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FINANCING FOR INDUSTRIAL DEVELOPMENT IN ASIA AND THE PACIFIC

TOWARDS EFFICIENT CAPITAL MARKETS

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PREFACE

The present study has been prepared by UNIDO as background document for the ESCAP Meeting of Ministers for Industry and Technology to be held in Teheran, 24 February - 11 March 1992. A draft version was presented to the High-level Expert Group Meeting Preparatory to the Meeting of Ministers of Industry and Technology in Bangkok, 14-16 November 1991. The valuable comments and suggestions made during that meeting have been incorporated into this final study report.

The study was carried out by staff of the Regional and Country Studies Branch based on inputs provided by Alexander Baum and S. Ghon Rhee as UNIDO consultants.

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List of Acronyms

ADB	Asian Development Bank
AFC	ASEAN Finance Corporation Limited
AFIC	Asian Finance and Investment Corporation Ltd.

AICA	ASEAN Industrial Complementation Agreement
AIJV	ASEAN Industrial Joint Venture
ASEAN	Association of Southeast Asian Nations
ASSET	Automated System Stock Exchange of Thailand
BAPINDO	Bank Pembangunan Indonesia
BAPEPAM	Capital Market Executive Agency (Indonesia)
BI	Bank Indonesian
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
BoC	Bank of Communication (Republic of Korea)
BOK	Bank of Korea
BOP	Bank of the Philippines
BOT	Bank of Thailand
BSB	Bangladesh Shilpa Bank
BSRB	Bangladesh Shilpa Rin Sangstha
CATS	Computer-Assisted Trading System (Taiwan Province Stock Exchange)
CCI	Controller of Capital Issues (India)
CD	Certificate of Deposit
CGC	Credit Guarantee Corporation Malaysia Berhad
CIMTC	Citizens Investment Management Trust Company (Republic of Korea)
CLOB	Central Limit Order Book (Security Exchange of Singapore)
CMEA	Council for Mutual Economic Assistance
CRISIL	Credit Rating Information Services of India Limited
DBP	Development Bank of the Philippines
DFI	Development Finance Institution
DITC	Daehan Investment Trust Company (Republic of Korea)
ECB	Expanded Commercial Banking (Philippines)
ESCAP	Economic and Social Commission for Asia and the Pacific
FA	Financial Assistance
FDI	Foreign Direct Investment
FIBV	Federation Internationale des Bourses de Valeurs
GDP	Gross Domestic Product
GIC	General Insurance Corporation of India
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IFCT	Industrial Finance Corporation of Thailand
IMF	International Monetary Fund
IRBI	Industrial Reconstruction Bank of India
JSE	Jakarta Stock Exchange
KDB	Korea Development Bank
KDIC	Korea Development Investment Corporation
KITC	Korea Investment Trust Company
KLSE	Kuala Lumpur Stock Exchange
KLTCB	Korea Long-Term Credit Bank
KSE	Korea Stock Exchange
KTAC	Korea Technology Advancement Corporation
KTDC	Korea Technology Development Corporation
KTFC	Korea Technology Finance Corporation
LDC	Least Developed Country
LIC	Life Insurance Corporation of India
MAB	Monetary Affairs Branch (Hong Kong)
MAS	Monetary Authority of Singapore
MIGA	Multilateral Investment Guarantee Agency

MFC	Mutual Fund Company (Thailand)
NABARD	National Bank for Agriculture and Rural Development (India)
NASDAQ	National Association of Securities Dealers Automated Quotation (USA)
NBFI	Non-Bank Financial Institution
NCD	Negotiable Certificate of Deposit
NIE	Newly Industrializing Economy
NIF	Note Issuance Facility
ODA	Official Development Assistance
OTC	Over-the-Counter
PIDS	Philippine Institute for Development Studies
RBI	Reserve Bank of India
SB	Specialized Bank
SBI	State Bank of India
SCORE	System on Computerized Order Routing and Execution (Kuala Lumpur Stock Exchange)
SEBI	Securities and Exchange Board of India
SEED	Small Enterprise Equity Development (Philippines)
SEHK	Stock Exchange of Hong Kong
SEC	Securities Exchange Commission (Philippines)
SES	Stock Exchange of Singapore
SESDAQ	Stock Exchange of Singapore Dealing and Automated Quotation
SET	Stock Exchange of Thailand
SFC	Securities and Futures Commission (Hong Kong)
SHCIL	Stock Holding Corporation of India Limited
SIDC	State Industrial Development Corporation (India)
SMATS	Stock Market Automated Trading System (Republic of Korea Stock Exchange)
SMI	Small- and Medium-scale Industries
TA	Technical Assistance
TSE	Taiwan Stock Exchange
UNDP	United Nations Development Program
USAID	United States Agency for International Development
UTI	Unit Trust of India
VCF	Venture Capital Funds

Currency Equivalents

(As of December 1989)

Hong Kong	HK $7.812/US$1.00
India	Rs 17.032/US$1.00
Indonesia	Rp 1797/US$1.00
Republic of Korea	W 679.60/US$1.00
Malaysia	M $2.7033/US$1.00
The Philippines	P 22.44/US$1.00
Singapore	S $1.8944/US$1.00
Taiwan Province	NT $26.16/US$1.00
Thailand	B 25.69/US$1.00

Symbols

...	not available
—	zero or negligible

I. INTRODUCTION: Background and Scope of the Study

The aim of the present study is to review major financing issues relevant for industrial development of the Asian and Pacific region in the years to come. For two reasons, the study pays special attention to international financial flows on the one hand and to the development of securities markets on the other hand: first, the international flow of investment capital reflects the increasing integration of manufacturing industries within the Asian and Pacific region. Second, securities markets have a potential for becoming a more significant vehicle for industrial financing as financial markets are progressively deregulated.

While the scope of the study is limited to industrial financing, a number of facts and conclusions are equally relevant to other economic sectors. For example, capital markets (particularly bond markets) are often utilized by governments to raise funds for infrastructure investments. Indeed, other sectors of the economy often compete with the industrial sector for investible resources.

Although the study is specifically aimed at treating industrial financing in the Asian and Pacific region, many findings apply to other regions and sub-regions as well. Various conclusions and recommendations of this study may therefore be relevant beyond the boundaries of the region under consideration. At the same time, given the limited time and resources available for conducting this study, the analysis could not fully cover the financial sectors in all countries concerned. Keeping in mind that the problems and conditions faced by the individual countries are, of course, heterogeneous, the analysis therefore concentrates on issues common to the region, a sub-region or a group of countries. The findings are, however, substantiated on the basis of the experience of specific countries.

The focus of the study is on manufacturing, whereas construction, mining and utilities are of secondary concern.

The term 'capital market' is used in its broadest meaning, deviating somewhat from the traditional definition. Capital markets are here seen to comprise all markets for long-term capital, i.e. including securities markets as well as bank lending and even borrowing from informal markets. However, in chapter IV.B the securities market receives special emphasis since it is felt that regional co-operation could become increasingly meaningful in this area.

After reviewing international trends relevant for industrial financing in the 1990s in chapter II, the different sources, both domestic and external, of investment capital are discussed in chapter III. In describing the allocation process in chapter IV, actors and mechanisms are treated separately from markets. In chapter IV.A, the main institutions active in industrial financing - domestic commercial banks and development finance institutions - as well as other relevant mechanisms such as venture capital funds and small- and medium-enterprise financing schemes are analyzed. Chapter IV.B focusses on the securities markets of the region. Since conditions are not uniform within the region, securities markets in the following selected economies are studied in greater detail: Indonesia, Malaysia, Philippines, Thailand, Singapore. Republic of Korea. Taiwan Province of China. Hong Kong and India. In these economies. securities markets exist and have a high potential for acquiring a more significant role in industrial financing over the next decade. Recent approaches at regional co-operation are reviewed in IV.C.

Chapter V. provides an action-oriented summary of the study's main findings and conclusions and puts forward a number of recommendations for improving industrial financing both at the national and regional level.

II. FINANCING REQUIREMENTS FOR INDUSTRIAL DEVELOPMENT IN THE 1990s: MAIN TRENDS AND CHALLENGES AHEAD

A. Global Trends Affecting Industrial Financing Patterns since the 1980s

The structure of industries and the needs for financing industrial development in Asia and the Pacific are highly diverse. There are, however, some general trends that will influence industrial development in the region as a whole in the 1990s. As is well-known, the financial flows to developing countries during the 1970s was much influenced by the two oil crises in 1973 and 1979 and the subsequent high liquidity within the world-wide banking system caused by the process of petro-dollar recycling. The access of advanced developing countries to industrial and other financing through commercial bank lending was relatively easy and real interest rates were low and at some point even negative. For the less developed countries, however, which had no easy access to the international financial markets, the strong negative impact of the higher oil price on the terms of trade tended to drain their domestic resources for investments.

