

number of measures. These relate to, inter alia, the dissemination of information about investment opportunities in developing countries, especially the ones that receive meagre flows; financial and fiscal support to outward investors; insurance schemes; and greater market access that would be of particular relevance to export-oriented FDI. Some developed countries already have in place measures in one or more of these areas. All developed countries could emulate best practices regarding such measures and devise others.

## OTHER PRIVATE CAPITAL FLOWS

External private capital flows into developing countries have several dimensions: loans from overseas commercial banks; bond and equity issuance by developing country governments or corporations on overseas markets; external private participation in local capital markets; and other financial instruments that provide access to external funds. Table VI.2 reports on the overall situation with regard to net external private capital flows to developing countries

**Table VI.2. Private capital flows to emerging markets, 1992-1999**

### A. Net

(Billions of US dollars)

	1992	1993	1994	1995	1996	1997	1998	1999
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3
Asia	9.0	21.8	11.8	14.2	12.9	3.5	-17.9	-5.6
Five crisis-affected Asian countries <sup>a</sup>	6.4	17.2	9.9	17.4	20.3	12.9	-6.0	6.3
Bank loans and other	21.0	28.3	-57.3	97.4	24.9	-44.0	-76.7	-92.5
Asia	-3.9	1.7	4.7	44.1	38.1	-60.4	-82.9	-71.3
Five crisis-affected Asian countries <sup>a</sup>	15.3	7.0	17.4	49.2	37.1	-43.6	-28.2	-41.1

**Source:** IMF, *International Capital Markets* (Washington DC, September 2000).

<sup>a</sup> Referring to Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.

### B. Gross

(Billions of US dollars)

	1996	1997	1998	1999	2000 <sup>a</sup>
Emerging market	218.4	292.5	150.2	173.2	128.2
Asia	118.5	128.6	35	62.9	54.9
Capital markets <sup>b</sup>	127.7	179.1	90.6	110.2	74.2
Asia	62.3	69.7	17.4	42.4	28.7
Loan commitments	90.7	123.2	60	63	53.8
Asia	56.2	58.9	17.7	20.5	26.1

**Source:** IMF, *World Economic Outlook* (Washington DC), October 1999 and September 2000.

<sup>a</sup> Up to June.

<sup>b</sup> Comprising bond issues, other fixed income and equity issues.

for 1992-1999.<sup>9</sup> The ESCAP region did not have a very important share of net portfolio investment flows; Latin American countries dominate this category, possibly because their approach to raising resources emulates that of the United States. In fact these net flows for the ESCAP area were negative in both 1998 and 1999. With regard to bank loans, the net position of countries in the ESCAP region has been more important relative to all emerging markets, particularly since 1995. But again there has been a negative net flow since 1997, showing more repayment than new money. It is interesting to note that the five countries affected by the crisis often have net positions larger than those for the region as a whole. Until 1997 they were drawing in more capital flows (both portfolio investment and bank loans) than the other countries. However, since 1997 they have in fact had a better (less positive or negative) net position than the region. This illustrates that they are still considered relatively more creditworthy than many other countries. The figures reported on gross private financing in part B of table VI.2 show that the region received over 50 per cent of the total flows in 1996, with this share falling to 23 per cent in 1998, the year after the crisis. However, it has risen again to about 42 per cent, or the same as in 1997. There have been gross portfolio investment inflows to the region throughout the period, these being larger than bank loans in 1996 and 1997, revealing a shift away from reliance on bank loans towards bonds and equity. However, since the crisis portfolio investment has fallen considerably, showing the move away from investment in emerging markets and the more stringent conditions being applied in bond markets. The pattern for loan commitments is very similar, falling off considerably after the 1997 crisis. However, whereas portfolio investment recovered in 1999

only to drop again in 2000, bank loans showed a slow but steady recovery. While these data exhibit some general patterns, they cannot show whether the recipients of the private lending were governments or corporations, or even individuals for bank loans. Therefore, it is not possible to know the uses made of the funds: balance of payments, productive investment, consumption or speculative activities.

Currently access to external private capital funds is concentrated in a handful of countries in the region. Yet private flows are becoming the principal source of external finance worldwide, and are likely to remain so for the foreseeable future. Therefore, a discussion on their rationale, composition, advantages and problems, as well as related policy issues, is certainly warranted. The contribution of external private capital flows to financing development can be both direct and indirect. Bank loans have the distinction of being a fungible form of finance, not tied to any specific firm or sector. They can be tapped by both domestic enterprises and foreign-owned enterprises in any area of activity. These can, of course, include speculative activities as well as productive ones. Some other forms, such as venture capital, primary equity issues (on the domestic or international capital markets), and corporate bonds can make a valuable and direct contribution to the financing of investment. Other forms, such as purchases by foreigners of securities on domestic capital markets or of government bonds and other financial products, have an impact on domestic wealth, savings and therefore investment. The positive wealth effect generated by purchases through the increase in asset prices can encourage an increase in consumption by domestic wealth holders or an increase in their savings if they decide to invest in other securities or assets. In addition, portfolio asset purchases from residents can increase bank liquidity and encourage a credit boom. The rise in domestic consumption can have a stimulating effect on the economy if it leads to an increase in investment through secondary effects. However, the credit boom can increase opportunities for financing speculative activities or increase inflationary tendencies and so the economy may lead to suffer a setback.

External private capital flows bring ancillary benefits through the addition of liquidity in domestic financial markets, thus favouring their development. They can also encourage the development of financial intermediaries, strengthening the financial infrastructure and deepening the process of financial intermediation. There can be an improvement in corporate governance as foreign investors tend to

<sup>9</sup> The available data on which to base the discussion in this section are very scanty and inconsistent. IMF and BIS started collecting data on private flows only recently and their figures do not tally. The IMF-BIS-OECD-World Bank working group on debt tables has agreed on the content but most countries are yet to report consistently, if at all. The BIS data are based on reporting banks and other financial institutions in developed countries. One major problem is that while commercial banks have some systematic reporting mechanisms, other financial markets do not necessarily have these for private flows. In addition on stock markets, for example, participation of external private capital can vary significantly from one day to the next and so reporting averages is not very helpful. Therefore, the analysis should be viewed as indicative of trends and not of absolutes.

demand better transparency and disclosure. They can, in addition, increase the amount of risk capital available for new enterprises. On the negative side, the costs of external private finance can outweigh its benefits when there is high volatility in inflows and outflows. It is hard to predict when and where private capital will flow and its use runs the risk of unexpected withdrawal.

