

MOBILIZING AND MANAGING FOREIGN PRIVATE CAPITAL IN ASIAN DEVELOPING ECONOMIES

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Financial resources for development can be mobilized from both domestic and foreign sources. This paper focuses on the latter. Before the 1970s, ODA was the largest source of foreign capital for development. In the 1980s and 1990s, the balance shifted in favour of private capital, but the 1997 crisis revealed fundamental problems in its utilization. The paper examines the costs and benefits of foreign capital in the region's development and issues involved in its prudent management.

The post-crisis need for development resources in the Asia-Pacific region is large. First, high and sustained growth is required to reduce the pervasive poverty in the region. While the region has made substantial economic and social progress over the last four decades, the level of poverty remains unacceptably high. Nearly one in three Asians or about 900 million people are poor and recent progress in poverty reduction has been set back by the Asian financial crisis. Moreover, a large number of people in the crisis economies, particularly in Indonesia and Thailand, have joined the ranks of the poor owing to the crisis. Second, the need for additional resources for financial restructuring has also increased considerably in the crisis economies. Third, in nearly all the developing nations of Asia, a large number of projects have had to be cancelled or put on hold for lack of financial resources. In the case of the worst-affected crisis countries, the number of new infrastructure projects in 1998 declined to about one quarter of their level in 1996. The need for investment in not only those projects but also in new areas such as information technology (IT), environment and social safety nets remains large.

While enhanced levels of resource mobilization can be achieved through both domestic and foreign sources, this paper will restrict itself to some of the salient issues arising from the latter. Before the 1970s, official development assistance (ODA) constituted the largest component of foreign inflows to the region, but since then private capital has dominated foreign inflows. Although the Asian financial crisis has revealed problems inherent in foreign private capital (FPC) flows, they will nevertheless

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continue to play a vital role in the region's economic development. Keeping this in mind, this paper will examine the benefits and costs of foreign private capital, how to successfully mobilize it and how to prudently manage it.

I. MAXIMIZING THE BENEFITS OF FOREIGN PRIVATE CAPITAL

Foreign capital can have substantial benefits. Borrowing countries can use foreign savings to grow faster than purely domestic savings would allow. Foreign capital can fill the domestic resource gap, namely, the gap between national investment and savings. When combined with a more open trading system, it is argued that capital will flow to where it produces the greatest return. Many Asian-Pacific economies are capital-constrained (see table 1). Since the crisis, the worst-affected countries have become capital-surplus nations owing to subdued investment.

In addition to supplementing domestic savings, long-term capital inflows in the form of foreign direct investment (FDI) bring a range of dynamic benefits such as the transfer of technology and improved management practices and market access. Pressures on domestic companies to either compete with foreign investors or to compete among themselves in order to attract foreign investment may also help to boost domestic productivity (Commonwealth Secretariat, 1997). Foreign capital inflows can also lead to greater competition and increased efficiency in financial markets, leading to improved resource allocation. At the micro level, capital flows can lower the cost of capital to creditworthy firms.

Portfolio equity flows have also played an important role in providing external finance to developing countries and have significantly lowered the cost of capital. Portfolio flows in the form of venture capital, primary equity issues and corporate bonds can contribute directly to financing investment. Although other forms of portfolio flows such as the purchase of secondary market shares have an initial impact on wealth and absorption, they too can lead to an increase in investment through the acceleration effect (UNCTAD, 1999a). Moreover, the increased liquidity resulting from portfolio flows can facilitate the development of other financial intermediaries and deepen financial markets. This in turn facilitates the relocation of capital from low-return to high-return activities and promotes new start-ups (Reisen and Soto, 2000).

However, as the recent financial crisis in Asia has amply demonstrated, private capital flows potentially carry enormous risks and costs. The presence of microeconomic distortions within an economy can misdirect flows. Although trade liberalization and structural reforms have made the "immiserating inflows" argument less relevant today, recent experience has shown that ill-regulated financial sectors, or implicit credit guarantees, can create credit-boom distortions that are magnified by foreign inflows (McKinnon and Pill, 1997). Capital flows can also greatly complicate macroeconomic management, particularly where such flows are volatile. Capital

