Sustainability of Private Capital Flows: Comparing China with Mexico

Shu-Yun Ma
Department of Government and Public Administration
The Chinese University of Hong Kong

This paper attempts to explain the varying degrees of sustainability of private capital flows (PCFs) to China and Mexico, the two largest recipient developing countries of such flows in recent years. It tackles the question by comparing both the composition and causes of the flows. In using the first approach, PCFs to China were found to be more sustainable than those to Mexico because the former have consisted mainly of direct investment and loans, whereas most of the latter have been portfolio equity flows. Another explanation suggested by the second approach is that PCFs to China are mainly due to more sustainable factors such as the country's huge size, the rapid growth of its domestic economy, its cheap labor, its far-reaching real domestic policy reforms, and its high savings rates. On the other hand, in the Mexican case, less durable factors such as external influences and domestic credit policy changes play an important role.

Keywords: China; Mexico; foreign direct investment; foreign debts; equity flows

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The surge of private capital flows (PCFs) to developing countries in recent years has attracted the attention of both academic researchers and financial analysts. This trend represents the renewed interests of foreign lenders and investors in the growth potential of Third World economies, after a decade of intense debt crises. One of the major research interests in this rather new issue has been the sustainability of these flows. As recently as 1993-94, the World Bank believed that there were many "good reasons" why PCFs would be durable: most developing countries had adopted better economic policies; most of the flows had gone to private users; and the emergence of equity flows had improved risk sharing between borrowers and creditors.[1] Such

[1] *World Debt Tables* (1993-94) 1:4.

optimism, however, was destroyed by the Mexican financial crisis in early 1995.

Existing literature on PCFs to developing countries includes case studies on Mexico, Chile, Colombia, Indonesia, South Korea, Malaysia, Thailand, Egypt, and Spain.[2] Among them, Mexico has been the most commonly cited example of an emerging market, and has received the greatest attention. On the other hand, no major research on PCFs to China has been conducted, although the amount of PCFs to the country has increased rapidly in recent years. According to World Bank records between 1989 and 1993, in absolute terms, China and Mexico were the world's two largest recipients of PCFs among developing countries.[3] However, PCFs to Mexico began to decline in 1994, resulting in a collapse of the Mexican peso's value. In contrast, flows to China continued to rise, forcing the Chinese *yuan* to appreciate. By early 1995, the amount of flows had reached a level that even some Chinese leaders deemed to be excessive.[4] The fact that Mexico has been the origin of both the Third World debt defaults in the 1980s and the recent emerging market chaos, while China has been able to avoid both crises, merits comparison of these two countries. In fact, Chinese economists have already recognized that the financial crisis in Mexico offers a lesson about the importance of controlling PCFs.[5]

From 1986 to 1994, total PCFs to China amounted to US$150.1 billion, accounting for 27.5 percent of the sum absorbed by all developing countries. The Chinese figures were almost double those of Mexico (see tables 1 and 2). After adjusting for the size of their re-

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[2]Vittorio Corbo and Leonardo Hernandez, "Macroeconomic Adjustment to Capital Inflows: Rationale and Some Recent Experiences," in *Portfolio Investment in Developing Countries*, ed. Stijn Claessens and Sudarshan Gooptu, World Bank Discussion Paper no. 228 (Washington, D.C.: 1993), 353-82; Susan Schadler, Maria Carkovic, Adam Bennett, and Robert Kahn, "Recent Experiences with Surges in Capital Inflows," *International Monetary Fund Occasional Paper* (Washington, D.C.: 1993); Kenneth Bercuson and Linda Koenig, "The Recent Surge in Capital Inflows to Three ASEAN Countries: Causes and Macroeconomic Impact," *Occasional Papers*, no. 15 (Kuala Lumpur: The South East Asian Central Banks Research and Training Centre, 1993).

[3]*World Debt Tables* (1993-94) 1:9.

[4]There seems to be some disagreements among Chinese leaders on this issue. Tian Jiyun, vice chairman of the Standing Committee of the National People's Congress, is among those who have urged a lowering of the country's foreign exchange reserve in order to help reduce domestic inflation. See *Sing Tao Daily* (Toronto edition), April 12, 1995. But the State Administration of Exchange Control has defended the reserve level as appropriate. See *China Daily*, March 4, 1995.