### Bank loans

Almost all ESCAP members have relied on bank lending for financing their economic development. This is true in terms of domestic resources as well as international ones. In particular, loans in foreign exchange provide finance to governments to overcome balance-of-payments problems and, as such, they are very useful to governments that are short of foreign exchange. Such flows also enable banks to lend money to private-sector firms. However, cross-border bank lending behaviour is fundamentally different from both FDI or securities investment. Although loans are made for both the long term and the short term (less than one-year maturity), short-term loans are often lent on the implicit understanding of being rolled over indefinitely; when a bank continues to receive a positive interest rate spread, its loans are usually rolled over. However, once a bank suspects that the credit (default) risk is very large, any interest rate spread or innovative use of risk derivatives<sup>10</sup> will not be sufficient to keep it making loans. In fact, it was the reversal of short-term loans rather than portfolio equity investment which was behind the Asian currency crisis in 1997.

As shown in table VI.2, loan commitments from the private sector to the ESCAP region were high in the mid-1990s, around \$56 billion or over 60 per cent of the total commitments to developing countries in 1996, falling to a low of \$18 billion or 30 per cent in 1998 just after the financial crisis, and then increasing to almost half of total commitments. Table VI.3, which presents information on total and short-term bank loans as reported by banks to BIS,<sup>11</sup> reveals two interesting facts. First, bank

loans flow mainly to a few countries: China; Hong Kong, China; India; Indonesia; Republic of Korea; Singapore; Thailand; and Turkey account for over 80 per cent of the total. However, compared with other forms of private capital flows, a large number of countries throughout the region receive bank loans. Second, there is a relatively high percentage of short-term loans. Regionwide, over 60 per cent of loans made in 1998 and 1999 were short-term ones, and this trend is fairly widespread over all countries, illustrating the point made earlier about the specific modalities of this type of borrowing.

In terms of the origins of bank lending, Japanese banks lend mostly to Asian countries while American banks mostly lend to Latin American countries.<sup>12</sup> Among the Asian economies, Japanese banks have a large share in Thailand (54 per cent), Indonesia (39 per cent) and Malaysia (36 per cent), while European banks, collectively, have more than a 40 per cent share in China, India, Malaysia, and Taiwan Province of China. During the 1990s there was a rapid expansion of loans from European banks in both Asia and Latin America. During the period 1993 to 1997, in aggregate, European banks increased their share of lending to Asia by 6 per cent, while the Japanese banks decreased their lending by 8 per cent. In China, Indonesia, Malaysia, Republic of Korea, and Taiwan Province of China, European banks increased their share markedly at the expense of Japanese banks, while in the Philippines, European banks increased their share at the expense of the United States banks.

In order to assess the vulnerability of a country to potential problems with bank lending, such as a sudden refusal of rollovers, the ratio of short-term lending to the foreign reserves is often used as an indicator. If the ratio is higher than 1, it implies that if all banks refused to roll over the short-term loans, foreign reserves would be exhausted. Among Asian countries, the ratio in 1997 exceeded 1 in Indonesia (1.6), the Republic of Korea (2.1) and Thailand (1.4). These three countries needed IMF assistance later in that year. In 1998, the economies where the ratio was larger than 1 were Hong Kong, China; Indonesia; Singapore; and Turkey, and close to 1 in the Philippines and Thailand. In 1999, the ratio was greater than 1 only in Pakistan and Singapore and

<sup>10</sup> Risk derivatives are innovative tools used by banks and other financial institutions to break up and sell off risky investments that they hold.

<sup>11</sup> These figures are significantly different from those reported by IMF. This is partly because of a larger coverage of countries and partly as a result of difference in the origin of the figures being reported.

<sup>12</sup> For information on the origins of bank loans, see Takatoshi Ito, "Capital flows in Asia", National Bureau of Economic Research Working Paper No. 7134 (May 1999) pp. 13-14.

Table VI.3. Loans in foreign currency from overseas commercial banks, 1998-1999

(Millions of US dollars)

	1998		1999 <sup>a</sup>	
	Total loans	% of short-term loan <sup>b</sup>	Total loans	% of short-term loan <sup>b</sup>
<b>Developing economies of the ESCAP region<sup>c</sup></b>	588 973	64.3	561 440	63.1
<b>South and South-West Asia</b>	61 078	51.3	72 885	49.8
Afghanistan	39	12.8	22	36.4
Bangladesh	231	62.3	218	49.1
Bhutan	0	0	0	0
India	19 301	40.1	22 616	37.4
Iran (Islamic Republic of)			8 900	59.5
Maldives	32	28.1	29	34.5
Nepal	50	58.0	54	75.9
Pakistan	5 027	44.9	5 710	43.0
Sri Lanka	721	47.9	1 282	53.2
Turkey	35 677	58.4	34 054	56.6
<b>East and North-East Asia</b>	277 422	62.2	258 159	63.1
China	58 236	53.7	51 935	46.7
Hong Kong, China	131 413	71.5	120 994	72.6
Democratic People's Republic of Korea	338	70.7	735	26.7
Republic of Korea	65 293	45.3	63 626	53.6
Macau	1 122	78.5	1 323	91.4
Mongolia	55	56.4	60	41.7
Taiwan Province of China	20 965	79.1	19 486	77.6
<b>South-East Asia</b>	249 957	69.8	229 767	67.4
Brunei Darussalam	335	9.6	491	81.1
Cambodia	33	93.9	193	68.4
Indonesia	44 827	52.7	43 792	49.6
Lao People's Democratic Republic	10	10.0	37	21.6
Malaysia	20 826	44.5	18 649	42.3
Myanmar	222	62.6	606	21.9
Philippines	16 160	53.7	16 521	49.6
Singapore	125 125	86.5	113 045	85.5
Thailand	40 749	58.2	34 736	54.8
Viet Nam	1 670	43.4	1 697	38.5
<b>Pacific islands</b>	516	48.6	629	39.4
Fiji	21	66.7	15	80.0
French Polynesia	36	94.4	57	91.2
Kiribati	1	100.0	15	100.0
Nauru	11	54.5	16	12.5
New Caledonia	14	78.6	19	78.9
Papua New Guinea	392	39.3	432	22.5
Samoa			30	90.0
Solomon Islands	2	0.0	2	100.0
Tonga	12	50.0	15	6.7
Tuvalu			1	100.0
Vanuatu	27	92.6	27	88.9

**Source:** BIS, "International banking and financial market developments", *BIS Quarterly Review* (Basel), various issues.