Table 1. Resource gap as a percentage of GDP (investment – savings)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|-------|-------|-------|-------|-------|-------|
| Newly industrialized economies | | | | | | |
| Hong Kong, China | 4.3 | 1.4 | 3.4 | -0.5 | -4.4 | -3.4 |
| Rep. of Korea | 1.7 | 4.4 | 1.7 | -12.7 | -6.2 | -2.4 |
| Singapore | -15.1 | -12.3 | -11.7 | -16.4 | -18.5 | -17.8 |
| Taiwan Province China | -2.0 | -3.4 | -2.1 | -1.1 | -1.6 | -2.6 |
| China and Mongolia | | | | | | |
| China | -0.3 | -0.9 | -3.4 | -3.1 | -1.2 | 0.4 |
| Mongolia | 4.6 | 4.7 | -4.7 | -1.1 | – | – |
| Central Asian Republics | | | | | | |
| Kazakhstan | 3.1 | 3.6 | 4.0 | 6.8 | – | – |
| Kyrgyzstan | 12.9 | 25.8 | 13.3 | 19.8 | 14.6 | 13.1 |
| Uzbekistan | 0.5 | 7.2 | 4.0 | 0.3 | 1.3 | 1.0 |
| South-East Asia | | | | | | |
| Cambodia | 14.5 | 17.3 | 8.8 | 8.0 | 8.4 | 9.0 |
| Indonesia | 3.3 | 3.4 | 2.4 | -4.1 | -1.6 | -2.2 |
| Lao People's Democratic Rep. | 13.0 | 16.6 | 16.8 | 10.6 | 10.3 | 11.0 |
| Malaysia | 3.9 | -1.4 | 5.6 | -12.9 | -14.0 | -11.3 |
| Myanmar | 0.9 | 0.8 | 0.7 | 0.5 | – | – |
| Philippines | 4.1 | 4.5 | 5.3 | -1.9 | -1.0 | -0.5 |
| Thailand | 8.0 | 8.1 | 0.8 | -13.2 | -9.7 | -5.9 |
| Viet Nam | 11.0 | 10.3 | 6.5 | 4.4 | -2.3 | -0.8 |
| South Asia | | | | | | |
| Bangladesh | 6.1 | 7.7 | 2.2 | 1.2 | 1.4 | 1.0 |
| Bhutan | 4.8 | 9.7 | 9.4 | 9.4 | – | – |
| India | 1.5 | -1.4 | 1.5 | 1.1 | 1.5 | 2.0 |
| Maldives | 6.1 | 9.2 | – | – | – | – |
| Nepal | 8.9 | 13.5 | 13.2 | 11.2 | 6.7 | 8.3 |
| Pakistan | 2.7 | 4.5 | 4.6 | 1.0 | -0.3 | 0.4 |
| Sri Lanka | 6.2 | 5.2 | 2.9 | 1.4 | 2.5 | 4.0 |
| The Pacific | | | | | | |
| Fiji | 0.2 | -3.7 | -0.7 | 4.5 | – | – |
| Papua New Guinea | -9.5 | -4.3 | 4.0 | 2.0 | 0.1 | 7.6 |
| Other net investment | 49.2 | 37.1 | -43.6 | -28.2 | -41.1 | |
| Net official flows | 0.7 | -0.4 | 17.9 | 19.7 | -4.7 | |
| Change in reserves ^a | -18.5 | -5.4 | 30.5 | -52.1 | -44.5 | |
| Memorandum Current account ^b | -40.4 | -53.0 | -25.0 | 69.1 | 62.9 | |
| Other Asian emerging markets | | | | | | |
| Net private capital flows | 30.8 | 38.3 | 19.0 | -17.0 | -2.5 | |
| Net direct investment | 39.1 | 44.6 | 45.1 | 49.7 | 39.6 | |
| Net portfolio investment | -3.2 | -7.4 | -9.4 | -11.9 | -11.9 | |
| Other net investment | -5.1 | 1.1 | -16.7 | -54.7 | -30.2 | |
| Net official flows | 5.8 | 4.1 | 3.7 | 7.9 | 3.8 | |
| Change in reserves ^a | -27.6 | -44.8 | -46.7 | -18.2 | -15.9 | |
| Memorandum Current ^b | -4.5 | 16.2 | 48.2 | 44.5 | 32.9 | |

Source: IMF, *World Economic Outlook*, May 2000.

^a A minus sign indicates an increase.

^b The sum of current account balance, net private capital flows, net official flows and the change in reserves equals, with the opposite sign, the sum of the capital account and errors and omissions.

account liberalization in itself reduces the ability of domestic monetary authorities to set monetary policy independently and can increase the risks faced by domestic banking systems and other financial institutions as a result of increased deposit volatility and foreign exchange risk.

Although there is a general preference among recipient countries for more stable longer-term capital flows in the form of longer-maturity loans and/or FDI than short-term flows, in practice it could be difficult to distinguish between the two kinds as capital is fungible. For instance, if there are active secondary markets, longer maturity obligations may in reality be highly liquid and may be equally volatile in their short-term behaviour as shorter-term flows (Claessens, Dooley and Warner, 1995). In terms of FDI, transnational corporations (TNCs) also manage liquid funds in addition to flows of real goods and services and often borrow from foreign and domestic financial institutions. FDI can therefore be associated with higher rather than lower volatility in capital flows, a reflection of the ability of TNCs to manage international intra-firm financial transactions. Moreover, not all FDI flows are equally beneficial. A number of recent studies have found FDI to have positive growth effects where it promotes export-oriented, as opposed to import-substitution, activities (Balasubramanyam, Salisu and Sappford, 1996). The latter, by substituting for trade, could in fact worsen efficiency losses associated with trade protection. It is also the case that some of the benefits associated with FDI, such as technological spillovers, depend on recipient countries having adequate levels of human capital. There is also considerable dispute as to whether the high costs of the fiscal incentives given by many Asian Governments to attract FDI are offset by their associated benefits. These costs include the loss of revenue to the Government, the economic distortions induced by the incentives and, in some instances, the corruption they could lead to (World Bank, 2000). It should also be noted that FDI could crowd out domestic firms through unfair competition or through monopolizing domestic savings.

In conclusion, the costs or risks involved in foreign private capital would be closely related to management issues. If the financial authorities at the macro level prudently manage foreign capital flows, costs and risks could be minimized and benefits maximized. It would be dangerous to simply say that foreign private capital per se is harmful to host countries. Management issues will be discussed in section V.

II. RECENT TRENDS IN CAPITAL FLOWS

According to balance of payment figures from IMF, net private capital flows to the worst-affected crisis countries – Indonesia, Thailand, the Republic of Korea, Malaysia and the Philippines – reversed from an inflow of US\$ 65.8 billion in 1996 to an outflow of US\$ 20.4 billion in 1997 (table 2). These outflows increased further to US\$ 25.6 billion in 1998 before slightly moderating to US\$ 24.6 billion in 1999. During this period the financial inflows to the rest of Asia also deteriorated, with net

Table 2. Emerging market economies: net capital lows

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|-------------------------------|------|------|------|------|------|-------|-------|-------|
| Asia ^a | | | | | | | | |
| Crisis countries ^b | | | | | | | | |
| Net capital flows | 29.0 | 31.8 | 36.1 | 74.2 | 65.8 | -20.4 | -25.6 | -24.6 |
| Net direct investment | 7.3 | 7.6 | 8.8 | 7.5 | 8.4 | 10.3 | 8.6 | 10.2 |
| Net portfolio investment | 6.4 | 17.2 | 9.9 | 17.4 | 20.3 | 12.9 | -6.0 | 6.3 |

Source: IMF, *World Economic Outlook*, May 2000.

^a Includes Republic of Korea, Singapore and Taiwan Province of China. No data for Hong Kong, China are available.

^b Indonesia, Republic of Korea, Philippines and Thailand.

private capital flows reversing from an inflow of US\$ 38.3 billion in 1996 to an outflow of US\$ 17 billion in 1998. Private net capital flows to these countries contracted again in 1999, but with total outflows amounting to US\$ 2.5 billion, the rate of decrease appears to be moderating. A closer examination of the data reveals that the major cause of the collapse in private capital inflows to both the crisis and non-crisis countries in Asia was the sharp contraction in bank lending, reflecting substantial net repayments to banks. Although the contraction in bank lending to the crisis countries showed no sign of abating in 1999, the rate of contraction appears to have eased somewhat for the rest of Asia.