[5]*China Daily*, March 27, 1995.

spective economies, the relative amount of China's PCFs was slightly higher than Mexico's: PCFs accounted for 4.5 percent of China's gross national product (GNP), and 3.3 percent of Mexico's (see table 3).

PCFs to China have also been much more stable than those to Mexico. From 1986 to 1988, PCFs to China increased steadily at the average annual rate of 24 percent. Although political turmoil and domestic austerity programs caused some ups and downs during 1989-91, the fluctuations were mild. A dramatic surge took place in 1992, as PCFs in that year increased by 180 percent, followed by a 79 percent increase in 1993 and a 24 percent increase in 1994. In comparison, PCFs to Mexico have been extremely volatile, with the annual rate of change ranging from -60 percent in 1988 to +243 percent in 1993 (see table 1).

Hence, even before the Mexican peso crisis in early 1995, PCFs to China had already shown signs of higher sustainability than Mexico. The purpose of this paper is to explain this difference. It will tackle the question by comparing both the composition and causes of the flows to the two countries.

By-Component Approach

One way to explain different degrees of sustainability is through comparing the composition of PCFs. According to the World Bank definition, PCFs have three components: direct investment, private debt flows, and portfolio equity flows.[6]

Direct Investment

From 1986 to 1994, direct investment constituted over 60 percent of PCFs to China, compared to Mexico's 48 percent (see table 1). Although the difference is not very significant, it does suggest a reason for China's greater stability of PCFs, since direct investment usually involves a longer time frame than other types of flows.

While direct investment provides inflows to the financial account,[7] demands for imports by foreign enterprises in the recipient country

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[6] *World Debt Tables* (1994-95) 1:7.

[7] "Financial account" is a new design that first appeared in the fifth edition of the *IMF Balance of Payments Manual* and roughly equivalent to the commonly known "capital account." See *Balance of Payments Statistics Yearbook 1995*, part 1:x.

Table 1
Private Capital Flows to China and Mexico

	Direct Investment		Debt Flows		Portfolio Equity Flows		Total
	US$bil	% of total	US$ bil	% of total	US$ bil	% of total	US$ bil
China							
1986	1.88	33.7	3.69	66.3	0.00	0.0	5.57
1987	2.31	29.8	5.46	70.2	0.00	0.0	7.77
1988	3.19	37.1	5.43	62.9	0.00	0.0	8.62
1989	3.39	47.2	3.80	52.8	0.00	0.0	7.19
1990	3.49	43.0	4.62	57.0	0.00	0.0	8.11
1991	4.37	58.1	2.49	33.2	0.65	8.7	7.51
1992	11.16	52.9	8.75	41.5	1.19	5.7	21.10
1993	27.52	73.0	7.89	20.9	2.28	6.0	37.69
1994	33.79	72.6	8.85	19.0	3.90	8.4	46.54
1986-94	91.10	60.7	50.98	34.0	8.02	5.3	150.10
Mexico							
1986	1.52	***	-0.93	***	0.00	***	0.59
1987	3.25	46.5	3.73	53.5	0.00	0.0	6.98
1988	2.59	91.8	0.23	8.2	0.00	0.0	2.82
1989	3.04	***	-0.44	***	0.00	***	2.60
1990	2.55	40.5	3.18	50.5	0.56	8.9	6.29
1991	4.74	46.8	0.99	9.8	4.40	43.4	10.13
1992	4.39	***	-3.62	***	5.37	***	6.14
1993	4.39	20.8	2.37	11.3	14.30	67.9	21.06
1994	7.98	52.6	2.66	17.5	4.52	29.8	15.16
1986-94	34.45	48.0	8.18	11.4	29.15	40.6	71.78

Note: Some figures are replaced with asterisks, as negative debt flows to Mexico in some years make it misleading to present "% of total" figures in those cases. Negative debt flows appear when loan disbursements exceed principal repayments.

Sources: *World Debt Tables*, various issues.

