Investment in East Asia since the Asian financial crisis[1]

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Investment in many East Asian economies fell dramatically following the Asian financial crisis and has remained relatively weak since then. This is despite improved economic conditions and strong underlying investment needs typical for developing economies.

This so-called 'investment puzzle' is the subject of considerable commentary, which has largely sought to explain the reasons for such a decline and whether lower investment rates are 'optimal'. On this latter point, there is a concern that East Asia's future growth trajectory may be impaired given the linkages between investment and economic growth.

The consensus appears to be that investment is too low for a number of regional economies and that a key contributing factor has been the apparent deterioration in 'institutional factors', such as regulation and governance. This underscores the need for continued domestic and regional initiatives to further strengthen the investment environment.

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1 East Asia includes: Indonesia, Thailand, the Philippines, Malaysia (ASEAN-4), and Korea, Taiwan, Singapore and Hong Kong (Newly Industrialised Economies (NIEs)).

2 The authors are from International Economy Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Milovan Lucich. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

Eleven years after the Asian financial crisis (henceforth 'the crisis'), economic conditions in East Asia have vastly improved. The region has averaged over 5 per cent growth for the last six years. The dramatic declines in living standards experienced in the wake of the crisis have been reversed, with Indonesia being the last country to return (in 2005) to per capita GDP levels that existed before the crisis.

The improving economic situation reflects the broader recovery in corporate, government and financial sectors. Most of the constraints that afflicted these sectors have lessened. For example, the corporate sector has rebuilt its balance sheets, and capacity utilisation and profitability have improved; the government sector has made large advances improving budget balances and reducing debt; and the financial sector has reduced bad loans and lifted capital adequacy ratios. Furthermore, savings rates have remained high.

Despite these favourable developments, investment has continued to languish. Focusing on two sub-regions in East Asia, the NIEs and ASEAN-4, investment rates have fallen and remain relatively weak (see Charts 1 and 2). This decline has raised a number of questions about the sustainability of growth in the region over the longer term.

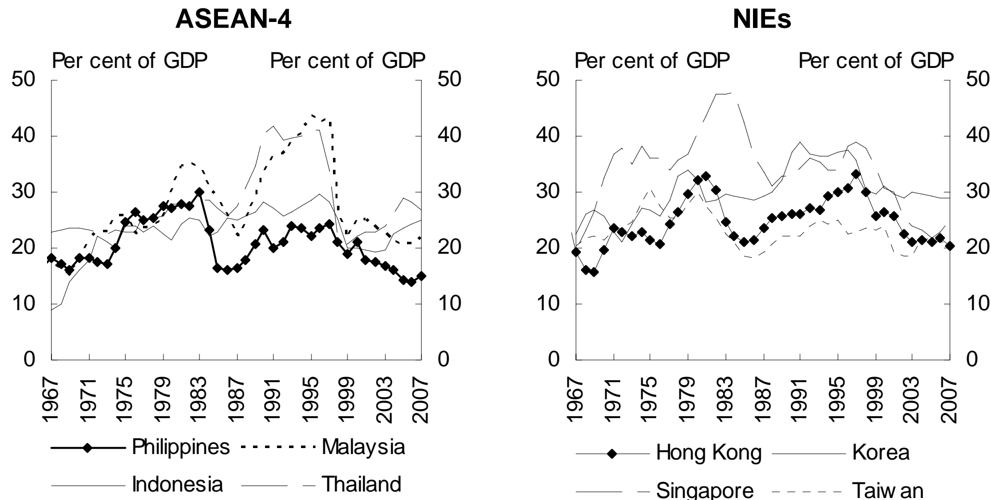
In attempting to explain the relative weakness in investment, attention has focused on: factors influencing the investment climate, such as governance and transparency; a changing global environment, including the emergence of China and possibly a heightened perception of risk; and whether there was overinvestment prior to the crisis with the implication that current rates of investment might simply be a reflection of investment returning to more sustainable levels.

Against this background, the first section of this paper reviews the investment performance in East Asia since the crisis, the second section examines the reasons for lower rates of investment, and the final section outlines country and regional initiatives to improve investment.

Trends in investment since the crisis

As shown by Charts 1 and 2, investment rates have fallen in both the NIEs and the ASEAN-4 economies. While the magnitude of the fall has varied across countries, all countries have experienced a decline in investment rates since the crisis. The sharpest declines were initially within the ASEAN-4 which also had the largest acceleration of investment rates in the lead-up to the crisis. The NIEs have experienced similar declines, but over a longer time period.

Charts 1 and 2: Gross fixed capital formation



Source: CEIC, EcoWin and World Development Indicators (WDI) databases.