However, portfolio inflows, comprising bonds and equities, to the crisis countries declined sharply between 1997 and 1998 before rebounding strongly in 1999. The return of portfolio flows reflects mainly a recovery in regional equity markets while the relatively more subdued growth in bond markets has been attributed to greater investor attention to credit risk and the inability of highly leveraged regional borrowers to issue new debt in global capital markets. In contrast to these private market flows, foreign direct investment remained broadly constant throughout the crisis period – even as domestic investment contracted severely. Much of the new FDI inflows to the worst-affected countries since the crisis has been in the form of mergers and acquisitions as foreign investors have responded to the opportunities offered by corporate restructuring and the more liberal environment for such acquisitions. This process has been driven by significant excess capacity in many industries. During this period, there has also been a significant change in the origin of these flows from intraregional to non-Asian OECD countries as many intraregional firms from Japan and the newly industrialized economies of the Republic of Korea, Singapore, Hong Kong, China, Taiwan Province of China and China have been forced to concentrate on restructuring efforts closer to home.

Table 3. Gross private financing to Asian emerging market economies

(Billions of US dollars)

| Asia | 1997 | 1998 | 1999 | 1999 | | | | 2000 | | | |
|--------------------|-------|------|------|------|------|------|------|------|------|------|------|
| | | | | Q1 | Q2 | Q3 | Q4 | Q1 | Jan. | Feb. | Mar. |
| Total | 128.6 | 35 | 62.7 | 11.9 | 17.1 | 17.4 | 16.4 | 20.5 | 2.6 | 12.5 | 5.4 |
| Bond issues | 45.5 | 12.4 | 24.1 | 7 | 6.3 | 6.2 | 4.7 | 6.8 | 1.5 | 1.4 | 3.9 |
| Other fixed income | 9.8 | 0.5 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Loan commitments | 58.9 | 17.7 | 20.3 | 3.5 | 5.1 | 5.9 | 5.8 | 10.8 | 0.3 | 10.2 | 0.3 |
| Equity issues | 14.4 | 4.5 | 18.3 | 1.4 | 5.7 | 5.3 | 5.8 | 2.9 | 0.9 | 0.9 | 1.2 |

Source: IMF, *World Economic Outlook*, May 2000.

Gross private financing data for emerging Asia indicate increased issuance in international capital markets in 1999, although at levels considerably below those prior to the crisis (see table 3). The data also suggest a shift in the composition of flows towards securitized, rather than bank intermediate finance due, in part, to a cutback in lending by mature-market banks, changes in risk management practices and a sharp pullback in international lending by Japanese banks owing to their own financial problems. This is evident from the data in table 4, which show a steady cutback in exposure to emerging Asia by mature-market banks. While this has had the desirable effect of reducing the external liabilities of some countries, in others including India, the Republic of Korea and Malaysia this reduction in debt has been accompanied by a corresponding increase in short-term liabilities.

Although equity issuance from the region rebounded strongly in 1999, the aggregate data mask considerable variation as between different countries and industrial sectors. While equity prices more than doubled in China and the Republic of Korea and almost doubled in Indonesia and India, equity inflows lagged behind in Thailand and the Philippines owing to concerns about the pace of bank restructuring in the former and policy slippages in the latter (see IMF, 2000). While increased foreign participation in the financial sectors of a number of crisis countries has been a source of equity inflows, regional exchanges such as India's which offer significant IT-related investments appeared to have performed better than others. Moreover, renewed interest in Indian equities has also been stimulated by recent liberalization measures, including the raising of limits on foreign ownership of domestic stocks. The recovery in regional bond issuance in 1999 also appears to have been restricted to the more creditworthy Asian countries as spreads on bond issues from these countries narrowed during the year.

In the first quarter of 2000 there was an indication that bank lending was increasing. While this is, to some extent, a consequence of a strengthened regional recovery, the institutionalization of stronger risk management practices would suggest

Table 4. Consolidated cross-border claims in all currencies and local claims in non-local currencies