Table 2
Private Capital Flows to China and Mexico as a Percentage of Flows to All Developing Countries

	Direct Investment	Debt Flows	Portfolio Equity	Total
China				
1986	18.5	40.2	0.0	27.9
1987	15.9	55.5	0.0	30.9
1988	15.8	31.9	0.0	22.5
1989	14.2	31.0	0.0	18.2
1990	13.9	77.5	0.0	23.4
1991	12.5	24.0	8.6	14.2
1992	23.9	45.6	8.5	26.4
1993	40.3	34.2	5.0	27.5
1994	42.2	46.6	11.2	34.7
1986-94	28.6	42.8	7.2	27.5

Table 2 (Continued)

	Direct Investment	Debt Flows	Portfolio Equity	Total
Mexico				
1986	15.0	-10.1	0.0	3.0
1987	22.3	37.9	0.0	27.7
1988	12.8	1.4	0.0	7.4
1989	12.7	-3.6	0.0	6.6
1990	10.2	53.3	15.0	18.1
1991	13.6	9.6	58.3	19.2
1992	9.4	-18.9	38.2	7.7
1993	6.4	10.3	31.3	15.4
1994	10.0	14.0	13.0	11.3
1986-94	10.8	5.8	26.1	12.7

Sources: *World Debt Tables*, various issues.

Table 3
Share of Private Capital Flows in Gross National Product (%)

	China	Mexico	All Developing Countries
1986	2.0	0.5	0.6
1987	2.9	5.2	1.0
1988	2.8	1.7	1.0
1989	2.1	1.3	1.0
1990	2.3	2.6	0.8
1991	2.0	3.6	1.2
1992	5.0	1.9	1.7
1993	8.8	5.9	2.8
1994	8.9	4.2	2.6
1986-94	4.5	3.3	1.5

Sources: *World Debt Tables*, various issues.

will generate outflows through the current account. In 1995, foreign enterprises in China imported about US$63 billion worth of goods, representing 48 percent of the country's total imports in that year.[8] On the other hand, the government used a series of incentives to encourage foreign enterprises in the country to export their products

[8]*China's Customs Statistics*, various issues.

while restricting their domestic sales.[9] As a result, foreign enterprises in China have been highly export-oriented; in 1994, about 85 percent of their output was exported. In fact, they have been the engine of China's export growth in recent years. In 1995, the growth rate of foreign enterprise exports in China, at 35 percent, was much faster than the national pace of 23 percent. In that year, these enterprises earned about US$47 billion through exports, accounting for 32 percent of the national total. The export earnings combined with the amount of direct investment, were more than enough to cover imports by foreign enterprises, with a balance of US$22 billion.[10] In other words, direct investment in China has produced overall favorable effects on the country's balance of payments.

In Mexico's case, the government also intended to make foreign enterprises in the country export-oriented. A study based on 1987 data found that foreign enterprises in Mexico made a positive contribution to the country's trade balance.[11] However, in more recent years foreign direct investment in Mexico has shifted from producing exports to providing local services. From 1989 to 1993, manufacturing, which is the base of exports, accounted for only 30 percent of direct investment in Mexico compared to China's 54 percent. On the other hand, 26 percent of foreign direct investment in Mexico was used to develop financial services and local trade, whereas the amount in China was less than 4 percent.[12] In particular, a significant amount of foreign capital in Mexico was used to encourage North American-style consumption in the local market—that is, to open Wal-Mart, McDonald's, Pizza Hut, and Baskin-Robbins stores.[13]

To summarize, whereas direct investment in China has brought generally favorable effects to its balance of payments, this type of

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[9]Lucille A. Barale, "China's Investment Implementing Regulations," *China Business Review*, March-April 1988, 19-23; Christine A. Genzberger et al., *China Business* (San Rafael: World Trade Press, 1994), 43-44.

[10]See *China's Customs Statistics*, *China Statistical Yearbook*, and *China Economic News*.

[11]UNCTC, *Foreign Direct Investment and Industrial Restructuring in Mexico*, UNCTC Current Studies, Series A, no. 18 (Washington, D.C.: 1992).

[12]Sectoral classifications of foreign direct investment in Mexico do not match those of China exactly. Hence the data cited are only for general but not exact comparison. The Mexican data are from Marie-France Moude, "Mexico and Foreign Investment," *The OECD Observer*, no. 190 (October/November 1994): 10-13; and the Chinese data from *Almanac of China's Foreign Economic Relations and Trade*.