The situation altered when commercial banks adopted a more cautious attitude towards developing countries after the 1982 debt crisis. Access to commercial bank lending became difficult particularly for highly indebted countries with a low standing as debtors in international capital markets. The net resource flow to the developing countries as a group turned negative. At the same time, the USA emerged as the world's largest importer of capital with a current account deficit much higher than that of all developing countries combined. Through the high real interest rates in the USA the flow of "fresh money" to developing countries was partly diverted. Japan became the main structural capital exporter both to the USA and particularly to Asian developing countries.

Although the global balance of payments imbalances continued to dominate international capital flows, the tense situation of the early eighties eased somewhat towards the end of the decade, partly due to tough structural adjustment programmes in the middle-income developing countries. However, the main causes of global balance of payments imbalances are of a structural nature and will therefore not suddenly change. The tremendous investment-savings gap particularly of the USA with a savings rate of only [illegible] and an investment rate of 16.0% (1989), may be reduced but not closed over the next decade. The trade surplus of Japan [illegible] to increase again in the wake of the "Heisei boom"[1] of the recent years and [illegible] expected to remain at a high level. The repositioning of the entire Japanese industry towards high-tech production from sunset [illegible] heavy industries [illegible] electronics industries in response to new international competitive conditions in the wake of the Plaza Accord in 1985 is likely to [illegible] reversal of this situation. Technology intensive production has [illegible] higher value added and tends to be also less import intensive so that the trade surplus may even increase. Moreover, the [illegible] the trade surplus [illegible] the income from Japanese overseas investment [illegible] billion in 1986) and compensates partly for a possibly [illegible] trade surplus.

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[1] The so-called "Heisei boom" is named after the reign of the present Japanese emperor, Akihito.

The global imbalances of current accounts have been accompanied by declining savings rates in both developing and industrial countries. Gross savings in industrial countries declined from 26 per cent of GNP in 1973 to 20.5 per cent in 1988 and in developing countries from an average of 27 per cent in 1976-81 to 22.5 per cent in 1982-88 (IMF 1991, p. 39).

The Asia and Pacific region as a whole has not been affected by the debt crisis to the extent that Latin America and some Sub-Saharan African countries have been, but individual countries such as Indonesia, the Philippines, Republic of Korea, China and India have become major international debtors. With the possible exception of the Philippines they could, however, maintain a sufficiently good standing so that their access to international finance was not seriously hampered. Much of the international surplus capital has also been generated in Asia where the newly industrializing economies (NIEs) Hong Kong, Republic of Korea, Singapore and Taiwan Province of China emerged as important capital-exporting nations after Japan. The Republic of Korea even changed its position from a major debtor to a net capital exporter. In general, the gap in economic development within the region has been widening with the NIEs and middle-income countries achieving a higher GDP growth rate than the low income countries on the basis of their dynamic industrial sector, while LDCs tended to record the lowest growth rates. There was a marked tendency for countries with a higher domestic resource mobilization rate to achieve higher growth rates.

The financing requirements for industry in the region changed significantly during the 1980s. The NIEs, and to a certain extent Malaysia and Thailand, went through a phase of rapid structural change and moved into more technology-intensive industries, a trend that was well reflected in their pattern of exports. In order to promote business start-ups and investments in new technology-oriented ventures bearing high risks, venture capital funds were established in many Asian countries. At the same time, labour-intensive production was increasingly shifted from these countries to Asian low-wage economies thus initiating a wave of intra-Asian foreign direct investment (FDI).

In the past, most developing countries of the region had adopted interventionist regimes to promote industrialization. Public enterprises had been set up in industries in which private initiative was considered unlikely to develop or to be successful. Furthermore, high protectionist barriers had been erected in order to ensure the growth of "infant industries". Public-sector-led industrialization did, however, not meet the high expectations. Growth rates of industrial output and manufacturing value added were generally lower in countries with extensive public ownership in industrial enterprises than in countries which emphasized private sector ownership. Loss-making public corporations moreover put a heavy burden on government budgets in many countries.

The reassessment of the government's role in industrial development was another important trend of the 1980s that had indirect effects on industrial financing. Most Southeast and East Asian countries adopted reforms of the protectionist import policies and of the role of state enterprises during the 1980s. Public enterprises still play a dominating role in the South Asian sub-region, although also countries such as Bangladesh and Pakistan have launched significant privatization programmes.

Economic reform is also the dominating trend in most centrally planned economies. China, Viet Nam and Lao PDR have encouraged foreign investments and have expanded trade with market economies. Reform of institutions and improvement of the resource allocation are, however, lagging behind.

With the trend towards a more competitive and private sector-oriented approach to industrialization new financing requirements have emerged. The often privileged access of public enterprises to financing has given increasingly way to a more market-determined allocation of investible resources. In many countries of the region, the financial sector itself has become a target for reform programmes which emphasize competition within the sector.

Technological change has become a major driving force of the world economy and determines the competitive strength of whole nations. Technological advances have set in motion a process of differentiation which has particularly affected Asia where Japan has emerged as a technological superpower. The Asian NIEs are striving to catch up with the industrialized world. A significant share of their national investments is being allocated to high-technology infrastructure - science parks for example were established in Republic of Korea, Taiwan Province and Malaysia. South Asia and particularly the LDCs (with a few exceptions such as the Indian nuclear and software industries) are lagging behind in the fierce competition in advanced industrial technologies. Technological change in tandem with liberalization towards more market-oriented policies in most developing countries will speed up the process of integrating the world economy in the 1990s. This will continue to have an impact on the global mobility of capital and the international division of labour. The Pacific rim being the fastest growing economic region in the world, East- and Southeast Asia are well placed in this process of integration. The region can be expected to benefit more than other developing regions from enhanced mobility of capital since these flows tend to favour economies with high growth rates and positive future prospects.

B. Main Determinants of Demand for Industrial Investment Capital

This section briefly touches upon some broad trends that are likely to influence the demand side of industrial financing in the years to come. At the global level, the growing demand for long-term investments since the end of the 1980s could increase competition for international capital during the 1990s. Successful implementation of structural adjustment programmes in Africa and Latin America may increase opportunities for profitable investments. The restructuring of Eastern European economies will require huge investments to rebuild their obsolete capital stocks. Industrial countries will also face the need to rebuild infrastructure and to undertake investments to cope with environmental pollution. Global competition forces industrial countries operating on the forefront of technological advance into massive capital investment and expenditure on research and development. In this respect, Japan has set new standards with capital investments which have soared to US$ 660 billion in 1990 in response to changing competitive conditions induced mainly through the Plaza Accord in 1985 - almost three times as much as Germany and significantly more than the USA which spent US$ 510 billion in the same year. The expected high global demand for investment capital and the declining trend of world-wide savings suggest that without measures to stimulate either private or public sector savings in both industrial and developing countries, high real interest rates could become a characteristic of the 1990s (IMF 1991b, pp. 38 ff.).

In line with the global trend, the Asia-Pacific region is likely to maintain a high absorption capacity for investment capital. The demand for capital in the region is mainly driven by the growing contribution of the industrial sector to GDP. The share of manufacturing value added in GDP has continuously been increasing during the past three decades. The shift to manufacturing has been at the expense of the agricultural sector whose share declined substantially in most countries during the 1960s and 1970s. This restructuring process shows substantial variations in individual countries. The share of manufacturing in GDP has increased significantly in the ASEAN-4 countries, (Indonesia, Malaysia, the Philippines and Thailand) and the four NIEs except Hong Kong where the services sector expanded more rapidly. South Asia has achieved a more modest increase in the share of manufacturing in GDP with India as the most important industrializing economy of the sub-region. On the average, manufacturing value added grew by 6.9% and 9.4% in 1988 and 1989 respectively in South Asia and 9.8% and 10.2% in 1988 and 1989 respectively in Southeast Asia (ESCAP 1991a, pp. 56 ff.).

Demand for industrial investment capital will compete with infrastructural investments within the region. The rapid economic expansion during the last two decades was not accompanied by an equally rapid expansion of the infrastructure, and therefore limited capacities of the transport and communication network as well as utilities are posing serious bottlenecks for further growth. Limited capacities for power generation, transmission and distribution will require investments to the tune of US$ 400 to 500 billion during this decade of which the bulk will have to be made by India and China.

There have been great differences in the pattern of structural change in industry among Asian developing economies. This has been most pronounced in the NIEs and least marked in the LDCs. The NIEs switched from labour-intensive production processes to technology-based and capital-intensive industries. The Republic of Korea, for example, showed a remarkable progress in manufacturing of electronics: the sub-sector's share in total manufacturing value added increased from a mere 1% in 1971 to 14% in 1990. In terms of employment, the Asian NIEs move towards service-based economies with the services sector characterized by strong linkages with industries and highly productive and skill-based inputs provided to the production system. Rapid structural changes could also be observed in the ASEAN-4 economies which switched over from an import-substituting industrialization strategy to export-led growth when domestic markets reached the saturation point.