| <i>Positions vis-à-vis</i> | <i>In billions of Us dollars</i> | <i>Distribution by maturity</i> | | <i>Distribution by sector</i> | | |
|---------------------------------|--------------------------------------|--|--------------------------|-------------------------------|--------------------------|------------------------------------|
| | | <i>Up to and including one year</i> | <i>Over one year</i> | <i>Banks</i> | <i>Public sector</i> | <i>Non-bank private sector</i> |
| | | <i>In percentages of total consolidated claims</i> | | | | |
| Asia | | | | | | |
| mid-1998 | 319.6 | 53.0 | 39.0 | 37.0 | 9.0 | 53.9 |
| end-1998 | 299.0 | 52.5 | 38.8 | 34.7 | 9.8 | 55.3 |
| mid-1999 | 287.1 | 51.4 | 39.5 | 32.1 | 13.6 | 53.9 |
| end-1999 | 270.9 | 51.0 | 42.1 | 30.3 | 13.5 | 54.8 |
| China | | | | | | |
| mid-1998 | 58.7 | 51.8 | 40.3 | 39.4 | 11.3 | 49.2 |
| end-1998 | 58.4 | 53.7 | 38.3 | 36.7 | 11.9 | 51.3 |
| mid-1999 | 51.9 | 46.7 | 44.8 | 35.3 | 16.2 | 48.4 |
| end-1999 | 46.6 | 40.6 | 54.5 | 33.8 | 13.8 | 52.4 |
| India | | | | | | |
| mid-1998 | 18.5 | 36.0 | 53.3 | 20.4 | 15.3 | 64.3 |
| end-1998 | 19.3 | 40.0 | 49.4 | 20.2 | 14.7 | 65.1 |
| mid-1999 | 22.6 | 37.4 | 53.4 | 17.0 | 22.1 | 60.9 |
| end-1999 | 22.0 | 39.5 | 54.6 | 15.1 | 22.6 | 62.2 |
| Indonesia | | | | | | |
| mid-1998 | 48.4 | 54.1 | 42.6 | 13.7 | 15.7 | 70.7 |
| end-1998 | 44.9 | 52.7 | 43.6 | 11.8 | 14.8 | 73.4 |
| mid-1999 | 43.8 | 49.6 | 46.6 | 10.1 | 21.0 | 68.8 |
| end-1999 | 40.7 | 47.0 | 49.3 | 10.3 | 20.8 | 68.8 |
| Malaysia | | | | | | |
| mid-1998 | 22.8 | 48.2 | 41.9 | 30.8 | 6.6 | 62.5 |
| end-1998 | 20.9 | 44.6 | 44.1 | 27.7 | 8.9 | 63.4 |
| mid-1999 | 18.6 | 42.3 | 45.9 | 21.7 | 13.8 | 64.3 |
| end-1999 | 18.1 | 43.0 | 47.2 | 21.4 | 14.3 | 64.2 |
| Republic of Korea | | | | | | |
| mid-1998 | 71.6 | 45.1 | 39.4 | 56.6 | 6.8 | 36.6 |
| end-1998 | 65.5 | 45.3 | 38.2 | 57.0 | 8.3 | 34.4 |
| mid-1999 | 63.5 | 53.6 | 28.8 | 57.4 | 8.2 | 34.1 |
| end-1999 | 60.7 | 57.9 | 29.3 | 57.8 | 8.6 | 33.4 |
| Taiwan Province of China | | | | | | |
| mid-1998 | 22.5 | 80.5 | 16.7 | 55.7 | 1.6 | 42.7 |
| end-1998 | 20.9 | 78.7 | 14.3 | 56.6 | 1.9 | 41.4 |
| mid-1999 | 19.5 | 77.6 | 17.4 | 46.2 | 2.9 | 50.9 |
| end-1999 | 20.1 | 76.5 | 18.2 | 42.9 | 5.9 | 51.1 |
| Thailand | | | | | | |
| mid-1998 | 46.4 | 59.3 | 36.5 | 26.1 | 4.3 | 69.6 |
| end-1998 | 41.2 | 58.3 | 37.2 | 22.0 | 4.7 | 73.2 |
| mid-1999 | 34.7 | 54.9 | 39.4 | 19.3 | 6.2 | 74.4 |
| end-1999 | 28.4 | 50.1 | 44.4 | 12.5 | 7.1 | 80.2 |
| Other | | | | | | |
| mid-1998 | 49.1 | 48.9 | 44.1 | 33.2 | 12.2 | 54.5 |
| end-1998 | 47.2 | 47.4 | 45.5 | 27.8 | 12.8 | 59.3 |
| mid-1999 | 55.1 | 46.1 | 46.9 | 23.8 | 19.7 | 54.7 |
| end-1999 | 56.3 | 48.8 | 45.9 | 19.7 | 19.1 | 55.3 |

Source: Bank for International Settlements, BIS consolidated international banking statistics for end-December 1999.

that with the exception of trade finance, banks are unlikely to be the major source of external financing for the region overall in the foreseeable future. However, the increased gross credit inflows together with a likely decrease in repayments suggests that in 2000, net repayments to commercial banks will moderate relative to 1999 and 1998. Bond financing is also likely to increase somewhat as spreads narrow owing to reduced volatility and the normalization of investor attitudes towards risk. Equity issues, however, indicate a slowdown during the first quarter of 2000 following the sharp increase in 1999. In part, this reflects increased volatility in United States equity markets and continued weakness in corporate profitability. Gross equity flows are, however, likely to increase over 1999 levels as an increasing number of companies reduce their traditional dependence on bank credit and raise finance through listings abroad. Available data suggest that foreign direct investment inflows may remain relatively stable owing to ongoing privatization of State-owned enterprises and corporate restructuring in the region.

These trends suggest that capital flows to the region are likely to increase moderately over 1999 levels and that their composition will move further away from debt-creating flows. Notwithstanding these improvements, capital flows in 2000 are likely to remain well below their pre-crisis levels, as international markets will remain closed for large segments of Asia's corporate sector. International investors have become more discerning towards the region and are increasingly differentiating among countries based on credit risk. Flows of foreign private capital into the region are not likely to pick up significantly in the immediate future, causing concern about development financing in the region.

III. POLICIES FOR MOBILIZING FOREIGN PRIVATE CAPITAL

Strengthening the absorptive capacity of the financial and corporate sectors

The crisis exposed considerable operational weaknesses in the corporate and financial sectors of these economies. They include weaknesses in: (a) fund and cash flow management; (b) risk identification and management; (c) maturity management; (d) project evaluation; (e) mid- and long-term financial planning; and (f) transparency in operations. Although much progress has been made towards resolving these problems and restoring international confidence in the worst-affected countries, the unfinished agenda is large and without further progress the borrowing capacity of banks and corporate investment will remain impaired. For the other Asian countries, much can be learned from the reforms currently being implemented in the crisis countries so that they could strengthen and improve the absorptive capacities of their own financial and corporate sectors.

Despite considerable progress in financial sector restructuring, large segments of the banking industry in the crisis countries remain undercapitalized and loan growth

remains subdued. Moreover, greater efforts need to be made to privatize nationalized financial institutions to contain the public sector's exposure. There is also a need to accelerate reforms among non-bank financial institutions, which have lagged behind.

Financial reforms are also needed in those countries that retain some degree of capital controls since in a number of these countries, the financial and corporate sectors remain considerably more underdeveloped and weaker than in the crisis countries. For instance, South Asian countries are, in general, less financially developed in comparison with both the crisis economies and world norms (table 5). An ADB study on the financial markets of selected member countries also suggests that transparency and bank supervision in a large number of non-crisis countries are no better than in the crisis countries (ADB, 1999). However, key macroeconomic aggregates such as the fiscal and current account balance, the level of savings and the rate of inflation remain considerably weaker for these countries than for the crisis economies and their exchange rates are less flexible. Thus, irrespective of whether capital controls are maintained or not, financial sector reforms and improved macroeconomic management are desirable in themselves.