[13]Margaret M. Price, *Emerging Stock Markets* (New York: McGraw-Hill, 1994), 143; James K. Glassman, "Making the Most of the Mexico Mess," *The Washington Post*, January 15, 1995.

Table 4
China's and Mexico's Balance of Payments (in US$ Billion)

	China		Mexico	
	Current account	Financial account	Current account	Financial account
1987	0.1	6.0	4.2	-3.1
1988	-3.9	7.1	-2.4	-4.5
1989	-4.4	3.7	-5.8	1.1
1990	11.9	3.3	-7.5	8.4
1991	13.1	8.0	-14.9	25.1
1992	6.2	-0.3	-24.4	27.0
1993	-11.7	23.5	-23.4	33.8
1994	6.5	32.6	-28.8	12.8
1987-94	17.8	84.0	-103.0	100.6

Sources: *Balance of Payments Statistics Yearbook*, various issues.

flow has produced severe adverse impacts on Mexico's current account. As revealed by International Monetary Fund (IMF) statistics, from 1987 to 1994 China's overall current and financial accounts were both in surplus. In contrast, Mexico's current account had a deficit during this period, a chronic crisis that was concealed under continuous capital inflows (see table 4).

Debt Flows

Private debt flows, the second component of PCFs, are loans from private creditors net of principal repayments. Our data refer to long-term debts that have an original or extended maturity of more than one year.[14] From 1986 to 1994, private debt flows accounted for 34 percent of China's PCFs, compared to 11.4 percent in Mexico (see table 1). Since 1986, the average maturity of China's new debt commitments has consistently been longer than that of Mexico (see table 5). In other words, China has been able to obtain more and longer-term loans than Mexico.

The reason for the above is that Mexico's debt default in 1982 severely damaged the country's ability to obtain loans from foreign private creditors. New loans obtained in some years were even insufficient to cover repayments of earlier debts, resulting in negative debt flows. It was not until the early 1990s when Mexico's debt indicators fell to pre-1982 levels, and its debt crisis was considered "finally

[14] *World Debt Tables* (1994-95) 1:179.

Table 5
Average Maturity of New Debt Commitments to Private Creditors

	China	Mexico	All Developing Countries
1985	6.6	8.5	N.A.
1986	11.0	7.3	9.8
1987	12.2	11.8	11.4
1988	12.0	7.2	10.3
1989	13.2	7.6	10.1
1990	13.3	10.9	14.2
1991	12.8	7.5	9.8
1992	12.3	7.4	9.7
1993	11.4	10.0	9.3
1994	13.1	4.8	9.4

Sources: *World Debt Tables*, various issues.

over."[15] In contrast, China has maintained a much better credit record. From 1985 to 1993, no major debt restructurings were required on China's part, whereas over US$136 billion Mexican debts were rescheduled.[16] Throughout this period, China's international creditworthiness was consistently higher than Mexico's, and all the major debt indicators suggest that lending to China is much safer than lending to Mexico (see figure 1 and table 6).

Portfolio Equity Flows

Portfolio equity flows are the most liquid form of PCFs and are highly sensitive to changes in interest rates. From 1986 to 1994, it accounted for only 5.3 percent of PCFs to China, compared to Mexico's 40.6 percent. In fact, there were no portfolio equity flows to China until 1991, a year after China established a stock exchange in Shanghai.[17] From 1991 to 1994, the total amount of portfolio equity flows to China was about US$8 billion, or 7 percent of total PCFs to China during that period (see table 1).

[15] *World Debt Tables* (1992-93) 1:8.

[16] *World Debt Tables* (1994-95) 2:101, 317.