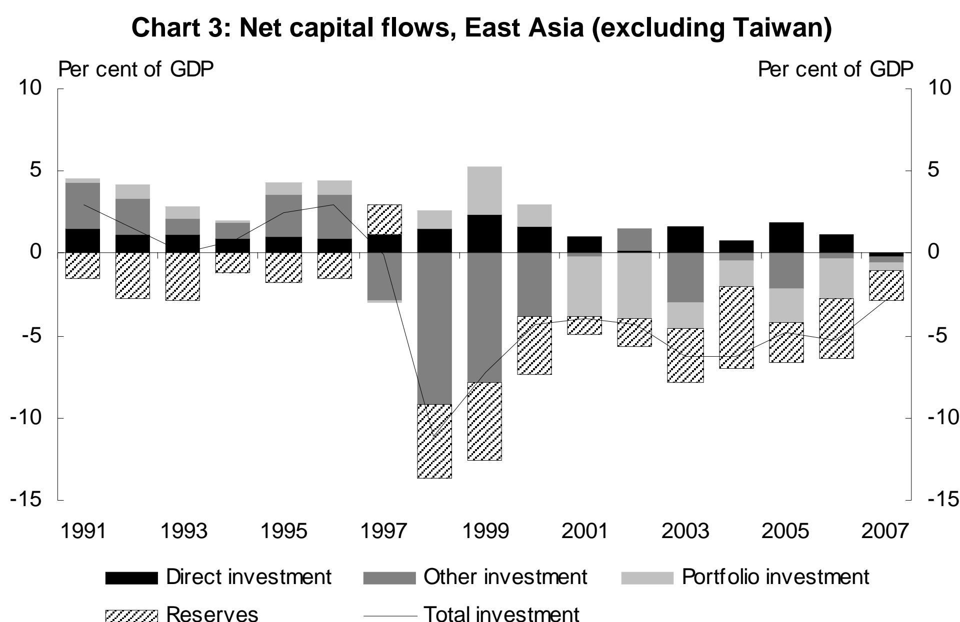
The decline in investment in East Asia has been predominantly driven by private investment, which has accounted for about 90 per cent of the total decline. Of this, approximately two-thirds is attributable to falling investment in the construction sector. Much of the construction investment that took place before the crisis turned out to be excessive, leading to an over-supply of real estate which has gradually been unwound as reflected in falling vacancy rates.

Corporate investment also fell dramatically after the crisis, with plant and equipment investment declining in absolute terms in a number of East Asian economies. This was partly because, as the stock market value of existing firms fell more sharply than the replacement cost of capital, it became more attractive to purchase an existing firm than to invest in new plant and equipment. In addition, the crisis generated large deteriorations in balance sheets, creating a need for major corporate and financial sector restructuring. Companies therefore concentrated on reducing debt and strengthening balance sheets, rather than investing in capital.

Public investment rates also fell after the crisis as governments were faced with fiscal pressures and the need for fiscal consolidation, largely due to: costs associated with the recapitalisation of insolvent banks; weakening revenue collections due to slower economic growth; and an increase in public sector debt as contingent liabilities were realised. In Thailand and the Philippines the decline in public investment was particularly pronounced, accounting for between 35 and 40 per cent of the decline in aggregate investment.

Prior to the crisis, the region was also an important destination for foreign investment. As Chart 3 shows, the region was a substantial net importer of capital prior to the crisis but this is no longer the case. Net private capital inflows to the region have partially recovered but capital is still flowing out of the region in net terms. This net export of capital reflects the fact that saving in the region exceeds domestic investment and for most economies the key factor driving this result has been the large fall in investment rates since the crisis. Some have argued that the fall in investment is the by-product of policies aimed at maximising current account surpluses and minimising risk.

Chart 3: Net capital flows, East Asia (excluding Taiwan)



Source: IMF International Financial Statistics database.

Why has investment remained weak?

There are a number of possible reasons why investment has remained subdued since the crisis, including: investment returning to more sustainable levels; the emergence of China; increased risk aversion; and a weak investment climate.

Was investment too high prior to the crisis?

A simple explanation for subdued investment is that it is returning to more sustainable levels. As referred to earlier, there was a rapid rise in investment in the lead-up to the crisis, much of which proved to be speculative and of poor quality. However, given improving fundamentals and the passage of time since the crisis, one would have expected cyclical factors to have receded by now. Yet investment continues to be lower than suggested by fundamentals.

This raises the question, what is the 'optimal' level of investment? The 'optimal' level is influenced by a number of factors, and therefore may change over time in response to changes in any of these factors. The first factor we consider here is the price of capital. As capital goods have become relatively less expensive, nominal investment rates have declined. This is partly due to the process of capital deepening in information technology, and productivity growth in sectors that produce capital goods. As a result, a given level of investment can be achieved at a lower price (IMF 2005). However, the Asian Development Bank (ADB) finds that it is unlikely that falling capital goods prices explain the decline in investment rates because this effect has been small.[3]

A second factor relates to the efficiency of investment. A number of possibilities — such as corporate restructuring, increased competition and more efficient allocation of capital by financial institutions — may have increased the efficiency of investment since the crisis, which would imply that a given rate of growth is now achievable at lower rates of investment (ADB 2007a). One commonly used measure to assess the efficiency of investment is the incremental capital output ratio (ICOR). The economy-wide ICOR is measured by the ratio of the level of investment in a given period to the change in GDP in that period (a lower ICOR represents greater investment efficiency). Between 1995-97 and 2003-05 the ICOR fell for most countries in East Asia, suggesting increasing investment efficiency. It must be noted, however, that the use of the ICOR as an indicator of investment efficiency is limited by the fact that the ICOR can change for reasons other than a change in investment efficiency (such as an increase in output by utilising spare capacity).