Table 5. Size of the financial sector in Asia^a

| | <i>Domestic assets of deposit money banks/GDP</i> | <i>Stock market capitalization/ GDP</i> | |
|--|---|---|----------------------|
| | (1) | (2) | (1)+(2) ^b |
| Indonesia | 0.46 | 0.18 | 0.64 |
| Malaysia | 0.97 | 2.01 | 2.98 |
| Philippines | 0.28 | 0.52 | 0.80 |
| Republic of Korea | 0.65 | 0.37 | 1.02 |
| Thailand | 0.78 | 0.57 | 1.35 |
| Hong Kong, China | 1.42 | 1.96 | 3.38 |
| Singapore | 0.83 | 1.37 | 2.2 |
| Bangladesh | 0.22 | 0.04 | 0.26 |
| India | 0.24 | 0.28 | 0.52 |
| Nepal | 0.16 | 0.05 | 0.21 |
| Pakistan | 0.23 | 0.16 | 0.39 |
| Sri Lanka | 0.21 | 0.16 | 0.37 |
| World average | 0.48 | 0.39 | 0.87 |
| Average of non-Asian developing countries | 0.29 | 0.24 | 0.53 |

Source: Demirguc-Kunt and Levine (1999).

^a Data are 1990-1995 averages.

^b Since data on the domestic assets of other financial institutions are not readily available for a large number of the sample countries, they are not shown here.

In non-crisis Asia, financial weaknesses have arisen, in part, owing to the distortions created by the need to finance large budget deficits (South Asia) and/or directed lending to State-owned enterprises (China and Viet Nam). Moreover, State banks in these countries are also given preferential treatment relative to private banks (in terms of tax concessions, access to public-sector deposits, etc.), which greatly hinders competition and efficient bank intermediation. A number of these countries also have significant unbalanced currency exposures, pointing to the need to develop managerial and supervisory capacity. Poor bank supervision has also led to non-performing loans being understated and banks being insufficiently capitalized. Even though liberalization of the South Asian financial systems has proceeded further than in China and Viet Nam, enforcement of key legislation remains weak owing to political interference and corruption. In many instances, there is a need to improve financial procedures and timely data reporting to enhance transparency. Throughout the region there is also a need for bank privatization to enhance the banks' commercial orientation.

Despite recent progress, there is also a need for further improvements in corporate governance throughout the region to facilitate foreign investment. To varying degrees, in most Asian countries, more needs to be done to upgrade accounting, auditing and disclosure requirements to facilitate asset evaluation and strengthen the rights of minority shareholders. Complementing these measures is the need for further reforms to increase competition in corporate operations and ownership, including strengthening anti-trust procedures. In a number of countries, bankruptcy and foreclosure procedures remain weak, whereas in others, where such procedures have recently been strengthened, there are often problems of enforcement owing to the lack of properly trained staff to implement them. Moreover, firms in many instances also face long and costly procedures to resolve commercial disputes through the judiciary owing to complex and outdated laws.

Issuance of bonds to international investors

Raising foreign funds through issuing bonds has an advantage in terms of securing the funds for a longer time than bank loans or equity investments. Bond maturities generally range from 3 to 20 years. Bonds also improve the reputation of the issuer, either a Government or a corporation, which increases investor confidence, creating positive effects for the country or the corporation. There are two methods to raise foreign funds by issuing bonds: (a) opening of local markets to foreigners to buy local bonds (in local currency terms) and (b) selling of bonds in international financial markets (in foreign currency terms).

Owing to currency risks and foreign exchange restrictions imposed by host countries, funds raised through the first method are negligible whereas the second method has been attempted occasionally by Asian developing countries. International

**Table 6. International bonds issued by Asia-Pacific economies
(outstanding, billions of US dollars)**

| <i>Countries</i> | <i>Mar. 94</i> | <i>Mar. 95</i> | <i>Mar. 96</i> | <i>Mar. 97</i> | <i>Mar. 98</i> | <i>Sep. 99</i> |
|-----------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Australia | 42.1 | 50.1 | 53.7 | 88.5 | 80.4 | 90.0 |
| China | 9.6 | 13.0 | 12.0 | 13.0 | 14.8 | 14.2 |
| Hong Kong, China | 10.9 | 14.7 | 12.4 | 17.5 | 20.1 | 23.8 |
| India | 3.0 | 3.3 | 3.7 | 4.6 | 5.9 | 5.1 |
| Indonesia | 1.4 | 3.1 | 3.9 | 5.6 | 5.8 | 3.9 |
| Japan | 279.8 | 276.6 | 226.2 | 188.4 | 145.5 | 132.2 |
| Malaysia | 17.7 | 4.4 | 5.9 | 10.1 | 12.1 | 14.3 |
| New Zealand | 6.5 | 5.9 | 5.4 | 6.3 | 7.9 | 6.8 |
| Philippines | 0.0 | 2.0 | 2.2 | 6.4 | 8.0 | 11.6 |
| Republic of Korea | 0.0 | 19.4 | 23.4 | 40.6 | 48.1 | 46.4 |
| Singapore | 1.2 | 1.0 | 1.2 | 2.5 | 3.2 | 6.7 |
| Taiwan Province of China | 3.3 | 2.4 | 2.8 | 3.8 | 5.7 | 6.6 |
| Thailand | 0.3 | 4.0 | 5.4 | 9.9 | 11.5 | 12.6 |
| Total: Crisis economies | 19.4 | 30.9 | 38.6 | 66.2 | 77.5 | 77.2 |
| Total: Developing economies | 47.4 | 67.3 | 72.9 | 114.0 | 135.2 | 145.2 |
| Total: Developed economies | 328.4 | 332.6 | 285.3 | 283.2 | 233.8 | 229.0 |
| Total: All economies | 375.8 | 399.9 | 358.2 | 397.2 | 369.0 | 374.2 |

Source: BIS, *International Banking and Financial Market Developments* (various issues), Table 13, "International bonds by nationality".