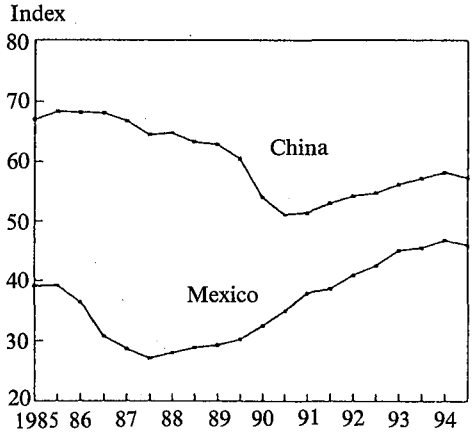
[17] The Shanghai Stock Exchange, first established in 1920, was closed down in 1952. It was reopened in 1990. The following year, China established another stock exchange in Shenzhen. See Solomon M. Karmel, "Emerging Securities Markets in China: Capitalism with Chinese Characteristics," *The China Quarterly*, no. 140 (December 1994): 1105-20.

Table 6
Selected Debt Indicators

	Debt/Exports (%)		Debt/GNP (%)		Debt Service/ Exports (%)		Interest Payments/ Exports (%)		Interest Payments/GNP (%)		International Reserve/Debt (%)	
	China	Mexico	China	Mexico	China	Mexico	China	Mexico	China	Mexico	China	Mexico
1985	56.1	326.0	5.7	55.2	8.3	51.5	4.0	34.4	0.4	5.8	100.9	5.9
1986	76.8	356.1	8.4	82.9	9.6	45.7	3.4	29.6	0.4	6.9	69.2	6.6
1987	87.7	363.3	13.2	82.1	9.6	40.1	4.5	27.6	0.7	6.2	63.5	12.5
1988	89.3	309.1	13.8	59.8	9.6	48.2	4.6	27.1	0.7	5.2	56.0	6.4
1989	90.2	247.5	13.1	46.9	11.3	41.1	6.4	24.6	0.9	4.7	51.3	7.2
1990	87.2	238.8	14.9	43.8	11.5	25.9	5.2	16.7	0.9	3.1	65.4	9.8
1991	85.6	249.5	15.8	40.4	11.8	29.6	5.3	17.9	1.0	2.9	80.6	15.8
1992	82.1	238.6	16.6	34.6	10.2	44.3	4.0	16.0	0.8	2.3	35.8	17.1
1993	92.3	236.7	19.6	33.2	11.2	42.3	3.8	14.0	0.8	2.0	32.5	21.4
1994	80.4	228.1	19.3	35.2	8.9	33.9	3.8	14.2	0.9	2.2	57.5	5.0

Sources: *World Debt Tables*, various issues.

Figure 1
International Credit Ratings of China and Mexico



Sources: *Institutional Investor*, various issues.

In contrast, Mexico's stock market, Bolsa Mexicana de Valores, has a much longer history than China's. Established in 1894 in Mexico City, it has now become the largest in Latin America in terms of market capitalization. Foreign capital began to flow to this market in 1990, a year after the government opened the domestic stock market to foreign investors.[18] From 1990 to 1994, portfolio equity flows to Mexico were close to US$30 billion, representing 50 percent of total PCFs to the country during that period (see table 1).

Hence, Mexico absorbed much more portfolio equity flows than China in both absolute and relative terms. In fact, during the heyday of emerging stock markets in 1993, portfolio equity flows to Mexico accounted for 68 percent of the country's total PCFs; in the Chinese case, this proportion has never exceeded 9 percent (see table 1). As mentioned above, a characteristic of this form of flows is that it is highly sensitive to external interest rate changes. Hence, most emerging stock markets plunged after the U.S. Federal Reserve Board raised short-term interest rates in February 1994. In Mexico, total investment in stocks by foreigners fell by 11 percent in the first quarter of 1994. Margin calls and redemptions from mutual funds magnified selling pressures, causing a sudden decline in market

[18]Price, *Emerging Stock Markets*, 146-48.

liquidity.[19] Chinese stock prices also fell, but the repercussions were limited, since China's stock market is much smaller in scale than Mexico's.[20] More importantly, as will be mentioned in the next section, only a tiny portion of China's stock market has been opened to foreign influence.

In short, the different composition of PCFs provides a clue to the higher degree of sustained flows to China than Mexico. Flows to China have mainly consisted of direct investment and loans, which involve longer-term commitments, whereas a large portion of PCFs to Mexico have been more volatile portfolio equity flows. As a result, China has been less vulnerable to flow reversals than Mexico.