In South Asia, public ownership was traditionally considered an important tool or promoting industrial development. The industrial strategy was predominantly inward-looking and shaped to achieve self-sufficiency in basic industries. In recent years, as mentioned above, policy reforms have been implemented in most countries of the sub-region with the aim to promote private sector participation and to deregulate the economy. Yet there continue to be a large number of unprofitable public industries which are in need of rehabilitation investments. India, as the most important industrializing economy of the sub-region has, since 1986, undertaken major steps towards restructuring the industrial sector from traditional basic heavy industries to more sophisticated sub-sectors such as chemicals, metal products and electronics. In broad financing terms, the main challenge for the future will arise from the privatization of public enterprises and related rehabilitation of sick industries. Since domestic resource mobilization is relatively low in the South Asian sub-region, requirements for supplementing domestic savings with foreign capital are likely to remain high. As the liberalization and deregulation of South Asian economies and particularly the Indian economy is progressing, they may offer interesting opportunities for potential foreign investors in the near future. At the same time, large complementary investments will be required with a view to removing serious bottlenecks in infrastructural facilities such as transport systems, telecommunications and energy supplies.

Asian LDCs[2] have achieved only marginal structural changes and minor growth of manufacturing value added during the last decade. Their industrial and technological bases have generally remained very narrow. Industrial units tend to suffer from widespread problems of poor capacity utilization and low labour productivity.

It is thus evident that structural changes have followed quite different patterns in the individual countries of the region and will continue to do so (see ESCAP 1991). The above mentioned generalized trends emphasize, however, that the need for increased net investments is growing and will encounter stiff global competition for investment funds in the years to come. In light of such a scenario, both domestic resource mobilization and more efficient allocation of capital through the financial markets is becoming more pressing for the region to catch up with the industrialized world.

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[2] These are Afghanistan, Bangladesh, Bhutan, Kiribati, Lao PDR, Maldives, Myanmar, Nepal, Tuvalu, Vanuatu and Western Samoa.

III. ROLE OF DIFFERENT SOURCES OF INDUSTRIAL FINANCING IN ASIA AND THE PACIFIC: A STOCK TAKING

A. Domestic Sources

Given the main international trends, it is important to note from the outset that industrial as well as other investments in developing countries will have to be financed predominantly from domestic sources with foreign capital only supplementing the national efforts. Furthermore, access to foreign savings is to some degree dependent on the domestic resource mobilization as for instance in the case of foreign direct investment which mostly require counterpart funds. A high level of domestic resource mobilization also facilitates the access of a country to international financial markets, because the standing is directly related to the domestic savings rate.

Table 1 shows the level of gross domestic savings and investment in the developing countries of the region. In general, there is a lower level of savings and investments in South Asia than in East and Southeast Asia. This implies a wider resource gap and higher reliance on capital inflows in the

Table 1: Basic economic data for selected Asian developing countries, 1989

Country	GNP per capita	Average GNP growth rate 1985-90	Gross domestic savings ratio (% of GDP)	Gross domestic investment ratio (% of GDP)	savings[d] gap (% of GDP)
Bangladesh	180	4.2	2.7	11.6	8.9
Bhutan	190[a]	8.8[b]	...	...	...
China	360	8.5	36.5	37.0	0.5
Hong Kong	10,320	6.4	33.5	27.1	-6.4
India	350	5.9[c]	20.2	23.1	2.9
Indonesia	490	5.5	33.7	31.1	-0.6
Iran	3,200	...	28.0	30.0	2.0
Korea, Republic of	4,400	9.7	34.5	34.6	0.1
Lao PDR	180	4.6	10.0	30.0	20.0
Malaysia	2,130	5.4	33.5	27.9	-5.6
Maldives	420	11.0	...	...	...
Myanmar	...	-0.1	11.4	11.2	-0.2
Nepal	170[a]	4.4	7.6	20.0	12.4
Pakistan	360	6.3	9.4	17.5	8.1
Papua New Guinea	900	1.9	9.4	21.7	12.3
Philippines	700	2.7	17.4	18.8	1.4
Singapore	10,450	6.4	41.6	38.3	-3.3
Sri Lanka	430	3.6	9.2	21.0	11.8
Taiwan Province	6,070[a]	8.1	31.2	23.4	-7.8
Thailand	1,160	8.9	28.1	29.4	1.3

a/ 1988

b/ 1985-88

c/ 1985-89

d/ Note that a positive figure indicates a savings gap and a negative figure a savings surplus.

Source: ADB, Asian Development Outlook 1990; ADB, Key Indicators of Developing Asian and Pacific Countries, July 1991; World Bank, World Development Report 1991 (for Iran).

countries of South Asia. Within the sub-region, only India has maintained a relatively high level of domestic resource mobilization, and only marginally dependent on foreign savings. China has realized a remarkably high domestic savings rate of 37% of GDP and in fact generated excess savings in some years (US$ 13 billion in 1982-84). Economies of the size of China and India have huge investment needs. Access to foreign capital being limited, their investment rate cannot significantly exceed their savings rate. In general, there is a positive correlation between the savings and investment rate across Asian economies with the exception of those countries that rely heavily on official development assistance such as Pakistan, Bangladesh, Nepal, Sri Lanka and Papua New Guinea.

The availability of sufficient domestic savings thus generally remains the most important determinant for the total amount of investments in the economy. Table 2 shows to what extent gross domestic capital formation was financed from gross domestic savings. On the whole, the developing countries of the region have a relatively high degree of self-sufficiency in capital when compared with developing countries in Africa and Latin America. In fact, Asia is the only region where both the savings and investment rates have remained stable during the 1980s whereas for the rest of the world (including the developed countries) declining rates were recorded.

Table 2: Ratio of gross domestic savings to gross domestic capital formation in selected Asian developing countries, 1984-1989 (selected years)

Country	1984	1987	1989[a]
Bangladesh	0.28	0.29	0.29
China	1.03	1.00	...
Hong Kong	1.07	1.00	1.30
India	0.85	0 90	0.92
Indonesia	1.35	1.35	1.07
Korea, Republic of	0.99	1.27	1.07
Malaysia	1.06	1.57	1.15
Myanmar	0.77	0.78	0.92
Nepal	0.53	0.53	...
Pakistan	0.53	0.58	0.67
Papua New Guinea	0.38	0.59	0.46
Philippines	1.10	1.12	0.97
Singapore	0.93	1.02	1.28
Sri Lanka	0.88	0.57	0.48
Taiwan Province	1.52	1.88	1.28
Thailand	0.88	0.96	1.02

[a] 1988

Source: ADB, Key Indicators of Developing Member Countries, various issues.

Supplementing domestic savings with net factor income from abroad leads to the aggregate "national savings". In most developing countries, net factor income from abroad is insignificant but in Asia there are some noteworthy exceptions. Pakistan, Sri Lanka, the Philippines and Bangladesh rely to a considerable extent on worker remittances. For the latter country, it is such an important source of finance that national savings are more than twice as high as domestic savings. Property income from abroad plays a marginal but increasing role for Singapore and Taiwan Province which reflects the growing stock of foreign investments primarily in other Asian countries. Partly corresponding to this inflow there is a significant net outflow of interest payments on foreign debt and of profits on foreign equity investments in some countries of the region. This holds true particularly for India, Indonesia, Republic of Korea, Philippines and Thailand.

Table 3: M2/GDP-ratio in selected Asian developing countries, 1980 and 1988

Country	1980	1988
Bangladesh	0.20	0.30
China	0.43	0.69
India	0.37	0.47
Indonesia	0.17	0.30
Korea, Republic of	0.33	0.38
Malaysia	0.51	0.66
Myanmar	0.26	0.33
Nepal	0.24	0.34
Pakistan	0.42	0.42
Papua New Guinea	0.30	0.32
Philippines	0.21	0.23
Singapore	0.64	0.85
Sri Lanka	0.32	0.32
Thailand	0.38	0.65

Source: IMF, International Financial Statistics, Yearbook 1990.

The correlation between the investment rate and the GNP growth rate is less strong than between the savings and investment rate. Investments are to be translated into growth through the allocation of investible funds to the most profitable of alternative projects. In general, unlike all other developing regions, Asian economies have improved the efficiency of factors of production with an incremental output/capital ratio that rose from 0.20 in 1976-1981 to 0.26 in 1982-1988 (Black 1991, p. 17). The financial intermediation is, however, still very weak in many countries of the region and constitutes a source of waste of available economic resources.