Notes: Nepal, the Democratic People's Republic of Korea, Pakistan and Viet Nam have been excluded from the table since there were no international bond or note issues recorded. Crisis economies are Indonesia, Malaysia, the Republic of Korea and Thailand. Developing economies are all economies minus Australia, Japan and New Zealand.

bond issues comprise bonds issued in Eurobond markets or in foreign domestic bond markets such as the United States of America Japan or the United Kingdom. Details of these issues are provided in table 6. Bond issues (outstanding) by all Asian-Pacific economies as at September 1999 amounted to \$374.2 billion, of which developed countries (Australia, Japan, and New Zealand) accounted for 61.2 per cent (\$229.0 billion) and developing countries 38.8 per cent (\$145.2 billion). Bond issues by developing economies have increased significantly since early 1997, owing to a rapid increase in issues by the crisis economies. International bond financing by the crisis economies increased from US\$ 66.2 billion in March 1997 (before the eruption of the crisis) to US\$ 77.2 billion in September 1999 (an increase of 16.6 per cent over the

period). The Republic of Korea has been the largest issuer, while the level of international bonds issued by Japan has fallen as a function of low physical investment activities by Japanese firms.

The international issues from the crisis economies have largely focused on bond issues in the United States market (termed Yankee bond issues) by quasi-government or sovereign borrowers. Although these securities have to be registered, declining issuing and compliance costs, and the withdrawal by international banks from the region following the Asian crisis has encouraged borrowers to bypass national banking systems and pursue direct security market processes. United States investors have recently emerged as the largest buyers of crisis economy bonds, while United States financial intermediaries have historically demonstrated a lack of interest in pursuing intermediated bank lending business in crisis economies.

As stated above, international bond issuance by Asian developing economies has increased significantly since 1996, while foreign purchases of local bonds are negligible. However, it should be noted that even the international bonds issued by Asian developing economies are mostly sovereign or Government-guaranteed because the crisis Governments wanted to increase foreign exchange reserves through bond issuance. Therefore, issuance by the private sector has not been active. To promote foreign investment in local bonds and increase international bond issuance by the corporate sectors, some major issues need to be addressed.

First, foreign exchange restrictions should be eased so that foreigners may convert local currencies into foreign currencies and transfer them overseas. Although many Asian developing nations have significantly liberalized their foreign exchange regimes, many restrictions still exist.

Second, it is important to develop a risk-free benchmark yield curve in order that foreign investors may use it as a reference for the estimated rate of return. To this end, it is essential to develop a treasury securities market. Its risk-free yield curve facilitates private issuance. Investors traditionally price non-governmental securities based on a spread over the equivalent risk-free or government security with the same maturity. The normal procedure is to interpolate the yield for a particular corporate bond maturity based on the spread over a stripped benchmark yield curve derived from a series of on-the-run government bullet bonds. A number of regional Governments have recognized this fact (e.g., Australia, Hong Kong, China, and Singapore) and have been committed to maintaining benchmark curves despite the absence of a funding need.

Except for these economies, mid- and long-term benchmark government bonds have not existed in Asian developing economies. There are only short-term benchmark government bonds (including central bank issues) or quasi-benchmark bonds like guaranteed corporate bonds in the Republic in Korea. However, no substitute can replace government bonds given their low risks. Traditionally, the high-growth Asian developing countries have generally maintained balanced or surplus fiscal positions

and this discouraged the issuance of any government bonds to finance current fiscal expenditures, although various special-purpose government bonds were issued. There was also opposition to creating benchmark treasury bonds based on the fear of accumulation of government debts.

By contrast, Hong Kong, China made concerted efforts even before the crisis to develop Exchange Fund Bills (EFBs) and Exchange Fund Notes (EFNs) (referred to hereafter as Exchange Fund paper or EFP) and has significantly strengthened them in the aftermath of the crisis. As Hong Kong, China's fiscal status has generally been in surplus, the main objective of the EFP programme was to facilitate the development of the local debt market by increasing the supply of high-quality bonds and creating a reliable benchmark yield curve for its debt instruments. The EFP programme was introduced in March 1990 with the issuance of 91-day bills. Over the ensuing years, the programme expanded in terms of both size and tenor. The 182- and 362-day bills were launched in October 1990 and February 1991, respectively, followed by 2-year notes in May 1993, 3-year notes in October 1993, 5-year notes in September 1994, 7-year notes in November 1995 and 10-year notes in October 1996. EFP has been very well received by the market and provides a reliable benchmark yield as a result of the regular issuance of EFP with varying maturities, developing an effective market-making mechanism.

The Hong Kong, China case may offer a good example for developing a benchmark government bond market in developing economies, although Hong Kong, China has been in a much better situation in terms of financial and economic conditions. Recently the Republic of Korea and Thailand have also initiated a benchmark government bond programme. The benefits from a benchmark bond market are much larger than the costs incurred from government debts, which justifies the need to create a government bond-based yield curve. It is essential that benchmark government bonds be highly liquid through the offering of sufficient government bonds across a range of maturities. This facilitates the correct interpolation of yields for non-benchmark maturities and also helps to prevent distortion of the yield curve through illiquidity-induced volatility.

Third, Asian developing countries need to reform corporate governance. Good corporate governance enhances the protection of the legitimate interests of all stakeholders, including the holders of corporate bonds. Many Asian corporations have been blamed for weak and unsatisfactory corporate governance in the areas of anti-corruption, transparency in financial transactions, accounting methods satisfying international standards and ownership structure. These problems caused, among others, the erosion of investor confidence in the corporation's financial documents and accordingly the bonds issued by them. In many countries, accounting methods were changed in an ad hoc manner. While the crisis countries have redressed these practices, reforming governance to adopt best practices should be expanded to broader areas. Improved corporate governance will enhance the quality of corporate bonds. Investor

perceptions of intangibles such as corporate integrity, prevention of asymmetric availability of corporate information and the enforcement capabilities of securities market regulators are a key factor determining the quality of corporate bonds and capital market dynamism.