Causes-of-Flow Approach

Apart from the above by-component approach, another way to explain PCF sustainability is to examine the causes of the flows. A study by the IMF identified four causes of capital flow surges: external influences, credit policy changes, bandwagon effects, and real domestic policy reform. External influences such as falling interest rates and reductions in major industrial countries' output growth tend to drive capital to developing countries for higher returns. But PCFs so induced will fluctuate along with business cycles in developed countries. When flows are attracted by higher interest rates as a result of credit policy changes, the possibility of flow reversal is high since such flows tend toward relatively liquid assets and are responsive to any change in the credibility of the credit policy. Bandwagon effects occur when financial markets follow fashion or overreact to new information. By definition, flows due to this factor must be short-lived. Only PCFs induced by the recipient countries' public sector and structural reforms that improve the real economy are likely to be sustainable.[21]

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[19]Craig Torres, "Mexico Sees Direct Investment Rising, But Securities Investors Retreat," *Wall Street Journal*, April 12, 1994; Michael Adler, "Lessons from Mexico's Roller-Coaster Ride in the First Quarter of 1994," *Columbia Journal of World Business* 24, no. 2 (Summer 1994): 84-91.

[20]As of June 1993, market capitalization of China's stock market was about one-fourth that of Mexico's. See Shu-Yun Ma, "Stock Market Rebounds After Rescue Plan," *Canada-China Business Forum*, September/October 1994, 40.

[21]Schadler, "Recent Experiences," 2-10. The conclusion of this IMF paper is consistent with another study by the Asian Development Bank, which holds that "domestic

While bandwagon effects are very difficult to identify in all circumstances, PCFs to Latin America have been found to be largely determined by conditions in the world economy that are beyond the control of Latin American countries. Empirical data shows that flows to the region are highly correlated with world interest rates.[22] Moreover, the proliferation of Latin American companies' American Depository Receipts has resulted in a close correlation between the U.S. and Latin American stock markets. In addition to these factors that apply to Latin American countries in general, Mexico has been subject to the particular influence of the United States, as a result of the North American Free Trade Agreement (NAFTA). This agreement, which entered into force on January 1, 1994, significantly reduced trade and investment barriers among the United States, Canada, and Mexico. By linking up the three economies, NAFTA facilitates transmission of economic signals among the North American region. Consequently, as one equity researcher has observed, the Mexican market has responded not only to U.S. interest rates but also to a host of other American economic indicators.[23]

Credit policy changes have also been a determinant of PCFs to Mexico. In the uncertain pre-NAFTA period, the Mexican government maintained high interest rates, in order to induce continuous PCFs to the country. However, the negative impact of high interest rates on economic growth created the perception that the policy would not be sustainable. In January 1994, the Mexican government lowered interest rates, reinforcing speculation that the tight credit policy would be relaxed after the conclusion of NAFTA. Confidence about the stability of the peso's value was further weakened by NAFTA's requirement that the band within which the peso's exchange rates could vary be widened from the original 4 percent to 9 percent.[24]

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factors will be crucial for sustaining the inflow of external capital flows to individual countries." See Min Tang and James Villafuerte, "Capital Flows to Asian and Pacific Developing Countries: Recent Trends and Future Prospects" (Statistical Report Series Number 18, Asian Development Bank, November 1995), 15.

[22]Michael Gavin, Ricardo Hausmann, and Leonardo Leiderman, "The Macroeconomics of Capital Flows to Latin America: Experience and Policy Issues," in *Volatile Capital Flows: Taming Their Impact on Latin America*, ed. Ricardo Hausmann and Liliana Rojas-Suarez (Washington, D.C.: Inter-American Development Bank, 1996), 1-40.

[23]Deirdre Fretz, "The Trouble with Togetherness," *Institutional Investor*, October 1994, 181-87.

[24]Adler, "Lessons," 86-87.