The degree of monetization of an economy (M2/GDP ratio) is often taken as indicator for the level of financial development in terms of the size of the banking system and its loanable fund capacity. Table 3 shows M2/GDP ratios in 1980 and 1988 for selected Asian countries. In most economies the degree of monetization has improved during the 1980s but is still generally lower than in developed economies such as Japan where it is above one. M2/GDP is, however, an insufficient indicator for the efficiency of the financial intermediation with respect to the allocation to profitable projects.[3] In countries with a low savings rate financial policies usually aim at increasing it rather than improving the efficiency of savings utilization. A high investment rate achieved under strong government guidance often compensates for distorted capital markets.

[3] To the extent that M2/GDP reacts to short-term inflows of foreign savings it does not reflect a deepening or broadening of the financial system.

A number of factors influence domestic resource mobilization. Domestic savings are generated by companies, the government and private households; the latter sector traditionally provides excess savings to the other two sectors. Voluntary savings of private households are influenced by interest rates on deposits but also by per capita income, the inflation rate, available financial instruments and non-economic determinants such as the dependency ratio and the legal system. In order to boost investments, governments in developing countries have tended to keep lending rates and hence interest rates on deposits below the market rate. This distorts the allocation of capital with a trend to capital-intensive projects and discourages household savings. The negative effects are intensified when investments are channeled into ventures with negative yields, particularly in the public sector (loss-incurring companies). In some Asian countries such as Myanmar and Nepal real interest rates on deposits are even negative. The Republic of Korea provides an example for the positive correlation between interest rates and domestic savings. Real deposit rates were negative in the early 1960s and personal savings were close to zero. In the late 1960s, real deposit rates were lifted to over 10% and household savings increased to 8% of GDP (Polak 1989, pp. 86 ff.) It is evident that a policy of positive real deposit rates has a positive impact on domestic savings only if supported by a low-inflation policy to ensure confidence in the local currency. In order to attract non-financial savings in the form of land, real-estate, stocks of commodities, jewelry and precious metals, financial instruments may have to be designed to meet the preferences of potential savers. Excessively high real interest rates of course disturb the economic equilibrium just as negative real rates. Real interest rates that exceed the marginal return to capital investment lead to defaults and bankruptcies rather than to an economically optimal level of savings and investments.

Traditionally, domestic commercial banks have dominated the financial sector in virtually all countries of the region and played the role as major institutional mobilizer of savings. However, for various reasons commercial banks have often not been very successful in attracting deposits from private households and small firms. The lack of innovative attitude and initiative has been explained with restrictions imposed on their lending, strict regulations i.a. on deposit rates and the oligopolistic structure of the sector as well as the predominance of nationalized banks (G.J.Abbot 1984, pp. 11 ff.). In some countries specialized institutions such as post office savings banks and savings institutions have supplemented the savings mobilization efforts of banks. Private household savings are often institutionalized and in some centrally planned economies like China they are also enforced.

The social security system that is slowly but gradually developing in Asia has started to foster private savings. The various forms of insurance including life insurance, provident funds and pension funds can either be privately organized or enforced by the government. The successful social insurance schemes established in India and Sri Lanka generate a surplus to the tune of 1 to 2% of the GNP, in Malaysia the figure is 3% and in Singapore even 7% of GNP (Polak, 1989, p. 88). The Central Provident Fund of Singapore is a government enforced scheme that was designed to increase domestic savings. The ultimate impact on capital formation is, however, determined by the use of these funds. In many countries governments prescribe investment policy and often government securities remain the only or main investment outlet for surpluses. In India, for example, insurance companies and provident funds are obliged to hold 25% of their assets in low-yielding government bonds and additional 45% in public sector securities. In the Republic of Korea, Nepal and Sri Lanka government securities bear returns below markets rates.

Fiscal policy and particularly government budget financing is another important factor affecting domestic resource mobilization. Budget financing through monetary expansion imposes an inflation tax on financial assets and therefore has a strongly negative impact on domestic savings. Very often governments tend to minimize the cost of borrowing through high reserve ratios imposed on commercial banks and prescribed investment policies for portfolios of institutional investors, as indicated above. The optimization of portfolios of social insurance schemes requires, however, efficient domestic securities markets. Moreover, ceilings on interest rates make private deposits less attractive. Such fiscal policies distort capital markets and financial intermediation, as incentives no longer support investment in the most productive assets. Reducing the government deficit improves domestic resource mobilization in such cases.

Given the comparably high levels of domestic resource mobilization in the majority of Asian economies (except the LDCs) the intermediation between savings and investments seems to be the weakest element of financing, limiting industrial development. In most Asian countries the capital markets are highly fragmented with a large geographical and institutional variation of lending terms which indicates their limited transparency and integration. The waste of economic resources caused by the inefficient allocation process cannot, from a macro-economic point of view, be compensated by high investment rates which are enforced by some governments. High savings and investment rates are hence no substitute for efficient allocation of capital.

B. External Sources

1. Foreign Direct Investment (FDI)

a. Pattern of FDI Flows to the Asian-Pacific Region

World-wide flows of FDI have steadily increased during the 1980s and almost tripled from US$ 47 billion in 1985 to US$ 139 billion in 1988. Asian and Pacific developing countries were able to secure an increasing share of the world-wide flow of FDI to developing countries during the 1980s against the global trend of FDI concentration in developed countries. Total net flows to Asia from 1981 to 1987 amounted to US$ 18 billion with a heavy concentration on a few countries. China, Hong Kong, Indonesia, Malaysia, Republic of Korea, Singapore, Taiwan Province and Thailand received 92% of FDI flows to the region during 1981-85. (UNCTC 1988). Singapore and China were by far the biggest beneficiaries of the increase in FDI which reached US$ 4.0 billion and US $2.6 billion, respectively, in 1989 (Table 4). Apart from China, the more advanced countries of the region, ASEAN-4 and the NIEs received the bulk of the investments from outside the region and were also most actively involved in the intra-Asian FDI flows. South Asia, on the other hand, fell behind the rest of Asia and received a declining relative share of FDI in Asia. The two biggest investors in the region were the USA and Japan; the latter emerged as the leading capital exporter during the 1980s.

It is noteworthy, however, that in terms of contribution to domestic fixed capital formation, FDI tends to be of limited significance to most Asian countries; the highest contribution was reached in Singapore, Hong Kong and Indonesia (Table 5). FDI was more important for the transfer of technology as well as marketing connections, which is not reflected by these figures.

Table 4: **Foreign direct investment to selected Asian developing countries, 1985-1990**

(mil. US$)

Country	1985	1986	1987	1988	1989	1990
Bangladesh	...	2.4	3.2	1.8	1.1	...
China	1031.0	1425.0	1669.0	2344.0	2613.0	...
Indonesia	310.0	258.0	385.0	576.0	682.0	964.0
Korea, Republic of	200.0	325.0	418.0	720.0	453.0	-105.0
Malaysia	695.0	489.0	423.0	719.0	1846.0	2958.0
Pakistan	139.0	106.0	110.0	173.0	154.0	...
Papua New Guinea	82.4	99.5	115.4	119.7	221.3	...
Philippines	12.0	127.0	307.0	936.0	482.0	...
Singapore	809.0	1533.0	2696.0	2710.0	3963.0	...
Sri Lanka	24.8	29.2	58.2	43.6	17.6	...
Thailand	162.0	261.0	182.0	1082.0	1650.0	...

Source: IMF, International Financial Statistics, July 1991.

Table 5: Share of average annual FDI inflows in gross domestic capital formation in selected Asian developing countries, 1980-82 and 1985-87

Country	**1980-82**	**1985-87**
Singapore	23.4	25.5
Hong Kong	7.1	15.2
Indonesia	11.1	14.2
Papua New Guinea	11.7	12.8
Malaysia	8.2	8.7
Philippines	1.6	3.5
Taiwan Province	1.0	3.3
Fiji	9.9	3.1
Thailand	2.6	2.7
Sri Lanka	4.0	2.1
Pakistan	0.7	1.4
Republic of Korea	0.5	1.4
Bangladesh	0.2	0.4
India	0.1	0.2

Source: UNCTC, World Investment Report 1991.

There has been a phenomenal increase in intra-Asian flows of FDI in recent years which has been a result of shifting competitive conditions in manufacturing industries within the region. The major sources of FDI are Japan and the NIEs whose currencies (except the Hong Kong dollar) were under pressure to appreciate due to growing trade surpluses particularly with the USA. Following the Plaza Accord in 1985 the Yen appreciated 70% against the US$ between September 1985 and April 1987 which created a strong incentive to relocate certain export-oriented industries outside Japan. Overseas investments in manufacturing expanded by 61.8% during the fiscal year 1986 and total FDI amounted to US$ 47 billion in 1988. Two thirds of this outflow was, however, directed to developed countries, with 40% being absorbed by the USA alone. 48% and 49% of total Japanese FDI to developing countries flow to Latin America and Asia, respectively, but there has been a shift in favour of Asia in recent years. Japanese investments in Asia grew by 73% and 45% in 1987 and 1988, respectively. Japanese small and medium industries play an increasing role in FDI flows to Asian countries. 70% of them are involved in sub-contracting business with large industries and often tend to follow their parent companies abroad (Phongpaichit, 1987).