<sup>a</sup> Referring to June.

<sup>b</sup> Referring to consolidated international claims (of BIS reporting banks) of maturity up to and including one year.

<sup>c</sup> Excluding North and Central Asian countries.

close to 1 in Hong Kong, China; Indonesia; and Turkey. Therefore, it appears that most countries are now paying attention to keeping this ratio within reasonable bounds.

Bank lending is likely to remain an important, if not the only, channel of access of many countries to international financial markets. For this reason, the new agreement on the Basle capital adequacy framework and the attitude of major banks to the financial (banking) situation in developing countries is crucial. It is interesting to note that as countries start using international bank loans to a significant degree, there is an incentive for them to become members of BIS.<sup>13</sup> They can then participate in global economic reviews, in discussions on banking system regulation and norms of behaviour, exchange experiences, and receive considerable information

and training useful for their monitoring exercises. In fact, BIS has, since the Asian crisis, started to publish more information on the composition and maturity of debt, including short-term private debt, for developing countries.<sup>14</sup>

### Bond and equity issues on international markets

A few developing countries in the region have accessed finance through the international capital markets by issuing government or corporate bonds or shares. Table VI.4 reveals that 80 per cent or more of bonds were issued by only seven economies, China; Hong Kong, China; Malaysia; Republic of Korea; Russian Federation; Thailand; and Turkey, with Hong Kong, China and the Republic of Korea

**Table VI.4. Bonds and equity issued on international markets by ESCAP economies, 1997-1999**

(Billions of US dollars)

	Bonds			Equity		
	Dec. 1997	Dec. 1998	Dec. 1999	1997	1998	1999
<b>Total Asia</b>	170.0	186.0	197.5	18.6	7.9	27.5
<b>South and South-West Asia</b>	19.8	20.3	22.9	1.4	0.9	0.9
India	6.0	5.7	4.7	1.0	0.1	0.9
Turkey	13.8	14.6	18.2	0.4	0.8	0.0
<b>East and North-East Asia</b>	101.8	103.5	106.4	14.7	3.2	18.4
China	14.9	14.6	14.1	9.4	1.1	3.3
Hong Kong, China	32.0	31.8	39.3	3.1	1.2	5.6
Republic of Korea	49.4	50.6	46.7	0.6	0.5	6.9
Taiwan Province of China	5.5	6.5	6.3	1.6	0.4	2.6
<b>South-East Asia</b>	42.3	43.7	50.4	2.4	3.8	8.2
Indonesia	6.5	5.7	3.5	1.1	0.0	1.2
Malaysia	12.7	12.2	14.3	0.4	0.2	0.0
Philippines	8.2	9.1	12.6	0.3	0.5	0.2
Russian Federation	6.1	18.5	17.8	0.1	0.0	0.0
Singapore	3.2	4.9	7.2	0.6	0.8	5.1
Thailand	11.7	11.8	12.8	0.0	2.3	1.7

**Source:** BIS, "International banking and financial market developments", *BIS Quarterly Review* (Basel), various issues.

<sup>13</sup> BIS members in the ESCAP region are China; Hong Kong, China; India; Malaysia; Republic of Korea; Singapore; and Thailand.

<sup>14</sup> For more information on BIS, see *Survey 2000*, pp. 177-186.

accounting for almost half. It is not clear from this table whether the bonds issues were sovereign issues or corporate issues, but it is clear that to access the market, there needs to be an international credit rating of sufficient grade to attract investors. Table VI.5 provides a summary of the sovereign risk credit ratings of developing economies in the ESCAP region by the two major international credit-rating companies. Only four economies have A or better

ratings (China; Hong Kong, China; Singapore; and Taiwan Province of China). Three that used to have A ratings (Malaysia, Republic of Korea and Thailand) are now in the B range. This group is almost coincident with the listing of the major bond issuers. Furthermore, there are only 19 out of 47 developing countries in the region with ratings. Whereas there is no agreement on the validity of these ratings and some dissatisfaction with the ways in which the rating

**Table VI.5. Sovereign risk credit rating of economies in the ESCAP region**

	<i>Standard &amp; Poor's</i>		<i>Moody's January 2001</i>
	<i>date of change</i>	<i>rate</i>	
China	21 July 1999	BBB	A3
	14 May 1997	BBB+	
Fiji			Ba2
Hong Kong, China	31 August 1998	A	A3
	14 May 1997	A+	
	13 February 1995	A	
India	22 October 1998	BB	Ba2
	1 October 1996	BB+	
Indonesia	2 October 2000	B-	B3
	17 April 2000	SD	
	31 March 1999	CCC+	
	30 March 1999	SD <sup>a</sup>	
	15 May 1998	CCC+	
	11 March 1998	B-	
	27 January 1998	B	
	9 January 1998	BB	
	31 December 1997	BB+	
	10 October 1997	BBB-	
	18 April 1995	BBB	
Iran (Islamic Republic of)			B2
Kazakhstan	28 July 2000	BB-	B1
	16 September 1998	B+	
	5 November 1996	BB-	
Malaysia	11 November 1999	BBB	Baa2
	15 September 1998	BBB-	
	24 July 1998	BBB+	
	17 April 1998	A-	
	23 December 1997	A	
	28 March 1996	A+	
Pakistan	21 December 1999	B-	Caa1
	29 January 1999	SD	
	3 December 1998	CC	
	12 October 1998	CCC-	
	14 July 1998	CCC	
	1 June 1998	B-	
	3 August 1995	B+	

*(Continued on next page)*

Table VI.5 (continued)

	Standard & Poor's		Moody's January 2001
	date of change	rate	
Papua New Guinea	25 January 1999	B+	B1
Philippines	21 February 1997	BB+	Ba1
	30 May 1995	BB-	
Republic of Korea	11 November 1999	BBB	Baa2
	25 January 1999	BBB-	
	18 February 1998	BB+	
	22 December 1997	B+	
	11 December 1997	BBB-	
	25 November 1997	A-	
	24 October 1997	A+	
	3 May 1995	AA-	
Russian Federation	8 December 2000	B-	B3
	27 January 1999	SD <sup>a</sup>	
	16 September 1998	CCC-	
	17 August 1998	CCC	
	13 August 1998	B-	
	9 June 1998	B+	
	4 October 1996	BB-	
Singapore	6 March 1995	AAA	Aa1
Taiwan Province of China	24 June 1998	AA+	Aa3
Thailand	8 January 1998	BBB-	Baa3
	24 October 1997	BBB	
	3 September 1997	A-	
	2 May 1996	A	
Turkey	25 April 2000	B+	B1
	13 December 1996	B	
Turkmenistan			B2
Viet Nam			B1

**Sources:** Standard & Poor's sovereign ratings service, available at <[www.standardpoor.com/ratings/pdf/sovereigns/012001\\_sovhis.pdf](http://www.standardpoor.com/ratings/pdf/sovereigns/012001_sovhis.pdf)> (29 January 2001) and Moody's Investors Service rating list available at <<http://www.moodys.com/moodys/cust/staticcontent/2000400000333838/SovRatList.pdf>> (29 January 2001).