Last, there is a need to increase the reliability of local credit ratings. Some of the crisis countries have domestic credit rating agencies in collaboration with internationally reputable agencies. For instance, in Indonesia, PEFINDO was established in 1994 through an initiative of the Ministry of Finance and Bank of Indonesia under a partnership agreement with Standard & Poor's. Another new agency, Kasnik, Duff and Phelps was licensed in 1997 but is not operational. PEFINDO has rated some 200 companies involving about 250 debt securities (including CP). Requirements for rating of listed bonds and CP have increased the demand for their services. PEFINDO's partnership contributed to gaining international credibility. In the Republic of Korea three local agencies are in operation: Korea Management Consulting and Credit Rating Corporation (KMCRC), Korea Investors Service (KIS) and National Information and Credit Evaluation Corporation (NICE). All publicly-issued non-guaranteed bonds need to be rated by at least two credit-rating agencies and those corporations rated A or higher may issue non-guaranteed bonds. However, the dominance of guaranteed bonds in the Republic of Korea, which do not need a credit rating, has restricted the development of rating services.

In general, local rating agencies suffer low reliability of their ratings owing to problems associated with rating skills and techniques, limited sources of information and inadequate accounting practices of corporations. Partnership agreements with internationally reliable agencies such as Standard & Poor's or Moody's, as in the case of Indonesia, will significantly increase the reliability of local rating agencies.

Gradual opening of equity market

Portfolio equity investments by foreigners are basically of short-term duration and involve volatile movements, given that international investors are seeking short-term capital gains through active equity transactions. Rapidly improving information technology makes it possible for globalized portfolio investors to move from one place to another in an unprecedentedly speedy manner, further increasing the volatility of international equity investment. To those investors who maintain a globally-diversified portfolio, frequent moving is in fact consistent with their investment management strategy. This explains why a tremendous amount of short-term capital moves globally every day.

Equity investment flows into a country are determined by many factors, both external and domestic. Domestic factors include economic reforms, capital control, explicit and implicit government guarantees, and transparency and disclosure of information (Islam, 2000). External factors include changes in interest rates in the

United States, terms-of-trade shocks and increases in international risk premiums. Some suggest that external factors are more important (e.g., Calvo and Vega, 1993), while others argue domestic factors are equally or more important (e.g., Chuan, Classens and Mamingi, 1998 and Islam, 2000).

External factors are beyond the scope of this paper. Among the domestic policy options available, one of the most important would be to open domestic equity markets in a phased manner taking into account capital market development, corporate sector capacity and the urgency for foreign currency savings. The indicative suggestion is that a country should initially open only 1 per cent of the shares of a company, and gradually increase this to 3, 5 and 10 per cent. Capital control would not be desirable, except in an emergency situation, because it distorts the free-market system and weakens mid- and long-term investor confidence in the country. Other mechanisms to change the maturity structure of foreign capital, including taxation and reserve requirements for flows of equity market funds, would be preferred to capital controls.

Attracting foreign direct investment (FDI)

FDI is a significant long-term commitment to the host country. For developing nations, particularly low-income nations, FDI would be most desirable given their very limited absorptive capacity for portfolio investment and commercial bank loans. Since foreign concessional long-term assistance is increasingly being focused on poverty alleviation and soft sectors (e.g., agriculture, rural development, education, environment and poverty-related sectors), there is an increased reliance on domestic and foreign private investors to fund hard sectors (manufacturing and large-scale physical infrastructure) (Khan and Kim, 1999).

The positive developmental role of FDI in general is well documented (e.g., Chen, 1992). FDI tends to be directed at those industrial and infrastructure sectors that enjoy an actual or potential advantage. In those sectors of comparative advantage, FDI could create economies of scale and linkage effects and raise productivity. Moreover, in the case of FDI, repayment is required only if investors make profits. Another important benefit of FDI is its confidence-building effect. While the local economic environment determines the overall degree of investment confidence in a country, inflows of FDI could reinforce confidence, contributing to the creation of a virtuous cycle that affects not only local and foreign investment but also foreign trade and industrial production. This phenomenon well matches the directions of historical flows of FDI in the Asian and Pacific region.

Host country determinants of FDI, as prepared by UNCTAD, are given in the table below. While these cover broad areas that range from an appropriate policy framework to business facilitation by a host country, the discussion here will be limited to only a few factors that are deemed most important. First, in view of the Asian experience, the law and order situation is critically important to foreign investors in

making their decision to invest given that they need to stay in the host country with their families. Security concerns about themselves and their families are a critical factor. An unsatisfactory law and order situation keeps prospective investors on the sidelines. Second, political stability is essential to attract FDI because it creates confidence for foreign investment. Political turmoil could wipe out overnight even the most lucrative investments.

Third, there is a need for policy consistency. Abrupt changes in policies with a change in government as well as a change in policy within the tenure of a government could cause significant losses to foreign investor confidence. Inconsistencies are also to be found between the investment policies of different ministries and between the central and local government. For instance, although the central government may have a liberal investment system, numerous permits and clearances from different government agencies at the national and local levels frequently apply to investors. Fourth, the availability, reliability and cost of infrastructure facilities (power, telecommunications, water and transport systems) are important ingredients for a business environment conducive to foreign investment. In particular, ports should not be expensive and not have frequent delays and cancellations of loading/unloading of shipping. Last, but not least, a trained labour force is a critical factor, while frequent labour disputes will seriously discourage FDI.

Since the Asian crisis, all the worst-affected economies have made efforts to attract foreign direct investment, with the Republic of Korea being the most aggressive. In the two years following the crisis, the Republic of Korea attracted much more FDI than prior to the crisis: \$3.2 billion in 1996, \$7.0 billion in 1997, \$8.9 billion in 1998 and \$15.5 billion in 1999 on an approval basis. Increased FDI into the Republic of Korea has been greatly facilitated by its investment ombudsman system (Kim, 2000). The Office of the Investment Ombudsman (OIO) address the difficulties encountered by foreign investors with staffing of recognized experts on various areas. The most important difference between ordinary government offices and OIO is that the latter has the authority to make direct investigations into grievances submitted by foreign investors and to request relevant government offices to take necessary actions. OIO also enjoys access to the President of the country, which strengthens its position. Among 200 cases submitted to OIO, 132 cases have been resolved. The 132 comprise 26 for taxation, 23 for labour issues, 21 for financial matters, 18 for investment procedures, 14 for visas, 13 for customs, 12 for construction and 5 other matters.