The second major source for intra-Asian investments are the NIEs which have, as a group, invested slightly less than Japan. FDI flows of the NIEs are concentrated in Southeast Asia, particularly in the ASEAN-4 countries Malaysia, Indonesia, Thailand and the Philippines, where investments jumped 334% in 1988. Hong Kong played a pioneer role in FDI due to freedom from restrictions and has strongly invested in mainland China to relocate labour-intensive production to the "special economic zones" located near the border. However, FDI from Chinese business communities in Asia is partly channeled through Hong Kong and slightly distorts the statistics. Taiwan Province was the second NIE which forcefully invested in the region since the New Taiwan Dollar appreciated by 28% from 1986 to 1988 and the government liberalized the previously restricted flow of capital abroad.

Singapore and Republic of Korea were the most recent NIEs to become involved in the intra-Asian investment flows. Singapore's FDI was traditionally directed to neighboring Malaysia and Indonesia but has also increasingly gone to Thailand. The Republic of Korea has rapidly increased its engagement in the region with a tenfold increase in investment approvals in 1988. Appreciation of the Won and rising labour costs as well as the liberalization of the economy have initiated this move. Also Thailand and Malaysia have started to increase their investments in the region and may emerge as significant capital exporting nations in the future.

Table 6: Foreign direct investment approvals in Southeast Asia, 1988
(mil.US$)

\ To From \	Thailand	Philippines	Malaysia	Indonesia
Japan	3,063	95	214	225
Hong Kong	446	27	50	232
Korea, Republic of	106	2	9	209
Singapore	275	2	66	255
Taiwan Province	850	109	147	923
Asia Total	5,019	253	508	1,844
WORLD	6,225	452	768	4,426

Source: Asian Development Bank: Asian Development Outlcok 1990 based on national statistics.

Intra-ASEAN investments on the other hand have remained insignificant during the 1980s with Singapore being the single largest investor in other ASEAN countries. The high inflow of FDI into the individual ASEAN countries is based on their relations with third countries rather than on growing integration of ASEAN itself. The ASEAN-4 countries continue to have similar economic structures with similar comparative advantages, although there are signs that this may gradually change in the future. The potential for intra- and joint ASEAN investments lies particularly in the greater market size and the intimate knowledge of the market, but these advantages have not been significantly exploited yet.

b. Emerging Trends and Structural Change

FDI flows within the region primarily reflect a process of restructuring Asia's manufacturing industries in response to changing cost structures in the countries concerned. The Japanese industry is facing steadily rising labour costs at home and the appreciation of the Yen has put further pressure on the competitiveness in the export markets. As a result, the share of overseas production has been steadily increasing from a fairly low level of 2.9% in 1980 to 4.3% in 1984 and for 1993 a share of 8.2% is expected (Ozawa 1989). This is, however, much below the level of overseas production e.g. in the FRG and the USA where it is in the range of 17% to 20%. Parts and components from Japan and the NIEs are processed or assembled in Southeast Asian countries and China and then re-exported. Growing intra-Asian FDI, including rising cross-investments, have promoted this process of enhanced division of labour and the integration of East and Southeast Asian manufacturing industries which is well reflected in the changing trade pattern of the region. Trade among the major 15 Asian economies grew by 31% in 1988 and reached US$ 234 billion, half of it with Japan. From Table 7 it is evident that South Asia has played only a marginal role in Asia's fast expanding internal trade.

Table 7: Matrix of intra-Asian Exports, 1988
(US$ billion)

\ To From \	South Asia	Southeast Asia	NIEs	Japan
South Asia	0.8	0.6	1.5	2.3
Southeast Asia	1.6	2.3	13.6	15.6
NIEs	3.1	15.5	23.3	27.9
Japan	4.0	13.0	49.8	-
WORLD	35.5	56.8	201.8	175.3

Source: Asian Development Bank, Asian Development Outlook, 1990.

In recent years, there has been an upswing of FDI in services which has become the largest sector ahead of manufacturing with about 50% of the total flow in Asia. This trend is less marked in Southeast Asia than in other parts of Asia; Singapore and Thailand receive about 45%, the Philippines and Malaysia more than 25% and Indonesia less than 25% in this sector. The statistics on FDI in services may, however, be inflated by the role of offshore banking and tax havens and by the inclusion of sales offices of TNCs operating in developing countries. The shift to services is particularly evident for Japan whose "banks, insurance companies, trading companies and others rushed to take advantage of the process of financial liberalization in major capital markets and established affiliates in all financial centers" (UNCTC, 1988). 50% of Japan's FDI in Asia in 1988 was in services, as compared to 45% in manufacturing.

Although the relocation of labour-intensive production to developing countries, increasingly from first-tier NIEs, continues to be a major force behind FDI there is a marked trend towards technologically more advanced production. World-wide industrial restructuring centres on branches such as electronics, transport equipment, electrical machinery etc. The USA is increasingly relocating high-tech production to developing countries, particularly to the Asian NIEs and ASEAN countries. Electric and electronic machinery dominates US investments in Malaysia, Singapore and Thailand. While costs of unskilled labour are becoming less important for FDI in these sub-sectors, reducing costs of skilled and professional labour is increasingly determining relocation decisions. This process of technological upgrading has implications for the technology infrastructure and quality of labour to be provided by the host countries and it is evident that this trend affects particularly the more advanced countries in the region.

Another trend that has emerged since the mid-seventies refers to the so-called "new forms" of investment, which existed before but have been increasingly used in recent years. These are joint international investments with a local partner in which the foreign investor does not hold a majority ownership in equity and therefore no controlling interest. More specifically, these are licensing agreements, turnkey contracts, management contracts, service- and production sharing contracts etc. The basic idea is a breaking-up of the foreign investment package into its various elements such as foreign exchange costs, managerial and entrepreneurial expertise, technology and marketing channels, so that each partner brings in his particular advantages. These new forms have been used by Asian countries, particularly India and the Republic of Korea, as a vehicle for exports to other developing countries.

c. Major Determinants of FDI

Traditionally, the most important determinant of FDI in manufacturing has been the availability of cheap unskilled labour. Of course, low wages for unskilled labour are not equally important across the various industrial sub-sectors and complementary factors have always influenced relocation decisions. Nevertheless, in many consumer goods industries such as textile and garments, leather and certain electronic elements, low wages continue to be a significant driving force of FDI flows. Many low-income countries of the region such as Pakistan, India, Bangladesh, China etc. will continue to receive this type of FDI. In general, however, there has been a shift of key investment incentives away from low wages for unskilled labour in the wake of the contemporary technical revolution, particularly in micro-electronics. More sophisticated production technologies as well as new logistical and managerial approaches have changed the demand pattern for labour and complementary facilities. This does not mean that labour costs have become unimportant; but local managerial, design, research and scientific skills determine more and more the attractiveness of countries for FDI.

Changes in production systems comprise not only technologies and organization but also the complex of supporting services, infrastructure and human capital. FDI flows are particularly affected by the process of reducing the labour components in production costs and by changing profiles of labour skills. Efficient physical infrastructure such as power supply, informational and technological support services such as basic research, testing and quality control facilities, technological information banks, relevant university linkages etc. are increasingly important determinants. Global or at least regional integration of production and markets requires an optimal communication and transport infrastructure. Certain FDI types will depend on the availability of highly specialized supporting firms that provide components, services such as maintenance, software, consultancy etc. and backups of various kinds (UNIDO,1990).

Are Asian countries prepared to meet the changing requirements to attract FDI? The already described process of integration of East- and Southeast Asian manufacturing industries shows that many countries have been successfully adjusting to these developments, but the divergence within the region is growing. Although conditions differ in the various countries, Viet Nam, Lao PDR, Kampuchea, Myanmar, Nepal, Bangladesh, Sri Lanka, Bhutan, Mongolia, Afghanistan, Papua New Guinea, and the South Pacific Islands receive only marginal amounts of FDI and are also not well prepared to react on changing conditions. The building up of a stock of qualified workers and professionals as well as a good infrastructure requires substantial investment in human and physical infrastructure which is characterized by long gestation periods.