<sup>a</sup> SD = selective default.

agencies have performed their function,<sup>15</sup> having a rating is a prerequisite for accessing this type of finance. Therefore, such access will be denied to many countries and companies until they are able to obtain a satisfactory rating. This in itself will only

pose a problem if international bond issues are seen as a useful means of raising finance. Given that bond finance is by nature long term and so not easily reversible, countries and companies which desire to increase the percentage of longer maturity financial inflows and have weak domestic bond markets may need to consider this alternative.

<sup>15</sup> For a discussion on the rating agencies see *Survey 2000*, part two, pp. 190-193. Sovereign risk credit ratings are also used by banks to determine country limits for loans. However, having a rating is not a necessary condition for accessing a bank loan.

Portfolio equity issue from the ESCAP region on overseas stock markets is relatively minor to date. Most of this is undertaken by reputable companies with good international credit ratings from

countries also with good ratings. As can be seen from table VI.4, over 80 per cent of the issuings originated in five economies: China; Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China. Given the strict rules applied to companies wishing to list their shares on international stock markets in terms of disclosure and performance, this form of finance is likely to remain minor for the foreseeable future. While governments have used innovative ways to promote foreign portfolio issues by their corporations, the ideas in chapter V on enhancing the use of domestic stock markets within the region may be more feasible for most countries.

### **Foreign private participation on local capital markets**

The determinants driving portfolio investors to take an interest in the markets of developing countries are complex, involving the interactions of factors related to the external environment, investors' strategies and specific host-country determinants. As many developing countries and countries in transition embarked during the 1990s on a process of financial market liberalization, the number of markets to which international investors are able to allocate their savings has grown substantially. In parallel, the tremendous growth of assets for investment managed by institutional investors in OECD countries has flooded international capital markets with liquidity. For example, in 1998, total net assets of OECD pension funds were estimated at around \$11 trillion (14 per cent of which were placed in cross-border investments), while total assets of mutual funds in the world exceeded \$8 trillion (with United States funds alone accounting for more than \$5 trillion). Accompanied by rapid financial innovation, the combination of these events produced changes in investor strategies as well as a re-allocation of funds towards emerging markets. There are two key factors that explain the increased interest of international investors towards emerging markets as a group, at least until the recent Asian crisis: potentially higher returns and the benefits of diversification.

Once the decision is taken to invest in emerging markets, the allocation of funds to specific markets depends on host-country determinants. These country-specific determinants can be divided

between economic determinants and policy/regulatory determinants. Economic determinants are not directly linked to policies aimed at attracting external portfolio inflows. Instead, they are a reflection of the general health of the economy, and the potential for firms operating in the country to earn profits and obtain a satisfactory return on investment. Investors will typically focus on the following factors: the rate of economic growth (the higher the better); the degree of exchange rate stability (the more stable the better); the degree of macroeconomic stability; the level of foreign exchange reserves; the degree of soundness of the domestic financial system; the robustness of local stock and bond markets (amount of liquidity, depth and breadth); and the level of real interest rates. Some of these factors are of more importance to equity investors and others to fixed-income investors. For example, high economic growth rates and the liquidity of the stock market are of particular importance to portfolio managers specializing in equity investments. On the other hand, the degree of bond market liquidity and the level of real interest rates will be of particular importance for fixed-income investors.

Although the amount of portfolio capital invested in emerging markets has increased dramatically over the 1990s, the distribution of these flows has remained highly concentrated in countries which are associated with sound macroeconomic policies and relatively high growth rates. In Asia, which accounted for over a half of cumulative external portfolio investment between 1990 and 1997, a few economies (China; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore; and Thailand) account for nearly all of such inflows. All of these economies had liberalized access to the local capital markets in the early 1990s. The Republic of Korea, by contrast, maintained a strict upper limit on foreign holdings of each stock issue, 20 per cent at the end of 1996. This had the effect of limiting the amount of external inflows into the country's stock market until very recently. At the end of 1997 the limit was lifted as part of the effort to recover from the crisis.

The other set of determinants to which foreign investors pay particular attention includes policy and regulatory frameworks in individual emerging markets. These are the factors over which domestic governments have a direct influence. The main

determinants in this group are: the ease of repatriating dividends and capital; the rate of the domestic capital gains tax; the soundness of stock and bond market regulation; the quality of domestic accounting and disclosure standards; the speed and reliability of the settlement system; the availability of domestic custodians and brokers; and the degree of protection of investor rights. It is not possible to isolate any single factor as being the most important, although some tend to carry more weight than others. For example, the degree of investor rights protection and the ease of repatriating dividends and capital are often cited as being closely watched by potential investors.

Until the Asian crisis occurred, there was a strong argument for investing in emerging markets, based on the idea that their GDP growth was much higher than in OECD countries and that local companies, through higher earnings, share in such growth. Over the period 1988-1997 the relatively strong performance of some emerging markets compared with OECD markets lent some support to this thesis. As the reform process took hold in a number of Latin American countries and strong growth persisted in Asian emerging markets, the relative risk of investing in these countries was perceived as being increasingly smaller. In particular, this was evident in the continuous narrowing of spreads on emerging market bonds for East Asian and South-East Asian countries compared with United States treasuries over the period 1993-1997.