Host country determinants of FDI

| <i>Host country determinants</i> | <i>Type of FDI classified by motives of firms</i> | <i>Principal economic determinants in host countries</i> |
|--|---|--|
| I. Policy framework for FDI Economic, political and social stability Rules regarding entry and operations Standard of treatment of foreign affiliates Policies on functioning and structure of markets (especially competition and policies governing mergers and acquisitions) International agreements on FDI Privatization policy Trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies Tax policy Economic determinants | A. Market-seeking | Market size and per capita income Market growth Access to regional and global markets Country-specific consumer preferences Structure of markets |
| | B. Resource/asset-seeking | Raw materials Low-cost unskilled labour Skilled labour Technological, innovative and other created assets (for example, brand names), including as embodied in individuals, firms and clusters |
| II. Business facilitation Investment promotion (including image-building and investment-generating activities and investment-facilitation services) Investment incentives "Hassle" costs (related to corruption and administrative efficiency) Social amenities (for example, bilingual schools, quality of life) After-investment services | C. Efficiency-seeking | Physical infrastructure (ports, roads, power, telecommunications) Cost of resources and assets listed above, adjusted for labour productivity Other input costs, such as transport and communication costs to/from and within the host economy and other intermediate products Membership in a regional integration agreement conducive to the establishment of regional corporate networks |

Source: UNCTAD, *World Investment Report* (1998, 91).

IV. STRATEGY FOR MANAGING EXTERNAL CAPITAL FLOWS

The establishment of a target portfolio of foreign capital

One of the lessons learned from the Asian crisis is the need to successfully manage the flows of foreign private capital at the national level in order to prevent financial distresses or crises while maximizing their benefits. To this end, a crucial policy is to maintain a target portfolio of foreign capital at the macro level, which aims at keeping the best composition of foreign private capital, namely, commercial bank borrowings, equity investments, bond investments and FDI. The target portfolio needs to take into account the domestic investment and savings gap, the absorptive capacity of the financial sector, the maturity and stability of foreign capital, the economic usefulness of the capital and the Government's ability to control different kinds of capital. In short, three factors, namely, the magnitude needed by the country, the envisaged productivity of different kinds of foreign capital and their volatility, should be carefully examined in deciding on the best composition of the portfolio. As domestic and overseas economic conditions evolve, the composition needs to change also. This type of strategy was not made use of in the crisis economies, with detailed information on the capital flows being unknown to the Governments in many cases. The lack of such portfolio management at the national level caused the serious currency and maturity mismatch in the crisis economies.

The maintenance of a monitoring and management office

It is essential that the host Government operate a government office within its ministry of finance or central bank whose main functions should be to:

- monitor flows of foreign private capital;
- keep a database on capital flows which includes information on amounts outstanding, maturity, type, borrowers and lenders/investors, repayment schedule (principal and interest), etc.;
- assess on a regular basis (e.g., monthly) the flows of foreign capital, examining whether excessive inflows or outflows are taking place, which types of capital are more volatile or stable, which investors/lenders are more volatile and what policy actions need to be taken at the macro and micro levels;
- maintain an optimum portfolio composition of foreign capital at the national level;
- strive to establish a long-term foreign debt/investment strategy;
- guide and assist the private sector in terms of the legal aspects of their borrowing decisions or receiving foreign funds;
- assist the private sector in developing financing techniques and managing various risks;

- maintain a cooperative network with other countries and international financial organizations.

This kind of monitoring and management system is vital in developing economies, particularly low- and middle-income economies, given the underdevelopment of the financial sector, limited financing choices and weak balance-of-payments position. The management system should be fully computerized.

Gradual liberalization of capital flows

One of the important lessons learned from the Asian crisis is that developing countries should not liberalize their capital accounts until they have put in place effective regulatory and supervisory regimes for their financial systems and appropriate macroeconomic policies, including appropriate exchange rate regimes.

According priority to foreign-exchange-earning sectors

The allocation aspect of foreign capital has generally been neglected by policy makers in developing countries. Policy focus has been on maturity and borrowing conditions. However, it is critically important to encourage foreign capital to flow into foreign-exchange-earning sectors in view of the limited capability of low- and middle-income developing countries to service their foreign debt and investment. Priority should be accorded to foreign-exchange-earning sectors such as export-oriented manufacturing, the tourism industry and those directly supporting the export sectors. Foreign fund-based investment requires generally large importation of foreign goods including capital equipment, consuming foreign exchange reserves. As debt services and investors' remittances start to pick up, non-exporting foreign projects could also severely constrain the balance of payments.

Before the crisis, a large part of Thailand's foreign funds (borrowing and investment) were invested in real estate such as office buildings and condominiums which were purely domestic-oriented with little or no contribution to foreign exchange earning. In Indonesia, significant portions of foreign funds were also poured into non-export sectors and projects. This contributed to large deficits in the current account and constrained debt servicing, thereby aggravating the two countries' financial situation immediately before the crisis. In the case of Pakistan, FDI in recent years has been concentrated narrowly in a few sectors, such as power, and when the foreign independent power producers started to remit profits and earnings in the late 1990s, this contributed to a deterioration in the balance of payments and foreign exchange problems for Pakistan.

V. CONCLUSIONS

This paper has discussed the recent trends in foreign capital flows, how to mobilize foreign capital and how to manage it at the macro level. The last issue, namely, managing foreign private capital needs to receive the special attention of Asian developing economies since poor management of foreign private capital contributed to the eruption of the Asian crisis. Asia's globalized and highly interdependent financial regimes demand careful debt/investment management. Another important issue, though not addressed in this paper, is the need to increase efficiency in the use of foreign resources by Asian developing economies. The efficiency of the use of foreign resources was considered low before the crisis, and the resources were misused and wasted in many cases. It is therefore essential to continue financial and corporate reforms and strengthen governance and the policy and regulatory frameworks in order to increase efficiency in using financial resources in the post-crisis period. Lastly, Asia needs to maximize its use of regional financial resources under a regional cooperative framework. The region holds a large amount of foreign exchange reserves and domestic savings, which are mostly invested in non-regional assets in the absence of liquid debt securities markets in the region. Foreign exchange reserves held by ASEAN and East Asian economies now total as much as \$900 billion, which is more than seven times the amount of FPC reversal during the crisis. Strengthening regional financial cooperation is one of the most important tasks faced by Asian economies in the post-crisis period.

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