With a view to increasing the share of FDI going to the industrially less advanced countries of the region and specifically to those in the process of opening up their economies, it would also be important to institute a mechanism covering FDI against political risks. In this context, it may be worthwhile considering the launching of a regional investment guarantee scheme, possibly modelled after the Multilateral Investment Guarantee Agency (MIGA) under the World Bank.

d. Global Competition for FDI

Since the 1980s the positive contributions of FDI have been more and more acknowledged and most developing countries including centrally planned economies have liberalized their legislation regarding FDI. There are, however, some new factors in the global competition for FDI. The Eastern European countries have come forward with a liberal legislation and a transition of their economies towards a market-oriented allocation of resources. They are likely to absorb more FDI from the EEC countries but their attractiveness depends much on their overall political stability. The Soviet Union potentially offers a huge domestic market, cheap labour and vast natural resources but fundamental decisions on the future transition of the economic system are pending. The stock of FDI in the former CMEA countries has so far remained comparatively small with US$ 2.2 billion at the end of 1989. It is presently a rather speculative question whether FDI to this group of countries will displace FDI to developing countries in the future; there is no indication that this has happened so far. Yet the opening up of Eastern Europe will, in any case, increase the number of countries that show a positive attitude towards inflow of FDI and therefore enhance global locational competition (UNIDO 1990a).

The announcement of the completion of a common market in the EEC by 1992 has already initiated buoyant cross-investments within Europe and an increase in FDI flows into EEC countries. TNCs try to position themselves strategically in what will be the largest market of the world. Although this trend is likely to continue or become even more pronounced after 1992, FDI to the EEC does generally not compete with investment flows to and within Asian developing countries since it is directed to high-tech sectors and guided by the prospective market size. There could even be a positive effect of "1992" on intra-Asian FDI if Asian transnational corporations concentrate on domestic and regional markets in view of a perceived "Fortress Europe".

Asia as a region is generally well positioned in the global competition for FDI both from the supply and demand side. Two of the major global sources of FDI flows, the Asian NIEs and Japan, are located in Asia and while Eastern Europe and the EEC offer new investment opportunities, there is a marked inclination to invest in the region because of cultural affinities and geographical proximity. Many Asian countries can in fact offer favourable conditions for FDI with different comparative advantages: e.g. Malaysia and Indonesia have vast natural resources, the Republic of Korea can provide technological support, China offers cheap labour and a huge market potential etc. Other centrally planned economies such as Viet Nam have so far been less successful but offer also a tremendous potential. Asian countries that are less well positioned in the competition within the region such as Bangladesh, Pakistan, Sri Lanka, Nepal, Laos etc. will find it increasingly difficult to attract FDI and may be tempted to offer incentives that reduce the cost-benefit ratio of FDI to extremely low levels. However, the total flow of global FDI is not a given amount for which countries compete, but FDI flows react to opportunities. Therefore total FDI flows can be expected to increase with new opportunities so that also latecomers may be able to attract growing amounts of FDI.

2. Portfolio Investments

a. The Role in Industrial Financing

Portfolio investments are the second form of equity financing, differing from foreign direct investment in not constituting a controlling interest with some degree of involvement in company management.[4] The flow of portfolio investments to developing country equity markets has rapidly grown in recent years and amounted to US $2.5 billion in 1989. This amount is relatively small, however, compared to the US $22 billion of FDI inflows during the same year. UNIDO estimates that between 1985 and 1989 at least US $7.5 billion of foreign portfolio investment has been attracted to the manufacturing sector of developing countries (UNIDO, 1991 p. 167). As table 8 suggests, portfolio investment also have played a limited role in net resource flows to Asian developing countries so far.

Portfolio investments are often considered with suspicion by developing countries that apprehend a gradual selling off and foreign control of their most valuable national assets. Generally, developing countries have preferred foreign loans over equity financing. These do not affect the management of the industrial enterprises and were easier to acquire until the outbreak of the debt crisis. In most countries of the region, the allocation of capital among industrial ventures is controlled or at least influenced by the governments rather than through the capital market. Loan financing, mostly from development finance institutions, has therefore generally been considered a more attractive form of financing since interest rates are held artificially low and tax laws often favour debt over equity financing. In countries such as India and Nepal foreign investors are, with certain exceptions, not allowed to make portfolio investment. In Sri Lanka, portfolio investments are inhibited by the imposition of a transfer tax equivalent to 100 per cent of the value of a transaction between a resident and a non-resident which applies

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[4] It is, however, not obvious what constitutes a controlling interest and criteria applied by countries differ widely. Investments in shares of less than 5 to 10% of total equity are considered as portfolio investments in most countries.

Table 8: <u>Balance of portfolio investments for selected Asian developing countries, 1984-1990</u>
(mil. US$)

Country	1984	1985	1986	1987	1988	1989	1990
Bangladesh	1.6	7.2	-	-0.1	-	1.7	...
China	83.0	742 0	1567.0	1051.0	876.0	-180.0	...
Indonesia	-10.0	-35.0	268.0	-88.0	-98.0	-173.0	-
Korea, Republic of	333.0	982.0	301.0	-113.0	-482.0	-29.0	811.0
Malaysia	1003.0	335.0	599.0	-948.0	-966.0	-155.0	-363.0
Pakistan	9.0	110.0	83.0	132.0	126.0	22.0	...
Philippines	-3.0	5.0	13.0	19.0	50.0	372.0	...
Singapore	-151.0	175.0	-327.0	74.0	-57.0	-31.0	...
Thailand	155.0	895.0	-29.0	346.0	530.0	1466.0	...

<u>Source</u>: IMF, International Financial Statistics, July 1991.

to any sale of assets. On the other hand, portfolio managers in industrialized countries have tended to overlook the potential in developing countries because of the absence of institutions that manage portfolios in the existing capital markets as well as the limited size of these markets.

b. New Sources of Portfolio Investment

In recent years, the increasing availability of potential funds for portfolio investments has been accompanied by the trend towards liberalization of cross border capital flows and the emergence of significant capital markets in many Asian countries. The pool of funds comprising investible resources of pension funds, insurance companies, trust funds, mutual funds and investment companies based in the developed countries is presently estimated at US$ 7.5 trillion, an amount that grows at a rate of 15% annually. Only a marginal part has so far been invested in developing countries (Wider 1990, p. 12). Pension funds administer a huge pool of funds second only to the investible funds available to transnational banks. The total assets of the US pension funds amounted to US$ 950 billion in 1985 of which only US$ 21 billion were invested in foreign securities, mostly in London and Tokyo.

The recent liberalization of cross-border flows of funds has induced fund managers to take into consideration the fast growing emerging securities markets in the region. In terms of market capitalization four of the five largest emerging markets in developing countries (Taiwan Province, Republic of Korea, Malaysia and India) are located in Asia. Within the region only Japan disposes of significant retirement fund assets that are estimated at US$ 250 billion[5]. In Hong Kong an estimated amount of US$ 6.4 billion of assets is available of which two thirds are invested abroad, mostly in equities because the local capital market is too narrow and no legal obstacles hamper investments in foreign securities. In the rest of the region there are hardly any privately operated retirement funds. In some countries such as Malaysia or Singapore pension funds exist but are used by the government for budget

[5] According to the Bank of Japan, 24.9 per cent of individuals' holding of financial assets were in insurance and pension funds.

financing or domestic borrowing so that they have no deeper capital market implications. The future potential of institutional assets in the fast growing economies of East and Southeast Asia is rising, however, in line with the transformation of these societies.

Moreover, there is a changing attitude among institutional investors in developed countries who also seek attractive returns from well-diversified portfolios in emerging markets of developing countries. Though often accompanied by higher risks, returns on securities are often much higher in developing countries, the best performing markets in fact being the emerging markets. Among the four markets that world-wide showed the highest returns in 1988 were the Republic of Korea (96%) and Taiwan Province (96%) well ahead of Tokyo (31%) and the New York Stock Exchange (12%). The Philippines and Thailand are also highly profitable markets. In order to diversify certain risk components, institutional investors tend to put together portfolios containing low- or negatively correlated markets or industries. Losses in one part of the portfolio are thus compensated by gains in other parts. This puts emerging markets into a favourable position since as a group, and to a varying extent also individually, they are not strongly correlated with the markets in the USA, Japan and Europe.

c. Advantages of Portfolio Investments

Portfolio investments are an emerging alternative means of international financing with a high future potential. Foreign investors provide permanent finance through equity capital that bolsters domestic companies without reducing local control of the venture, since investors (and particularly institutional investors) do not seek participation in management. If required, governments can moreover restrict portfolio investments to a certain percentage of shares to prevent foreigners from gaining control of the management. This is e.g. a practice in the Republic of Korea. At the same time the company concerned is less vulnerable to interest rate changes. High debt-equity ratios are alleviated and access to outside financing, e.g. bank lending is improved through higher leverage. There are also advantages at the macro-economic level since local capital markets can expand and modern business techniques are introduced which help to increase their efficiency.