Hence, both external influences and domestic credit policy as causes of PCFs to Mexico have proven to be unsustainable, a conclusion that is consistent with the above-mentioned IMF study. In terms of real domestic policy reform, Mexico has been engaged in privatization, trade liberalization, tax reform, and deregulation.[25] Although the changes have been impressive, they failed to prevent the major flow reversal that precipitated the peso crisis. Inasmuch as PCFs to Mexico were largely caused by external influences, the flows were vulnerable to changes in foreign variables. Hence, a sharp reversal of capital flows occurred following the raising of U.S. interest rates in early 1994, despite Mexico's improving economic fundamentals.[26] As one study reveals, 80 percent of the volatility in Mexico's financial market was not caused by economic or political events inside the country, but by a retrenchment in liquidity that was taking place around the world.[27]

In contrast, external influences play a much less important role in determining PCFs to China. As mentioned in the last section, the majority of the flows to China has been direct investment. A recent empirical study found that direct investment in China generally moves in a similar pattern to the country's trade tendencies; that is, the largest trading partners of China (Hong Kong, Japan, the United States, and Singapore) are also the biggest direct investment source countries. This implies that the huge size of the Chinese market and its rapid growth have been the major causes of direct investment in China. Foreign capital has also been attracted by China's cheap labor supply.[28] Since these factors—the size and growth of the domestic market and cheap labor—are not cyclical in nature,[29] direct investment in China has tended to be stable.

To be sure, PCFs to China have also been sensitive to changes in foreign interest rates, the major cyclical factor that has made

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[25]Schadler, "Recent Experiences," 8.

[26]Adler, "Lessons," 85.

[27]Tim Carrington, "Private-Capital Flows Can Hurt Poor Nations," *Wall Street Journal*, January 30, 1995.

[28]Zhaoyong Zhang, "International Trade and Foreign Direct Investment: Further Evidence from China," *Asian Economic Journal* 9, no. 2 (July 1995): 153-67.

[29]Although rapid economic growth in recent years has raised wage rates in China's coastal areas, the vast supply of cheap labor in the large inland provinces will prevent China from losing the advantage of cheap labor in the near future. See Uri Dadush and Dong He, "China: A New Power in World Trade," *Finance and Development* 32, no. 2 (June 1995): 36-38.

Mexico's PCFs so unstable. However, unlike the Mexican case, China has not entered into any NAFTA-type agreement that would open its economy to the particular influence of individual countries such as the United States. In fact, until May 1993, most flows of U.S. funds to China could take only the form of direct investment or loans. Before that time, the U.S. Securities and Exchange Commission banned pension and mutual funds from buying Chinese shares, due to concerns about the Chinese stock market's clearing and settlement systems.[30] On the other hand, the Chinese government limits foreign access to the country's stock market. There are two types of shares issued by Chinese enterprises: A- and B-shares. The former are traded among local Chinese, and only the latter are available to foreigners.[31] As of the end of 1994, the B-share market, in terms of market capitalization, was less than 2 percent of the size of A-share market.[32] Hence only a tiny proportion of the Chinese stock market has been open to external influences.[33]

According to a recent joint study by the China Securities Regulatory Commission and the World Bank, the separation of A-share and B-share markets has produced a series of problems, including price distortions across markets, illegitimate transactions due to possibilities for arbitrage, reduced liquidity, and barriers to the spillover of benefits from the B-share to the A-share market. However, market segregation has the advantage of reducing the domestic market's vulnerability to external shocks. A pullout of foreign capital from China will have direct impact only on the price of foreign shares, but not domestic shares; this has saved China from a Mexican-type financial crisis.[34]

In terms of credit policy, China did not emulate Mexico, which,

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[30]*China Daily*, May 3, 1993.

[31]Apart from B-shares, foreigners may also purchase H- and N-shares, which refer respectively to Chinese shares listed in the Hong Kong and New York stock exchanges, and American Depository Shares listed on the New York Stock Exchange or traded over-the-counter in New York. See International Securities Consultancy, *The Capital Guide to China's Securities Markets* (Hong Kong: ISI Publication, 1994), 4.

[32]*Zhengjuan shichang zhoukan* (Securities Market Weekly).

[33]This is yet another indication that despite the almost two-decade-long open policy, the Chinese economy has only been "shallowly integrated into the world economy." See Susan L. Shirk, *How China Opened Its Door: The Political Success of the PRC's Foreign Trade and Investment Reforms* (Washington, D.C.: The Brookings Institution, 1994), 3.