Notwithstanding the plausibility of the argument that changes in the price of capital and the efficiency of investment may have lowered the optimal rate of investment since the crisis, a number of studies suggest that investment may still be too low. For example, a recent IMF study compares the investment and capital-output ratios of a number of East Asian economies to estimates of their long-run equilibrium levels (IMF 2005). The basic premise is that developing economies typically have higher investment needs associated with building infrastructure and upgrading capital stock, which means that investment rates should be above their long-run level. As economies mature and per capita incomes rise, investment rates tend to fall as the capital-output ratio approaches its long-run level. The IMF study finds that investment rates in East Asia were above their long-run level in 1996. However, investment rates since the crisis have remained below their long-run level, particularly in Indonesia, the Philippines and Thailand.

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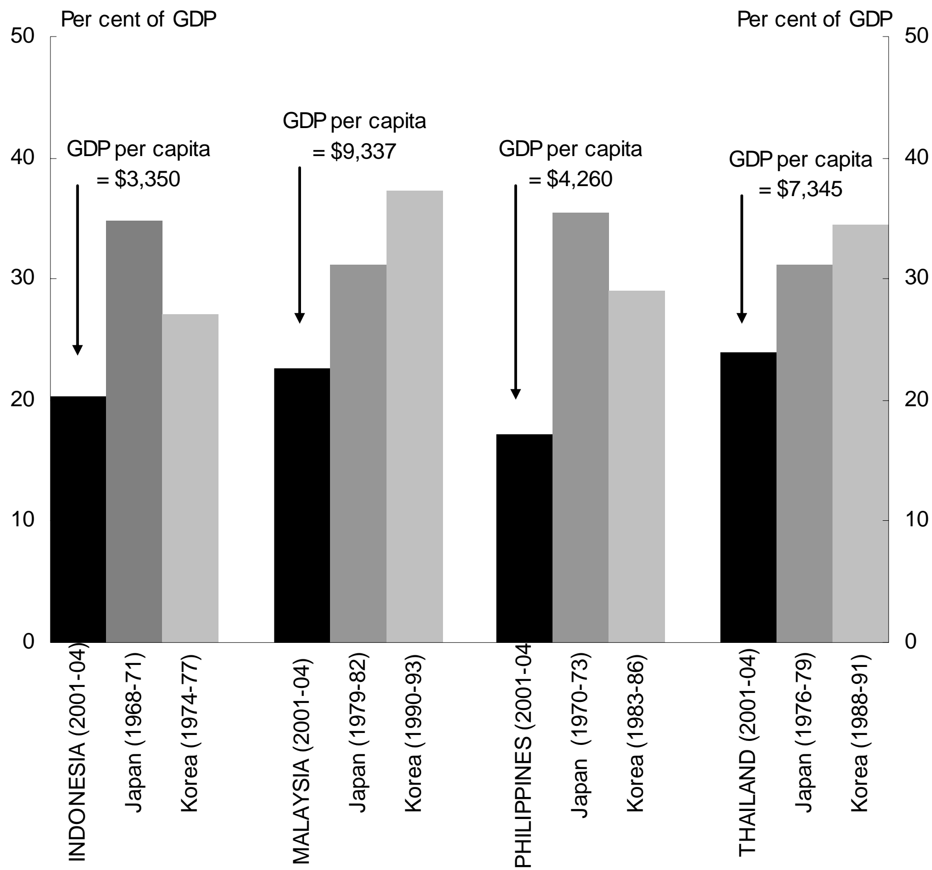
3 'Investment rates still drop sharply post-crisis after controlling for changes in relative prices' ; ADB, 2007b.

Eichengreen (2006) looks at the broader issue of global savings and investment imbalances and explores possible explanations for the existence of such imbalances. One aspect of global imbalances relates to the sizable current account surpluses being achieved in East Asia and how these surpluses have largely arisen because of falling investment. Eichengreen argues that temporary factors (such as the sharp economic downturn, domestic financial sector disruptions and political uncertainties) that had an adverse impact on investment following the crisis have largely retreated. He attributes ongoing lower investment to East Asian governments becoming more risk-averse, preferring less dependence on capital inflows, and current account surpluses to deficits.

Another study by Chinn and Ito (2005) examining the determinants of current account balances, also finds that investment rates in East Asia remain lower than predicted by their model, particularly since the 1996-2000 period. Their study investigates the medium-term determinants of investment and saving, using a model that controls for factors related to institutional development, such as the degree of financial openness and the extent of legal development.

Another way to look at whether investment is currently too low is to compare recent investment rates in emerging economies to those typical of other regional economies when they were at a similar stage of development (as measured by GDP per capita in purchasing power parity terms). Chart 4 shows that investment rates in each of the ASEAN-4 economies were substantially lower in 2001–04, when compared to investment rates in Japan and Korea at equivalent levels of GDP per capita.