On the other hand, there is certainly a risk that stock markets may become more volatile through sudden in- and outflows of capital responding to macro-economic changes in the host country or other countries. Such fluctuations would have implications not only for the companies concerned and the share prices but also for the national balance of payments. Table 8 shows the balance of portfolio investments.[6] The balance position of most countries strongly fluctuates. While China, Pakistan and the Philippines have received a steady inflow of portfolio investments Thailand had a net outflow in 1986 after a record net-inflow of US$ 895 mil. in 1985. In general, the balance positions show that flows can reverse at short notice.

In recen years, various instruments have been developed to reduce such volatility th ugh restrictions imposed on portfolio investments i.a. to certain closed-end funds (which have a fixed base value). The investor can withdraw only through selling to other foreigners or when the fund itself is wound up, so that the foreign exchange position of the country is not

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[6] The total in- and outflow may be much higher due to cross-investments. This certainly holds true for the Asian NIEs.

affected. Since the 1980s country funds with an actively managed portfolio have become increasingly popular and, in the meantime, comprise approximately one half of portfolio investments in emerging equity markets. Country funds are closed-end mutual funds which specialize in the equities of a particular country or a group of countries. Over 30 such funds are listed in U.S. stock exchanges, but they are also traded in London and Singapore. An important advantage of country funds is that the investor's risk is reduced to the country's economic risk which is easier to assess for a potential foreign investor who lacks the knowledge of the emerging market and the traded companies. The country's economic performance and future prospects, the performance of the stock-market and exchange rate considerations therefore determine their attractiveness. Asian emerging securities markets, particularly the Republic of Korea, Taiwan Province, Thailand and recently Indonesia have been successful in attracting country funds. Foreign portfolio investments in Republic of Korea are in fact restricted and confined to such funds, while India and Taiwan Province are accessible through a variety of funds. Country funds therefore allow the access to markets which are otherwise closed or prohibitively costly to enter.

d. Constraints on Portfolio Investments

There are various constraints on portfolio investments in developing countries. Out of approximately 8500 companies traded in developing countries' equity markets only 300 meet the financial, liquidity and visibility criteria expected by international portfolio managers. In most Asian developing countries corporate financial reporting and disclosure are generally far below American standards and also below Japanese or European standards.

The flow of portfolio investments is often restricted both from the investor's as well as from the host country's side. Pension funds and insurance companies in particular are often subject to regulations that limit the scope for investing their portfolio abroad. More relevant, however, are restrictions that limit the access of foreign portfolio investments to emerging markets. These can be direct restrictions on purchasing domestic securities other than country funds or indirect ones such as foreign exchange restrictions on repatriation, and time limits on liquidation of investments or on certain types of shares. Regulating procedures for registration and transfer of securities, dividend payments and fund transfer are often complex and inefficient in design and implementation. There is a general tendency to open up markets and to turn to specific regulations rather than to broadly restricting cross-border flows of portfolio investments.

3. Commercial Bank Lending

Table 9 shows the total amount of long-term debts (maturity of more than one year) of public and private debtors in Asian developing countries. Compared to Latin America and Africa, the degree of indebtedness of Asian economies measured against their export earnings is relatively modest. Among the 15 countries world-wide rated as heavily indebted by the IMF only one, the Philippines, is located in Asia. In absolute terms, India, Indonesia and China have accumulated the highest long-term debts in the region. The debt- service-ratios of Papua New Guinea, India, Indonesia, Myanmar and the Philippines have exceeded the 30% mark. 92% of the debts listed in Table 9 are public and publicly guaranteed with the share varying from 60% to about 100% for the individual countries. The LDCs have generally no access to non-guaranteed loans from commercial banks. The statistics include concessional loans from multilateral creditors (e.g. IDA) which are also covered in section 4. under ODA.

Table 9: **Long-term debt of selected Asian developing countries, 1988**

Country	Long-term Debt	Public/Public Guaranteed	Private non-Guaranteed
Bangladesh	9,330.0	9,330.0	0.0
Bhutan	68.3	68.3	0.0
China	32,196.0	32,196.0	0.0
India	51,168.0	49,695.0	1,473.0
Indonesia	45,655.0	41,258.0	4,397.0
Korea, Republic of	27,376.0	21,349.0	6,027.0
Lao PDR	816.0	816.0	0.0
Malaysia	18,441.0	16,101.0	2,340.0
Maldives	59.4	59.4	0.0
Myanmar	4,217.0	4,217.0	0.0
Nepal	1,088.0	1,088.0	0.0
Pakistan	14,027.0	13,944.0	84.0
Papua New Guinea	2,129.0	1,269.0	860.0
Philippines	24,467.0	23,475.0	992.0
Sri Lanka	4,253.0	4,139.0	113.0
Thailand	16,904.0	13,375.0	3,529.0

Source: World Bank, World Debt Tables 1989-90, Vol.2.

More revealing with respect to capital flows to Asian developing countries is the net lending from commercial banks, both non-guaranteed and publicly guaranteed (Table 10). In recent years, only China, India and Thailand have received a significant net inflow from this source. China

Table 10: **Net financial flow of commercial bank loans to selected Asian developing countries, 1980-1988**

Country	1980	1982	1984	1986	1987	1988
Bangladesh	0	4	0	-1	-1	-1
China	-3	-224	178	1,334	4,304	3,827
India	490	289	590	1,165	1,276	1,074
Indonesia	825	411	577	632	256	-168
Korea, Rep. of	1,407	1,755	2,530	-2,108	-7,142	-995
Malaysia	716	2,903	1,181	456	-378	-767
Maldives	0	0	4,8	0,3	-0,6	-1,4
Myanmar	2	-5	-6	-8	-3	-5
Nepal	0	0	0	2	-2	0
Pakistan	93	480	154	44	200	-116
Papua New Guinea	34	412	77	56	-36	-62
Philippines	771	967	85	254	-650	-713
Sri Lanka	59	115	57	-13	-76	-66
Thailand	1,234	448	609	-163	169	449

Source: World Bank, World Debt Tables 1989-90, Vol.2.

relies relatively strongly on bank financing as well as bond financing in addition to FDI. The reduction of capital inflow after the political unrest in June 1989 is, however, not yet reflected in the available statistics.

The Republic of Korea and Malaysia have considerably reduced their liabilities to commercial banks in recent years. The Philippines reached agreements on debt restructuring and new financial packages with the steering committee of bank creditors in December 1987 and October 1989. In the latter case fresh money was committed in securitized form and the total amount reduced by US$ 1.3 billion (about 20% of eligible medium- and long-term debt to banks) through debt buy-back at 50% (on the US$ value). The package included a rescheduling of maturities and waivers allowing for additional debt and debt service reductions. Since 1986 the Philippines have reduced foreign debt by more than US$ 2 billion through debt-conversion schemes (IMF 1990b). While in general the banking sector has been reluctant to expose itself to developing countries in the aftermath of the debt crisis, Asian countries have continuously maintained their creditworthiness and have, unlike most countries in Latin America and Africa, relatively good access to private bank lending. More than 50% of all long-term bank credit commitments to developing countries in 1989 were made to Asia.

In general, apart from India and China, commercial bank lending has become a less important external source of capital for the region in recent years. This is partly due to a shift of credit flows from bank lending to marketable debt instruments, a phenomenon that is often called "securitization". This could be interpreted as a return to the form of intermediation that was prevalent before the growth of euro-currency markets and syndicated loans that started in the early 1970. The scene has, however, changed since commercial banks have become major actors in issuing, purchasing, arranging and managing new issues of marketable instruments. Through various innovations the distinction between credit intermediation via the banks and the capital markets has been blurred (BIS 1986, pp. 129 ff.). Floating rate notes e.g. have become a close substitute for syndicated bank lending, which have generally been displaced to a large degree by issues of international bonds and Eurocommercial papers and the use of note issuance facilities[7]. The access to bond markets is, however, restricted to countries without debt-servicing problems. International bond issues by developing countries amounted to US$ 6 billion in 1988 and US$ 4.3 billion in 1989 almost exclusively in Asia and Europe. In Asia, China, India and Malaysia issued bonds of US$ 2.6 billion in 1988 (IMF 1990b, p. 92). In general, competition among banks has increased and spreads have narrowed partly due to increasing competition from emerging stock markets in the region.

Japan is not only the largest supplier of ODA, portfolio and foreign direct investment to the region but also of bank credit. Japanese banks have become instrumental in recycling the country's huge current account surplus and have increased their exposure to Asian countries that have not experienced debt-servicing difficulties. Indirectly, Japan has considerably contributed to loans channeled through multilateral agencies which increasingly cover their refinancing needs through bond issues on the Japanese market. Between

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[7] Note issuance facilities (NIFs) are medium-term arrangements under which a borrower can issue short-term papers known as Euro-notes, backed up by commercial bank underwriting commitments. NIF commitment is typically for five to seven years while the paper is issued on a revolving basis, most frequently for maturities of three to six months.