As markets started attaching a lower relative risk to emerging market investments, it was argued that including this asset class in the overall portfolio would lead to higher risk-adjusted returns.<sup>16</sup> However, the benefits of diversification in the context of emerging markets have turned out to be lower than what was widely expected in the early 1990s. Globalization and the increasing international integration of local financial markets have increased the correlation between individual emerging markets as well as between emerging and developed markets. Although a high cross-market correlation does not

<sup>16</sup> The concept of lowering the risk-adjusted returns of a global portfolio by including emerging markets as a significant part of invested assets came from the extension of the single market capital asset pricing model, which states that the risk of an investor's portfolio can be minimized by holding a diversified portfolio of shares.

entirely erase diversification benefits, it makes them much weaker, thus reducing the attractiveness of emerging markets.<sup>17</sup> In particular, the Asian crisis and the contagion effect to other emerging markets, as well as to the mature markets, have cast doubt on the benefits of investing in emerging markets.

Most global investors are found to invest between 2 and 5 per cent of their portfolio in emerging markets, which is well below the 20 per cent mark that was advocated as being the optimal allocation in the early 1990s. In a recent survey<sup>18</sup> 9 out of 10 investors cited as their primary motivation for investing in emerging markets the belief that by doing so they could achieve improved portfolio returns. Yet, 6 out of 10 investors reported that including emerging markets in their portfolio had resulted in decreased overall returns, two are uncertain of the benefits and only two investors report improved returns. Since the outbreak of the Asian crisis, 9 out of 10 investors reported that emerging market investments decreased their overall returns and one was uncertain. A further blow to the diversification hypothesis comes from the fact that 40 per cent of investors report that including emerging markets as an asset class had raised the volatility of their returns even prior to the Asian crisis. This percentage increases to 60 per cent when the period of the Asian crisis is included.

<sup>17</sup> The signs of increasing correlation were observed as early as 1994, when the United States Federal Reserve Board engaged in a series of monetary tightening measures. This caused a sharp fall in the price of United States treasuries, provoking a severe bond bear market. The steepness and rapidity of the fall in United States bond prices is partly attributed to the unwinding of large leveraged positions by hedge funds. There was a corresponding collapse of prices in emerging market debt instruments. It has been widely asserted that owing to rising interest rates in the United States, a number of leveraged investors had to sell securities across the board in order to meet the margin calls in United States markets where they sustained heavy losses. This in effect led to a domino effect, and all markets experienced a sharp correction in 1994. Even without the leverage effect, the attractiveness of international fixed income and equity instruments would have diminished and downward pressure on prices would have occurred. The decline in bond prices subsequently led to a decline in equity prices in mature and emerging markets. In fact, in percentage terms, the index of a number of emerging equity markets suffered a larger drop than did the United States equity market.

<sup>18</sup> UNCTAD, "Comprehensive study of the interrelationship between foreign direct investment and foreign portfolio investment" (UNCTAD/GDS/GFSB/5), p. 12.

While most investors do not believe that the theory of benefits by diversifying into emerging markets has been disproved, many of them plan to reduce, or have reduced, their positions in emerging markets. It appears that the Asian crisis has cooled the ardour of international investors towards investing in emerging markets, although it is too early to judge whether this is a short-term phenomenon or if it reflects a shift in attitude that will shape investment decisions for years to come. As investors are questioning the real benefits that they can reap from diversifying their investments into emerging markets, there is a strong probability that the flow of portfolio investment will not be sustained at the same level as occurred between 1993 and 1996. Because of abundant liquidity on international capital markets, there will continue to be interest in emerging market investment, but investors will likely be more demanding of the quality and security of assets in which they invest.

There is, thus, a question which emerging markets need to answer. Are they willing to live with the inherent volatility of foreign participation in their markets? This is central as the investments made in emerging markets are quite minuscule for the investors but may be large for the receiving market. Therefore, any sudden changes in their size may disrupt the market completely. It is interesting to note that up to the crisis, foreign participation in liberalized stock markets averaged somewhere around 20 per cent. There is evidence that this share has fallen; in Thailand it currently averages around 12 per cent of buying and selling. While there is a need for added liquidity in markets to increase their robustness, there is not a need to add volatility at the expense of the health of the market. India has approached this dilemma in another fashion. It has encouraged investment in its stock markets by expatriate Indians through investment funds where funds have to be kept for a specified period of time. However, this option can be seen as restrictive and may not be feasible in smaller markets in the region.

Similar problems will face local bond markets when they develop sufficiently to attract foreign interest. External buying and selling adds depth and liquidity to the market, but also adds instability as the external investors are making a marginal investment, not necessarily one in which they have a long-term interest.

## Innovative financial techniques

Developing economies can adopt some innovative methods to leverage additional private sources of finance. For example, multilateral financing agencies have started to provide joint financing with the external private sector and so provide increased leverage for countries and firms to tap international capital through loans and bonds. This has been done quite extensively for infrastructure projects and natural resources development. In addition, venture capital funds are being used to provide external private finance to SMEs through the grouping together of financial resources and the spreading of risks over a number of companies. These funds are usually either country-specific or industry-specific in terms of investment destination. Venture capital funds in developed countries tap into the pool of institutional investors, particularly pension funds. However, investment through venture capital funds into developing countries is relatively small, and, as this was based on the same theory of diversification as investment in emerging market stock markets, it may suffer the same fate.

The area of structured finance offers new opportunities for developing countries to increase access to and reduce the cost of finance. It has mainly been used to date for large natural resource projects, especially for energy and minerals, but its scope has been widened to include soft commodities and other products. Box VI.1 provides an analysis of structured finance and its possible uses in the region.

Another route is to encourage the use of financial derivative markets to hedge currency and interest rate exposures that arise with cross-border flows of capital. The fact that a company uses hedging instruments often provides a degree of comfort to potential investors and makes them more willing to lend money or to do so at a more preferred rate of interest.

While there are access constraints facing countries in the use of innovative instruments, many of them would appear to be attractive to countries now excluded from international financial markets. Therefore, their use needs to be explored seriously and assistance given to help countries determine when and where they can avail themselves of new, feasible and affordable ways of mobilizing resources

## Box VI.1. The potential of structured finance<sup>a</sup>

### *What is structured finance and for what areas is it relevant?*

Structured finance is a technique whereby specific assets from which regular, predictable cash flows can be derived are segregated from the other assets of the same owner and provided as security for the purpose of raising finance. The objective of the segregation is to cause the earnings from these specific assets to be out of reach of other creditors in the event of the insolvency of their owner. As for all loans, a single bank or a syndicate of banks can be the providers of the finance to be raised. For structured finance deals, however, the potential pool of financiers can be enlarged by the issuance of liquid, marketable securities (for example, notes, bonds or other marketable debt instruments) backed by the expected cash flow from the specific assets. This form of structured finance is known as "asset-backed securitization".