Chart 4: Comparison of investment rates at similar per capita income levels



Source: CEIC, EcoWin, World Development Indicators, Penn World Tables.

The emergence of China

Another possible explanation for weak investment relates to greater competition from China and the associated diversion of investment. Since the crisis China's economy has continued to strengthen, and combined with its ascension to the World Trade Organization (WTO) in December 2001, China has become a more desirable investment destination. Furthermore, China's relatively large pool of labour and resulting cost advantages have led to the formation of regional supply networks centred on China. Such networks have caused the relocation of many manufacturing businesses from a number of East Asian economies to China. As a result, these economies are experiencing a period of structural adjustment, which it is claimed is generating some uncertainty and a likely delay in investment decisions.[4]

However, the evidence on whether the rise of China has been detrimental to investment rates in East Asia is mixed. According to the IMF there is some anecdotal evidence to suggest a link between the relocation of production facilities from emerging Asian countries to China and lower investment rates across East Asia. However, it also notes that it is impossible to draw any definitive quantitative conclusions. McKibbin and Woo (2003), in modelling the potential consequences of China's 2001 WTO accession on its Asian neighbours, point to some partial evidence of foreign direct investment (FDI) diversion occurring.[5]

Another study by the ADB Institute assessed FDI shares across East Asia and found that as FDI into China rises, East Asia's share of FDI as a proportion of FDI to all developing countries declines (Chantasasawat et al. 2005). However, this does not imply that China is diverting FDI away from the rest of East Asia. Indeed, the ADB Institute finds a positive correlation through time between the levels of FDI into East Asia and China (see Chart 5). Indeed, in their 2003 study, McKibbin and Woo noted that it is possible that China's WTO accession could encourage the world to save more and thereby produce a larger stock of global capital, which would mean that China receives a larger share of a growing stock of capital rather than diverting capital from other countries in an absolute sense.

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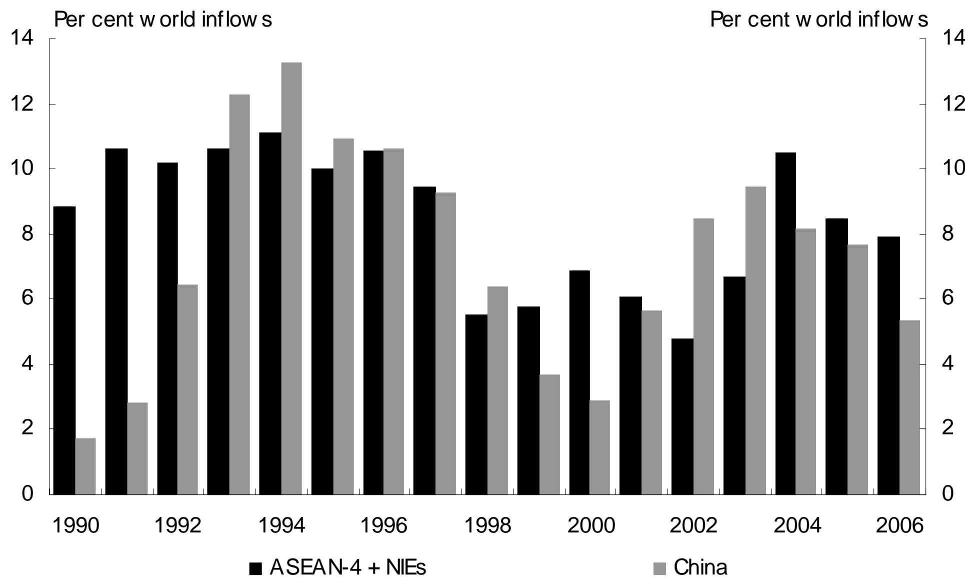
4 Further, while causation is difficult to determine, it appears that productivity growth (one effect of structural adjustment) in East Asia has indeed slowed in the post-crisis period (Groningen Growth and Development Centre and the Conference Board, Total Economy Database, January 2007, http://www.ggdc.net).

5 McKibbin and Woo (2003) modelled the potential consequences of China's 2001 WTO accession on its neighbours and found that China's accession could lead to diversion of FDI if countries did not adapt to the emergence of China through stronger policy settings.

Chart 5: FDI flows to East Asia and China



Source: UNCTAD database.

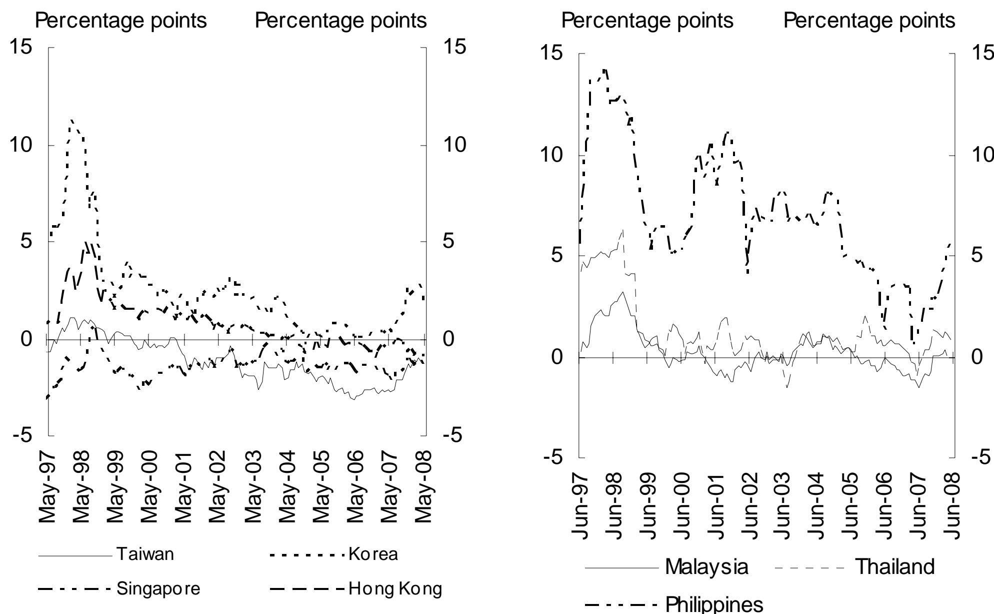
Increased risk aversion

It has also been suggested that the crisis triggered a fundamental reassessment of risk by investors in emerging Asia. The general notion is that investors underestimated risk prior to the crisis and were subsequently punished as economic conditions worsened. This experience led to increased investor wariness, which continues to linger despite improving economic conditions in the region. This proposition of increased uncertainty about the region's macroeconomic environment is supported by the findings of a study by Kramer (2006), which uses Consensus surveys to show a 60 per cent increase in the dispersion of GDP growth forecasts for a number of countries in the region between 1996-99 and 2003-05.

Drawing such a link between greater uncertainty and a greater dispersion of forecasts may be somewhat tenuous; however Kramer goes on to argue that the perceived increases in risks may not necessarily be just an artefact of the crisis. Rather they could be related to factors independent of the crisis, such as structural changes in trade and production that have resulted from the changing global environment. In particular, some East Asian economies have shifted towards the production and export of higher-end electronics, a sector characterised by changing technology and consumer tastes. Furthermore, it is also conceivable that investors are not only more uncertain and risk-averse, but have lowered their expected rates of return on investment in the region. This could be the result of increased uncertainty about the growth outlook, or as the ADB (2007b) notes, a consequence of other factors that influence expected returns, such as competitive pressures, productivity levels and institutional factors.

In contrast, there is also some evidence to suggest that some perceptions of risk have declined since the crisis. While attempting to measure risk is difficult, there are proxies which can provide an insight into how perceived risks vary over time. One possible measure is the yield spreads between government bonds in the US and in the East Asian economies. As is clear from Charts 6 and 7, yield spreads increased for most countries, particularly Korea and the Philippines, during the crisis but have gradually narrowed. This could be due to a number of factors, including convergence of inflation expectations, but it is also possible that the perceived risk associated with investing in these countries has declined relative to the US.

Charts 6 and 7: Yield spread differentials (10-year)[(a)]



(a) Philippines data uses two-year yields; Korea data uses five-year yields; Singapore data uses seven-year yields.
Source: IMF and Ecowin.

It would appear that there is conflicting evidence on whether investor perceptions of risk have increased since the crisis. On the one hand, the increased dispersion of growth forecasts since the crisis suggests that investors are now more uncertain about the region's macroeconomic outlook. However, the fact that risk premiums — as measured by yield spread differentials — have declined over time since the crisis suggests that investors consider that risk has diminished in individual countries. That is, while investors may be less certain about the region's macroeconomic outlook, they now have a greater degree of confidence in policy settings by governments in the region. As the next section shows, it also appears that there is now a greater perception

of microeconomic risk, as measured by a number of indicators of the investment climate.

The investment climate

The final factor we explore in explaining why investment has remained relatively weak is the investment climate. The investment climate is influenced by many tangible and intangible factors; however, key determinants are: macroeconomic stability; economic frameworks and policies, including policies affecting labour, financial and product markets; and governance frameworks. Macroeconomic stability and economic growth are fostered by sound fiscal, monetary and exchange rate policies, robust economic and financial institutions and strong regulatory frameworks, while strong governance frameworks have an important influence on the investment environment because they promote transparency and clear standards, which assist to minimise risk and uncertainty.[6] Labour and product market regulations that promote flexible markets also help, as flexible markets allow resources to flow to their most valuable uses.

A number of surveys note that while most economies have improved their macroeconomic stability, governance frameworks remain a substantial impediment to investment. However, trying to ascertain whether a country is making progress on governance is difficult because of the complexities associated with measuring governance. Notwithstanding these qualifications, Table 1 summarises some of the key governance indicators from various sources. The results suggest that crisis-affected countries have not performed well against governance and broader competitiveness measures. Many of these indicators are relative measures, which do not necessarily indicate that governance is deteriorating in an absolute sense; however, relative performance is likely to be important in attracting foreign investment.

- Most of the crisis-affected economies (except Malaysia) have experienced a deterioration in their overall competitiveness ranking since 1996. This is attributed to poorer performance in one or more of the following areas: the quality of infrastructure; the level of technological readiness; and the extent to which government policies are conducive to investment. In particular, inadequate infrastructure has been identified as one of the major factors constraining business operations.

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6 Macroeconomic settings help to improve resource allocation within the economy, thereby making an economy more attractive to investors. Since the Asian financial crisis, most countries in the region have actively pursued policies that have enhanced macroeconomic stability (this is also reflected in Table 1). For example, government fiscal positions are generally sound, including lower levels of public debt; a number of countries have adopted inflation targeting; most countries have built a sizable buffer of foreign reserves; and there has been a trend towards more flexible exchange rate regimes.

- Surveys by *The Economist* and World Bank point to a deterioration in a number of areas critical to the investment climate. Most notably, all crisis-affected countries are now performing worse across a range of categories, in particular, 'control of corruption' and 'financing'. The development of deeper and broader financial systems and capital markets should allow for improved management and diversification of investment risks, while also increasing the overall risk-bearing capacity of the economy.

- The most recent World Bank Doing Business Indicators shows that the costs of doing business in crisis-affected countries remain relatively high. For example, in Indonesia, despite some improvement in recent years, it still takes 105 days to start a business, 570 days to enforce contracts and 5½ years to close a business. The Philippines and Thailand also perform poorly, particularly in the number of days to enforce a contract, taking 842 and 479, respectively.

Table 1: Investment climate indicators

	Indonesia		Korea		Malaysia		Philippines		Thailand	
World Competitiveness Yearbook - IMD	**1996**	**2007**	**1996**	**2007**	**1996**	**2007**	**1996**	**2007**	**1996**	**2007**
Overall ranking	41	54	27	29	23	23	31	45	30	33
The Global Competitiveness Report - World Economic Forum	**1998**	**2007**	**1998**	**2007**	**1998**	**2007**	**1998**	**2007**	**1998**	**2007**
Overall ranking	31	54	19	11	17	21	33	71	21	28
Business Environment Ratings - Economist Intelligence Unit	**1995**	**2002**	**1995**	**2002**	**1995**	**2002**	**1995**	**2002**	**1995**	**2002**
Overall business environment	6.4	5.5	6.6	6.7	6.5	6.8	5.9	5.8	6.5	6.7
Market opportunities	7.0	6.6	7.9	7.9	6.7	6.3	8.2	5.5	7.0	6.9
Macroeconomic environment	5.8	7.9	6.7	9.3	6.4	8.1	5.6	6.9	6.2	9.4
Labour market	6.2	5.6	5.7	5.7	6.5	6.2	5.7	6.9	6.0	6.6
Political environment	5.2	3.9	6.7	6.5	5.7	6.9	4.7	4.9	5.2	6.3
Infrastructure	4.3	3.9	5.9	6.2	4.8	5.1	3.6	2.8	4.6	4.4
Policy towards private enterprise	7.8	3.5	8.4	6.3	6.9	5.8	6.5	5.2	7.5	5.2
Tax regime	8.6	6.1	5.8	6.8	7.0	7.6	5.9	6.9	7.5	7.2
Financing	7.8	4.4	7.4	5.5	7.1	7.0	6.6	5.5	6.9	5.9
Environment for foreign investment	4.3	4.9	6.6	6.1	5.7	7.2	5.5	6.1	5.6	7.2
Governance Indicators - World Bank	**1996**	**2006**	**1996**	**2006**	**1996**	**2006**	**1996**	**2006**	**1996**	**2006**
Voice and Accountability	15.8	41.3	61.2	70.7	39.2	38.0	55.5	44.2	58.9	32.2
Political Stability	21.6	14.9	47.1	60.1	65.4	58.7	29.8	11.1	44.7	16.3
Government Effectiveness	64.0	40.8	80.6	82.9	79.6	80.6	59.7	55.0	72.5	64.9
Regulatory Quality	63.9	43.4	65.9	70.7	80.0	69.8	72.2	52.2	69.8	62.4
Rule of Law	39.5	23.3	71.4	72.9	71.0	65.7	54.3	41.9	68.1	55.2
Control of Corruption	31.1	23.3	73.8	64.6	73.3	68.0	35.4	27.2	38.3	50.5
Doing Business Indicators - World Bank	**2004**	**2008**	**2004**	**2008**	**2004**	**2008**	**2004**	**2008**	**2004**	**2008**
Starting a business (days)	168	105	17	17	30	24	60	52	33	33
Rigidity of Employment Index	44	44	37	37	10	10	35	35	18	18
Enforcing contracts (days)	570	570	230	230	600	600	982	842	479	479
Closing a business (years)	6.0	5.5	1.5	1.5	2.3	2.3	5.7	5.7	2.7	2.7

Note: Shaded cells indicate deterioration in rankings between time periods.
Sources: World Bank Governance Indicators database; *World Bank Doing Business Report 2008*.

Policy measures to support investment

Investment is important because it is a key ingredient for economic growth. Furthermore, investment in infrastructure is needed to support urbanisation, as well as responding to rising demands for services (like health services) associated with higher income levels.

There is a large body of evidence that investment in physical capital is one of the main sources of economic growth (Ahn and Hemmings 2000) and that certain forms of physical investment matter more for growth than others. In particular, investments in equipment and information and communication technology are important for developing economies because the embodiment of technology in capital enables facilitation of technology transfer to developing economies (De Long and Summers 1993).

Evidence on the relationship between public investment and economic growth is mixed, with some studies indicating that infrastructure improves growth while others indicate that growth creates the demand for public investment (Ahn and Hemmings 2000). There is, however, general agreement that movement toward market-based mechanisms (such as competition policy) combined with the rigorous application of investment evaluation techniques (such as cost-benefit analysis) assists in creating clear signals for decisions on the level and nature of public investment.

The literature indicates that a high level of human capital is one of the key ingredients for improving economic growth (OECD 2004) and for attracting FDI (Miyamoto 2003). Two key elements in building human capital are investments in health and education.

The previous sections explored a number of potential reasons why investment has remained relatively weak in the region since the crisis. Of these, it seems that the deterioration in some aspects of the investment environment has been an important factor. While there seems to be more confidence in the macroeconomic policy settings, there remain a number of institutional and regulatory challenges.

Addressing these challenges is crucial to lifting investment in both physical and human capital, and requires both domestic and regional reforms. Drawing largely on a series of World Bank investment climate assessments, the section below outlines a range of behind-the-border reforms being pursued by countries in the region, and various regional initiatives aimed at lifting investment.

Policy measures — ASEAN-4 and Korea

Malaysia

Malaysia's investment climate compares favourably to many other East Asian economies, although there are a number of areas that could be improved. For example, World Bank and IMF reports have found that shortages of skilled workers and regulatory burdens need to be addressed to improve the performance of the services sector, which makes up around 50 per cent of Malaysia's GDP and employs nearly half the labour force. In addition, reforms to the labour market, taxation and customs, and streamlining bureaucratic processes, are crucial.

The Government's Ninth Malaysia Plan (2006-10) addresses a number of these concerns. The plan focuses on increasing the productivity and competitiveness of the services sector by addressing skills shortages through education and training. It also plans to: encourage the private sector as a driver of growth by supporting private financing initiatives and public-private partnerships; improve governance; and streamline administrative processes.

The Philippines

The Philippines' poor fiscal position has been cited as the key factor affecting the investment climate. Non-financial public sector debt in the Philippines is around 60 per cent of GDP, and has been identified as the most significant cause of concern amongst investors. Both the World Bank and IMF strongly encourage further fiscal consolidation, in combination with a range of reforms to enhance the quality of infrastructure, reduce the vulnerability of the banking sector, and improve the overall governance environment.

The Philippines Government has developed a comprehensive Medium-Term Development Plan (MDP) that outlines the Government's fiscal consolidation plan — which aims to balance the national budget by 2010 through a series of revenue initiatives. Additional funds will also be used to support public infrastructure, and public services. The MDP also aims to develop a stronger banking system by encouraging banks to dispose of non-performing loans.

Indonesia

Despite improvements to Indonesia's macroeconomic environment since the crisis, the investment climate remains characterised by: structural weaknesses in the economy; inadequate levels of physical infrastructure; systemic corruption; and excessive bureaucratic delays. As such, a range of measures are needed to: strengthen and diversify the financial sector; improve taxation and customs procedures; enhance labour market flexibility; promote small and medium enterprises; and improve corporate governance and the legal and judicial framework.

Policy measures — ASEAN-4 and Korea (continued)

Indonesia (continued)

In 2006, the Government announced an investment climate reform package, which aims to streamline business licensing procedures, simplify customs procedures, revise labour laws and reform taxation arrangements. The Government has also announced an infrastructure reform package and a financial sector reform package.[7]

To date, there has been some progress, including: passage of a new investment law, which stipulates equal treatment of foreign and domestic investment and measures to reduce bureaucratic delays in processing investment applications; a commitment by the Government to increase infrastructure spending and seek private sector funding of infrastructure through public-private partnerships; and the establishment of a financial sector safety net.

Thailand

There are a number of constraints to conducting business in Thailand, including: skills shortages and mismatch; regulatory burdens; and poor infrastructure. In addition, there are many low-skilled underemployed rural workers in the manufacturing sector and, as global competition in low-skill manufacturing grows, workers' skills will need to improve. In this context, improving the education system and increasing firms' access to information and communication technology are important.

The Government is addressing regulatory burdens through public sector reform. For example, government agencies have been streamlining work processes and establishing one-stop government service centres. In addition, the Government is addressing infrastructure bottlenecks through plans to build nine mass transit lines. The Government has also recently drafted a number of Acts to improve supervision of financial institutions to enhance transparency and flexibility.

Korea

The focus in Korea is on promoting FDI, recognising its importance for increasing Korea's openness to the world economy, and lifting productivity. Key ways to increase FDI include: reducing barriers to entry of foreign firms by relaxing FDI restrictions (notably foreign ownership ceilings), particularly in the telecoms and electricity sectors, as well as increasing the transparency of tax and regulatory policies.