1984 and 1986, this amounted to an annual average of US$ 2 billion p.a. (Ariyoshi, 1988).

On an aggregate level it is difficult to assess to what extent bank lending has been utilized for industrial financing in the region since virtually no statistics provide a sectoral breakdown of the utilization of funds. In many countries private and even public companies have direct access to foreign bank lending for investments in fixed assets, predominantly through export credits which are in part officially guaranteed. Statistics on such credits are also insufficient since they cut across the definitions of official long-term lending (i.e. credit that is officially guaranteed or provided by official export agencies), bank credit and supplier credit. As a source of industrial financing, official export credit deserves more attention particularly when other sources dry up.

4. Official Development Assistance

Table 11 shows that official development assistance (ODA), defined as grants and concessional loans, plays a significant role as external source of financing for a few Asian countries only, notably the LDCs. In absolute terms, India and China were the largest recipients followed by Indonesia, Bangladesh and Pakistan. But except Bangladesh none of them can be termed aid-dependent

Table 11: Net disbursements of ODA from all sources combined to selected Asian developing countries, 1982-1988

(mil. US$)

Country	1982	1984	1985	1986	1987	1988
Afghanistan	9,3	6,7	16,8	2,3	45,0	72,4
Bangladesh	1341,2	1200,5	1151,6	1455,7	1635,7	1592,2
Bhutan	11,3	17,9	24,1	40,0	42,1	41,5
Brunei Darussalam	0,3	0,8	1,4	2,5	3,3	4,5
China	524,0	798,2	940,0	1133,9	1461,7	1989,6
Kampuchea	43,9	16,9	12,9	13,2	14,2	18,5
Hong Kong	7,9	13,8	20,5	18,5	19,4	22,1
India	1643,9	1672,3	1592,0	2119,5	1838,8	2097,6
Indonesia	906,3	672,7	603,2	710,9	1245,9	1631,8
Iran	2,9	12,9	16,5	26,9	71,1	81,6
Korea, Rep. of	34,0	-36,6	-8,6	-17,3	11,2	9,7
Lao PDR	38,3	34,1	37,0	48,2	58,3	77,0
Malaysia	135,3	326,6	229,2	192,0	363,4	103,7
Maldives	5,4	5,6	9,3	16,3	18,6	27,5
Mongolia	...	0,1	3,3	4,6	3,0	3,1
Myanmar	318,9	274,8	355,7	415,7	367,7	450,9
Nepal	200,6	198,3	236,3	300,9	346,8	399,1
Pakistan	915,6	749,3	801,5	970,3	879,4	1408,1
Papua New Guinea	310,7	321,8	258,9	263,4	322,7	379,5
Philippines	333,4	397,0	486,2	955,8	770,2	854,3
Singapore	20,5	41,0	23,9	29,4	23,3	21,9
Sri Lanka	415,5	466,6	484,6	570,3	501,7	598,4
Taiwan Province	-6,4	5,4	-9,7	-10,1	-8,5	-6,8
Thailand	388,9	475,2	480,9	496,0	503,6	563,1
Viet Nam	135,5	108,8	114,0	146,5	111,0	147,9

Source: OECD: Geographical Distribution of Financial Flows to Developing Countries, 1985/88.

since only a marginal share of their overall investments is financed from this source. For countries such as Nepal, Myanmar, Sri Lanka, Viet Nam, Bangladesh and the Pacific Islands, ODA is a rather important external source in relative terms because they receive only a marginal share of foreign investments and have limited access to international capital markets.

Of the total ODA flow to Asia and the Pacific only a fraction is channeled to manufacturing industries. While no consistent statistics on sectoral distribution in the region are available, figures on ODA disbursements collected by UNDP in selected countries indicate that in most of them less than 20% of the total amount is allocated to the industrial sector. For example, of the total ODA to Bangladesh 12.3% is related to industries and in the Philippines only 1.8% of ODA is channeled to this sector. The share is generally higher for financial than for technical assistance (Table 12). Particularly in LDCs industrial investments are often financed by soft loans from both multilateral and bilateral donors.

Table 12: ODA disbursements channeled to manufacturing industries in selected Asian developing countries and share in total ODA, 1988
(mil. US$)

Country	TA multil.	TA bilateral	Percentage	FA multil.	FA bilateral	Percentage
China	12.4	14.9	14.1	137.7	54.4	15.4
India	14.5	6.9	3.6	154.2	318.6	14.0
Indonesia a/	4.0	10.9	4.0	384.0	34.4	10.8
Nepal b/	1.2	1.0	2.0	3.3	5.1	4.0

a/ 1989.
b/ 1987.
Source: UNDP: Development Cooperation Reports.

Table 13 shows that Japan has emerged as by far the largest bilateral donor for the region. Its actual share is even higher when its contribution to multilateral donors is taken into account. For Indonesia, China, the Philippines and Thailand, Japanese ODA surpasses that of all other bilateral donors combined. Japanese ODA is strategically directed to countries in Asia with a strong natural resource endowment.

Table 13: Total net flow of ODA to selected Asian developing countries by donor, 1988

Country	Bilateral Japan	Bilateral Other	Multilateral ADB	Multilateral IBRD/IDA	Multilateral Other
China	673.7	523.2	2.9	552.0	229.0
India	179.5	770.3	0.6	820.0	347.5
Indonesia	984.9	523.0	64.9	-5.0	64.9
Philippines	534.7	254.6	40.9	2.0	22.2
Malaysia	24.8	72.0	1.4	0.0	10.8
Thailand	360.6	153.4	3.5	0.0	52.4

Source: OECD: Geographical Distribution of Financial Flows to Developing Countries, 1985-88.

It is difficult to assess to what extent Japanese ODA has supported the economic impact of other Japanese capital flows such as FDI to the region. It can be assumed that ODA has some direct influence on trade flows since a considerable part of aid is source-tied. As far as technical assistance (TA) is concerned, the contribution of ODA to the development of manufacturing industries could be far higher than the amount suggests if the funds are efficiently used. TA in the field of education as well as science and technology can make an indirect but equally important contribution to industrial development. In many cases, however, particularly in LDCs with perpetual constraints on government budgets such as Bangladesh, Nepal and Myanmar, TA spendings substitute or at least supplement regular government expenditures with limited overall benefit for industry. Investments in manufacturing industries are often financed by development finance institutions which refinance their activities through bilateral and multilateral development banks.

The contribution of ODA to industrial development can hardly be assessed on a regional level, as the actual amount, the composition as well as the efficiency of utilization varies considerably among Asian countries. In general, the allocation of ODA rarely follows strict economic criteria, and unlike market-determined projects, investments financed from ODA sources tend to be channeled to projects with comparatively low returns. A particular shortcoming is the insufficient channeling of ODA to the private sector. Where the funds are directly used for economic/industrial development, they are predominantly channelled to public enterprises.

The future prospects of ODA flows to the region are positive since international pressure in favour of increased foreign aid remains high. Foreign aid is usually a permanent budgetary commitment of donor countries and its level changes only marginally from year to year. It can thus be considered as a relatively stable source of capital. However, it is likely that the ODA flow will be redirected within the region, away from the fast growing economies in Southeast and East Asia to the poorer nations. Japanese ODA is still strategically directed to Southeast Asia but the modest engagement in South Asia shows much scope for increase.

5. Off-shore Financial Markets

Off-shore financial markets, often termed Euro-markets or Asia-markets depending on their location, are a particular segment of the international financial markets whereby financial institutions accept hard currencies, mostly US Dollars, Yen, etc., outside their country of origin, and use these funds a.o. for investment purposes. In Asia, Tokyo, Singapore and Hong Kong are the main off-shore financial centers. The Singapore government has provided generous incentives since 1968 to promote Singapore's growth into a major financial center. Hong Kong lagged somewhat behind in off-shore transactions since the Hong Kong government was not ready to drop the 15% withholding tax on off-shore currency operations. However, both financial centers realized high growth rates of assets and transactions during the 1970s and took a growi· · share of the global off-shore markets. Since the Japanese government libera ·d its strict exchange rate controls and opened the off-shore market in Tokyo, the city has rapidly developed into the dominating financial center including for Asia currency bonds in the region leaving behind the other established financial centers, Hong Kong and Singapore.

Within the context of this study, the Asian currency markets which are basically money markets for short-term funds are of less interest. The long-term counterpart of, for example, the Asian dollar market is the Asian dollar bond market which is defined as the market for international bonds denominated in US dollars but issued outside the US. Domestic-currency bonds of foreign issuers are termed foreign bonds and do not belong to off-shore markets. The dollar bond market is quite closely related to bonds denominated in other currencies and alternative forms of borrowing and also to the short-term Euro-dollar market. Singapore, the first Asian dollar bond issue was launched in 1971. Since then, many banks and corporations inside and outside Singapore have tapped this source. