some cases would be even larger than from a negative global demand shock scenario (as described in the April 2012 *World Economic Outlook*, IMF, 2012c). In part, the greater sensitivity to global oil and commodity prices reflects the large weight of fuel and food in the consumer price index basket and the relatively large share of imported items in PICs consumption and investment, due to their smaller domestic manufacturing base.

[2] Details on these results and those in the following paragraph can be found in Sheridan, Tumbarello, and Wu (forthcoming).