[34]World Bank, *China: The Emerging Capital Market*, vol. 2 (Washington, D.C.: The World Bank, 1995), 127-29.

as mentioned above, used high interest rates to attract foreign capital in the pre-NAFTA period. On the contrary, from early 1992 to July 1993, under the political patronage of Deng Xiaoping, the Chinese government adopted an aggressive reflationary policy to stimulate the economy. An explosion of liquidity caused rapid increases in output and production capacity, serious bottlenecks in infrastructure, high inflation, sharp devaluation of the local currency, and surges in asset prices. Despite such strong signs of an overheating economy, interest rates remained at a very low level. It was only until July 1993 that an iron-handed financial squeeze was introduced. However, the austerity program relied heavily on administrative measures, such as the mandatory return of loans from enterprises to state banks and compulsory purchases of treasury bills. Thus, interest rates, the major market regulator of liquidity, have remained inflexible and negative in real terms.[35]

While external influences and domestic credit policy have been of less importance to China than Mexico, a series of far-reaching domestic policy reforms have significantly improved the attractiveness of the Chinese economy to foreign capital. The reforms have included the elimination of mandatory planning and direct administrative control of enterprise activities; removal of price control; liberalization of foreign economic relations; redefinition of property rights; hardening of enterprises' budget constraints; and creation of product markets.[36] These reforms have been accompanied by rising savings rates. Typically initial economic growth will be followed by a consumption boom, leading to decline in savings rates. This has been true in Mexico's case, as its domestic savings ratio (as a percentage of gross domestic product) fell from 25 percent in 1980 to 18 percent in 1994. However, during the same period, the Chinese traditional preference of savings over consumption raised China's savings ratio from 35 percent to 44 percent.[37] This has saved China from the

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[35]Zhao Chen, "China: Boom/Bust or Soft Landing?" *The Bank Credit Analyst* 45, no. 3 (July 1993): 27-52; Shu-Yun Ma, "China's Financial Squeeze: Soft Landing Expected," *Canada-China Business Forum*, September/October 1993, 9-12; Joe Zhang, "Tight Control on Rates Hurts China's Banks," *The Asian Wall Street Journal Weekly*, April 17, 1995.

[36]There is a huge amount of literature on China's economic reform. A recent concise review can be found in Joseph C. H. Chai, "Transition to a Market Economy: The Chinese Experience," *Communist Economies & Economic Transformation* 6, no. 2 (1994): 231-45.

[37]World Bank, *World Development Report 1996* (New York: Oxford University Press, 1996), 212-13.

adverse impact of declining savings on balance of payments and exchange rate stability, and thus enhanced the sustainability of its PCFs.[38]

Conclusion

This paper has attempted to explain the varying degrees of sustainability of PCFs to China and Mexico—the two largest recipients among developing countries of such flows in recent years—by comparing both the composition and causes of the flows. By the first approach, we find that PCFs to China have been mainly comprised of direct investment and loans, whereas a significant share of PCFs to Mexico are portfolio equity flows. The fact that China's PCFs have been more stable than Mexico's so far tends to confirm the conventional view that portfolio equity flows involve high volatility risks.[39] According to the second approach, PCFs induced by external factors and domestic credit policy are less stable than those induced by real improvement of the domestic economy. Our comparison of the Chinese and Mexican cases lends support to this proposition.

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[38]Declining private savings rate is a warning signal of capital flow reversals. See Uri Dadush and Milan Brahmbhatt, "Anticipating Capital Flow Reversals," *Finance and Development* 32, no. 4 (December 1995): 3-5. According to the distinguished economist Martin Feldstein, the fundamental cause of Mexico's financial crisis was the country's low savings rate, instead of the commonly cited factor of overexposure to the global capital market. See Martin Feldstein, "Global Capital Flows: Too Little, Not Too Much," *The Economist*, June 24, 1995, 72-73.

[39]Such a conventional view has recently been challenged by some economists. See Stijn Claessens, Michael Dooley, and Andrew Warner, "Portfolio Capital Flows: Hot or Cool?" in Claessens and Gooptu, *Portfolio Investment in Developing Countries*, 18-27.