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7 The infrastructure reform package aims to accelerate infrastructure development, including through promoting public-private partnerships. The financial sector reform package aims to strengthen coordination between fiscal and monetary authorities, implement regulatory changes to enable state-owned banks to offload their non-performing loans, and improve the liquidity, efficiency and integrity of capital markets.

Policy measures — ASEAN-4 and Korea (continued)

Korea (continued)

The Government's Vision 2030 plan aims to make Korea more attractive to foreign investors and less protectionist through measures such as: expanding the number of free trade agreements; developing economic zones that offer tax incentives and preferential regulatory treatment to foreign investors; improving regulations to attract foreign workers in order to ease labour shortages in certain sectors; and boosting spending on infrastructure.

Regional initiatives

Domestic reforms to strengthen the investment environment have been complemented by regional initiatives. The broader regional landscape has changed markedly since the crisis, with considerably stronger economic linkages and cooperation. For example, trade within ASEAN has tripled in the past decade, rising to over US$300 billion.[8] However, financial flows within the region remain much more limited despite the region amassing substantial foreign reserves. This has undoubtedly reduced external vulnerability, but at the expense of investing a considerable part of the region's savings in relatively low-yielding US bonds and foregoing opportunities to boost development and domestic investment.

One particular issue this raises is how much the underdevelopment of financial markets has contributed to this situation. One can think of this in two ways. The first is that underdeveloped financial markets may have directly contributed to high rates of saving and/or low rates of investment, by limiting access to finance and risk management opportunities. The second is that financial fragility may have caused regional policymakers to pursue macroeconomic policies designed to keep current accounts in surplus and, hence, avoid reliance on foreign capital.

In light of these developments, a number of forums have focused on promoting greater regional financial linkages. Key initiatives include the ASEAN+3 Chiang Mai Initiative, which is a network of bilateral foreign exchange swaps designed to provide funding in the event of a financial crisis in the region, and initiatives to promote bond market development, including the ASEAN+3 Asian Bond Market Initiative and the EMEAP Asian Bond Funds.[9] Furthermore, the fledgling East Asia Summit also has 'finance' as one of its five key themes.

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8 Bloomberg (2007a).

9 EMEAP is the Executives' Meeting of East Asia-Pacific Central Banks.

In addition, APEC supports the facilitation of capital flows by improving the efficiency of capital markets, broad regulatory reform to address structural impediments and the identification and removal of behind-the-border barriers. The APEC Finance Ministers' Process, for example, provides an important platform for officials and ministers to engage in substantive policy discussions that lead to the development and implementation of capacity building initiatives to support financial sector development and integration in the region.

In 2004, APEC Leaders adopted the *Leaders' Agenda to Implement Structural Reform* (LAISR), which identified, inter alia, competition policy, regulatory reform, governance, and economic and legal infrastructure as priority work areas to address. LAISR will, through policy dialogues and capacity building, seek to strengthen government policies, governance arrangements, regulatory frameworks, business operating systems and institutions that underpin the functioning of domestic markets, productivity levels and commercial activities. A ministerial-level meeting to address the priorities for structural reform will be convened in 2008 and is expected to intensify regional cooperation on structural reform.[10]

The APEC Investment Experts Group (currently chaired by the Australian Treasury) has undertaken substantial analytical and survey work in collaboration with the APEC Business Advisory Council (ABAC) to identify barriers to investment in the region. In June 2008, APEC's Ministers Responsible for Trade adopted an Investment Facilitation Action Plan (IFAP) to provide a comprehensive policy response by APEC to investment policy reform. This will involve significant cooperation with ABAC, the World Bank, the United Nations Conference on Trade and Development (UNCTAD) and the OECD. Effectively, the IFAP places investment policy reform on a par with trade policy reform which comes under APEC's Trade Facilitation Action Plan.

Conclusion

The subdued recovery of investment since the crisis is somewhat surprising, given that economic conditions in the region have improved significantly. In addition, a number of key constraints affecting the corporate, government and financial sectors have receded, and there is evidence to suggest that investors have a greater degree of confidence in macroeconomic policy settings.

However, it appears that a number of institutional and regulatory factors are negatively affecting the investment climate, and reforms to address these should assist in lifting investment rates in the region. This is particularly important for the

10 The meeting is being organised by the Australian Treasury through the APEC Economic Committee.

sustainability of long-term growth in the region, given the crucial role that investment plays in enhancing economic performance. In this context, it is encouraging that governments are pursuing practical initiatives — both individually and on a regional level — aimed at targeting these weaknesses and thereby improving the overall investment climate.

Of course, the ultimate policy objective is to improve GDP per capita and wellbeing. Better economic frameworks and policies will result in better signals to investors and, more broadly, improve the allocation of resources in the economy. For example, more flexible labour markets could improve employment outcomes and the matching of workers to jobs, lifting GDP per capita. Hence, the focus needs to be on policy frameworks that promote both the right level and mix of investment, as well as the right level and mix of economic activity more broadly.

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