A key element which distinguishes structured finance is the automatic payment of principal and interest from the cash flows generated from the specified assets. For a deal to materialize, these assets must be capable of generating a sufficient cash flow and arrangements need to be in place for the necessary part of the cash flow to be securely channelled for the repayment of the loan obligations before any part of it reaches the borrower. As a consequence, a main feature of structured finance, which differs from traditional bank or asset-based lending, is the manner in which risks are evaluated when granting the loan. In traditional finance, risk analysis concerns the general financial health of the borrower, in other words, the borrower's asset and liabilities as represented by the balance sheet. The concern of structured financiers is with all aspects of risk specific to the transaction involving the specified assets, starting from the production or realization of the assets, their storage (when applicable) through to their sale or preservation of the future value of the assets and, finally, the safe receipt of the sales proceeds. Their concern is a simple one, namely, to ensure that their loan is repaid with a competitive rate of return.<sup>b</sup>

The versatility of the technique is such that the areas relevant for structured finance are wide-ranging and cover the entire gamut of receivables financing.

<sup>a</sup> Based on a contribution by David Hew, Lawyer and Secretary-General of the Asia Pacific Countertrade Association, Singapore.

<sup>b</sup> In the case of asset-backed securitization, there is the added complexity of the issuing of liquid, marketable securities. However, the basic concern is similar, namely to ensure that the public or private investors are repaid with a sufficiently attractive rate of return.

While use of the finance raised need not be limited to investments related to the specified assets, this is often the case as then there is a direct link with the cash flow generated. In many instances, structured finance is used for investment in the production, processing and/or marketing of export commodities of various types, including minerals, raw materials such as timber, and agricultural commodities such as coffee.

### *Advantages for developing countries*

Developing countries face serious problems of non-availability of investment finance and, when the finance is available, it may be insufficient or involve high costs, or both. Some developing countries are, however, rich in commodity resources. For such developing countries, structured finance solutions can be a lifeline for investment in these resources, provided that a sufficiently attractive international market exists for their outputs. Perhaps the greatest advantage of structured finance to a developing country is securing finance at a more competitive cost basis, often longer-term financing and a higher quantum of funds.

### *Constraints on use*

Unfortunately, the development of a structured finance deal entails far more complex work than a usual loan. It involves more parties in the chain of negotiation and requires the exercise of greater vigilance. There is, thus, a demand for specialized expertise which most countries do not possess themselves, but have to locate and access. In fact, there is no reason to develop such expertise for a technique used on an infrequent basis. However, expertise alone is not enough; there must also be experience, contacts and information. Thus, awareness of the possibility of the use of structured finance arrangements and the attendant risks and constraints is needed, particularly in the relevant government departments.

In addition, the host country's legal, tax and accounting systems, transport networks, warehousing and other supporting infrastructure must be sufficiently developed and able to support the construction of a structure acceptable to a financier. Its securities, derivative and debt markets must be sufficiently developed with strong, respectable regulatory mechanisms in place to offer the financiers the degree of comfort and confidence they need. All these translate into a longer gestation period before a deal materializes, and a higher transaction cost.

The process of structured finance involves having a credit rating on each specific deal, usually by a major, internationally recognized credit-rating agency. This may be higher than the credit rating of the country, and can be done even if the country does not have a published credit rating. The resultant rating will clearly be related to the general credit-worthiness assessment of the country.

### Actual applications

Some actual applications of structured finance in trade and project finance<sup>c</sup> are as follows:

- (a) The financing of a buy-back structure where the purchase of processing machinery, plant and equipment is financed and repaid from the sales proceeds of the end products processed from the machinery, plant and equipment;
- (b) A tolling structure where the cost of processing primary (hard or soft) commodities into semi- or wholly-processed products is financed in part or in whole by the sale proceeds arising from the sale of the semi- or wholly-processed product;
- (c) The financing of an investment project to develop a commodity resource through the use of the commodity as the underlying unit of obligation. Such a transaction usually involves long- or medium-term debt instruments coupled with hedging and the use of an escrow account as part of the loan structure. An example, though not of an Asian origin, is the Mexicana de Cobre deal. In this project to develop a copper resource, a syndicated fixed rate loan from BNP Paribas of \$210 million was repaid via fixed monthly deliveries of copper, with the risks and benefits arising from price changes assumed by Mexcobre. An Asian example is the Karnaphuli Fertilizer deal in Bangladesh where a syndicated loan of \$423 million has been provided and is to be repaid from part of the sale proceeds of the urea. The required amount of the proceeds are paid into an escrow account maintained specifically for this purpose;
- (d) The short-term financing of the costs involved in exporting a commodity. An example is a structured commodity finance transaction in Kenya. Producers of coffee had obtained, under a traditional finance deal, a three-month loan where the loan quantum was only 50 per cent of the value of the coffee, which is also the security provided. Interest was charged at the London Interbank Offering Rate (LIBOR) plus 15 per cent. By introducing structured finance techniques, the quantum of the three-month loan increased to 80 per cent of the value of the coffee provided as security and the interest charged was reduced to LIBOR plus 2.5 per cent. While the initial transaction costs for setting up the structured finance transaction increased, this cost is amortized over time as the same financing structure is replicated every three months.

<sup>c</sup> Actual examples of asset-backed securitization are many and range across a spectrum of assets, such as commercial and residential mortgages, credit card receivables, automobile loans and most forms of consumer or credit receivables finance. There seems to be no end to the widening of the asset class to which asset-backed securitization techniques can be applied as it now includes intangible assets, such as royalties and fees earned from intellectual property rights.

### Potential applications

The versatility of the structured finance technique lies in its application to a wide spectrum of asset classes. Virtually any asset can be the subject of structured finance provided it fulfils the following characteristics:

- It is an asset or a pool of assets with a predictable and stable cash flow from which to service principal and interest
- The assets can be provided as security to “back” the stream of cash flow generated from its sale
- The financiers must be able to forecast the performance of all the parties in the host country (both private and government) material to the transaction and to gauge the likelihood of payback

Perhaps the greatest drive behind the increasingly widespread use of structured finance techniques is the growing realization of its risk-neutralizing and returns-enhancing attributes, which over time far exceed the high upfront transaction costs.

### Caveats

While the above presents a very positive picture of the potential of structured finance for developing countries, there are a few caveats to be kept in mind.

1. Each structured finance deal implies tying the use of export proceeds. If a high percentage of a country's export receipts become “tied” to pay back such loans, the country itself loses macroeconomic flexibility and becomes increasingly vulnerable or hostage to the international financiers providing the funds. Therefore, a government must know, if not be party to, every structured finance deal, proposed or negotiated, that uses assets of the country as security.
2. As structured finance deals are rated for creditworthiness, if a country has a bad rating or is generally not considered a good risk, then the probability of successfully negotiating a structured finance deal is low, or the implied costs negate its usefulness. Therefore, there is still a need to improve the general credit assessment of a country.
3. Any default on a restructured finance deal is a very serious matter, perhaps worse than default on an international bond, given the lower interest charges involved. Therefore, there is a need to be absolutely sure about the liability (amount and timing) of returns from the assets used.

Nevertheless, such a technique does offer a selective, reliable way of raising more finance at lower costs. It seems necessary, therefore, for the relevant government authorities to become familiar with the technique and to be able to judge its appropriateness in their particular country situation.

to support their development efforts. However, the level of awareness of and expertise in the use of these instruments in most developing countries is quite low. There is first a need to increase the general awareness in both the government finance ministries and in the business community of the tools available, their uses, their advantages and the inherent risks. Then, depending on the size of the economy and the potential use, assistance is needed to train local experts or to provide expertise when the need arises on an ad-hoc basis. Providing expertise is most appropriate when the use is envisaged to be occasional and so investment in developing local expertise is more costly than employing an outside team.

### Policy issues

External private capital flows to selected economies in the ESCAP region in forms other than FDI have been sometimes quite large, exceeding 10 per cent of GDP in many cases. These flows inherently carry with them potentially enormous benefits as well as very large costs and risks. From a purely financial point of view, both FDI and external private capital flows can contribute to filling the financing gap needed to complement domestic savings. This contribution is in fact supported by the economic success of countries in East Asia and South-East Asia. Excluding capital-exporting countries such as Singapore, there is a reasonably significant correlation between capital flows and growth: the correlation coefficient between the capital flows as a percentage of GDP and average annual GDP growth rates over the period 1993-1997 was found to be equal to 0.36.<sup>19</sup> However, on the negative side, external finance can become a real burden for the host economy if the cost of such finance exceeds the benefit derived and weighs heavily on the balance of payments. Such cost takes the form of interest and dividend payments in the case of external private capital. A negative impact can also arise when foreign flows displace domestic savings through a substitution effect. Furthermore, volatility or rapid reversal of flows can be detrimental to economic development as it increases risks and uncertainties and induces high instability in macroeconomic variables.

<sup>19</sup> *Ibid.*, p. 12.

Therefore, the first policy issue facing most governments in the region is whether or not to encourage external private capital inflows. Most will want bank loans. In order for this to be useful, they need to pay attention to the health of their domestic banking system through which the loans will be channelled. Some may wish to issue bonds on overseas markets. For this an international sovereign risk credit rating is usually needed. Others may wish to take advantage of innovative techniques on an occasional basis. However, the dilemma comes mainly with the participation of overseas investors in domestic capital markets. This is a welcome addition as inflows but unwelcome as outflows. The conditions needed to maintain overseas investors' confidence are very stringent and may pose a significant constraint on domestic macroeconomic policy-making beyond the capacity of many governments. Therefore, the opening of domestic capital markets to foreign participation of any significant extent is a risky proposition until countries reach a certain maturity in their macroeconomic structures and policies.

It should be noted that the volatility of external private capital flows is characterized by a high frequency in the reversibility of flows, or by a high variability in the volume of inflows. Reversibility and variability result from the fact that capital flows are very sensitive to changes in their determinants. The volatility of capital flows can contribute to an unstable investment environment detrimental to growth and development through at least three channels. The first is through unexpected changes in the availability of finance and the consequent changes in its cost and in asset prices. This will induce high variability in expected profits, making investment planning difficult. The second is through the effects of compensatory adjustments in monetary, fiscal and exchange rate policies in response to rapid changes in the availability of external finance. Finally, capital volatility has an impact on consumption and, consequently, on growth.

Volatility can be explained by the interplay of different factors which influence the risks of and returns to investment. These factors include changes in macroeconomic fundamentals; the degree of volatility of local stock markets; domestic and external financial factors (such as exchange and interest rates) and liquidity of international capital markets; investment cycles; contagion; asymmetric

information flows; and the strategies and behaviour of portfolio investors. While international financial markets are inherently volatile, the volatility of capital flows to individual emerging market countries tends to be even larger because of the small percentage they represent in the investment portfolio in developed countries, the boom-bust cycles of investment in developing countries and contagion. Under conditions of ample liquidity on international capital markets, private capital tends to overflow into a few countries that appear to have strong fundamentals (high GDP and export growth, a high level of domestic savings and macroeconomic stability). Excess capital flows induce real currency appreciation and excess liquidity in the domestic financial system. Excess liquidity encourages asset bubbles and more speculative investments. As excess capital inflows induce persistently high current-account deficits, investors change their perception of the creditworthiness of the recipient countries. This change in perception is reinforced by the existence of weak domestic financial systems. The resultant sudden and sharp withdrawal of capital is often triggered by a speculative attack on the currency, which is perceived as being overvalued.

Sharp fluctuations in capital flows cause major disruptions to domestic financial systems, not only through drastic changes in liquidity, but also through changes in asset prices. Changes in asset prices can rapidly transmit the shock waves to other markets, for example from foreign exchange markets to capital markets, and from a class of securities of one particular country to the same class of securities of another country. Through the contagion process, a loss of investor confidence in one country that is having severe economic difficulties leads to a loss of confidence in other countries. Contagion tends to hit countries that have similar economic structures or policy characteristics, that belong to the same region, or that are simply affected by panic reactions by investors despite the existence of good fundamentals.

The amplitude of the ebb-and-flow movements of capital flows is influenced by the herd behaviour of investors. This herd behaviour is in turn often the consequence of asymmetric information, which makes investors react in concert to the same source of information, such as that provided by international credit-rating agencies. In addition, investment strategies such as benchmark performance, leveraged

investment, and the pursuit of short-term capital gains add to the overreaction by investors to any change in fundamentals or in financial factors (whether internal or external to recipient countries).

Fluctuations in capital flows may also result from factors over which the recipient countries do not have control. Such factors pertain to changes in policies or in the investment environment of capital-exporting countries. For example, a change in United States monetary policy can feed directly into a change in asset prices in emerging markets.

The conclusion that external private capital flows are more volatile than FDI has been empirically confirmed by a study<sup>20</sup> comparing the coefficient of variation of FDI and external private capital flows. Comparing the coefficients of variation of equity securities and debt securities reveals debt securities to be more volatile than equity securities in 19 out of the 29 cases. The higher volatility of external private capital inflows can also be seen from comparing the quarterly changes in these two types of flows during the period 1993-1998 in the countries that have gone through a severe financial crisis (Indonesia, Republic of Korea and Thailand). The FDI data show much less fluctuation and flows are always positive, except in the case of Indonesia during the fourth quarter of 1997 and the first quarter of 1998. On the other hand, the data for external private capital registered net outflows during critical crisis periods, for example, for Indonesia from the third quarter in 1997 to the second quarter in 1998, and for the Republic of Korea during the fourth quarter in 1997 and the first quarter in 1998. The data also suggest that external private capital flows are capable of rapid recovery; periods of net outflows have tended to be rather short, no more than two or three years.

There are four major policy areas for developing countries in relation to the above problems with external private capital flows of any sort. First, the approach to the liberalization of the capital account needs to be one of caution and proper sequencing. External private capital flows often increase rather sharply following the opening of capital accounts. However, when the domestic financial system is weak, the flow of funds, particularly through bank

<sup>20</sup> Ibid., p. 18.

loans, may not be used in the most productive ways in the country. In the presence of imperfect and asymmetric information, free capital mobility is likely to amplify existing distortions, create situations of moral hazard, encourage excessive risk-taking, and generate serious and costly banking crises. In the absence of strong financial supervision in either lending or borrowing countries, there is a high risk that private capital flows will be misallocated and so cause major disruptions to economic growth and development in the receiving nations. Developing countries should thus be careful not to liberalize their capital accounts before they put in place effective regulatory and supervisory regimes for their financial systems.<sup>21</sup> It may be argued that the relaxation of controls on international private capital movements should take place only towards the end of market-oriented reform.

It is frequently said that the governments in East Asia and South-East Asia undertook rapid financial and capital account deregulation in the 1990s without addressing the concomitant need to strengthen their supervisory capacity. Thus arose a systemic risk posed by the growing possibility that the massive pre-crisis inflows of private capital might fail to earn enough returns to service the foreign debt being generated. Recent events have led to a serious reconsideration and now it is generally agreed that capital account liberalization should be undertaken with some caution and with appropriate sequencing. Many developing countries have domestic conditions which are not ripe for capital-account liberalization at present. However, they should prepare for it if they wish to attract external private capital flows.

Second, countries need to review the consistency of their monetary, exchange-rate and capital-account policies. When the size of capital inflows becomes larger than current-account deficits, there is pressure on the currency to appreciate. If the currency is pegged,<sup>22</sup> the pressure to appreciate can be countered by intervening in the foreign exchange

market through purchases of foreign exchange, leading to an increase in the level of foreign reserves. Foreign exchange market interventions can be sterilized or left unsterilized. Unsterilized intervention will increase the monetary base, resulting in lower interest rates. The stimulating effect of lower interest rates may cause inflation, particularly if the economy is already at full capacity, which is often the case for emerging market economies that attract massive capital inflows. Sterilized intervention implies domestic open market operation to keep the monetary base constant (in levels or in proportion to GDP in a growing economy). In practice this means that the interest rate will increase. This is likely to produce more capital inflows in the form of portfolio investment, and so defeat the objective of the exercise. Thus, for a small open economy, it is impossible to have simultaneously a free flow of capital, a fixed exchange rate, and independent monetary policy. The typical policy response to this is to float the exchange rate, as has been done in Indonesia, Philippines and Thailand. Another response is to adopt some mild forms of capital controls on short-term inflows, such as raising the reserve requirements on bank deposits by non-residents or imposing withholding taxes on short-term instruments held by non-residents. Many emerging markets, including notably Malaysia, have adopted some form of market-based capital controls. While the debate on fixed versus flexible exchange rates is far from resolved, and many countries are opting for some middle ground in terms of a managed float, the main point is to have consistency between the various policies so that unintended risks do not build up to crisis proportions.

Third, there needs to be more prudent management of external private capital inflows by the financial authorities of a country in order to minimize considerably the risks involved. This means that the magnitude, maturity and volatility of the various kinds of external private capital need to be closely monitored. The lack of sufficient monitoring and inadequate portfolio management led to serious currency and maturity mismatches that helped foment the serious 1997 financial crisis in East Asia and South-East Asia. The importance of developing and managing a target foreign-capital portfolio composed of, inter alia, commercial bank borrowing, equity investment, bond investment, foreign participation in local capital markets and FDI cannot be overstressed.

<sup>21</sup> As discussed in chapter V, the primary need is to have an appropriate and consistent set of macroeconomic policies, including appropriate exchange rate regimes.

<sup>22</sup> Stability in the exchange rate is often considered to be important for nurturing exporting industries and inviting FDI inflows.

Fourth, for countries that decide to encourage external private capital flows, there are two specific policy initiatives that can help to induce larger and more stable flows. The first is to strengthen the domestic financial and corporate sectors by expediting financial and corporate restructuring, modernizing the financial management techniques and reforming corporate governance. The second is to encourage the move to flows with longer maturity than bank loans or equity participation. This can be done through the issuance of longer maturity private debt securities, such as bonds, on international financial markets. This will require an internationally recognized credit rating for both the country and the corporations involved. It can also be approached through opening local bond markets to foreigners to buy bonds in the local currency. The development of viable local or subregional bond markets is thus a priority but, as outlined in chapter V, it is difficult to accomplish.

Both FDI and external capital inflows in the ESCAP region remain highly concentrated in a small number of countries. The problems facing these countries are substantively different from those which are not recipients of these flows. For them, maintaining larger and more stable flows is a priority and policy responses will be required to be in line with international norms and market requirements. For the other countries, decisions on the choice of types of flows to be encouraged are needed first and then the policy packages to attract these have to follow. There is no guarantee, of course, that they will be able to attract investor interest on a sustained basis, even if the policies of countries become consistent with prevailing international norms. They also need to be able to demonstrate a functioning domestic economy and an attractive and competitive production base. Therefore, for many countries in the region, official flows of various kinds will remain important for the foreseeable future.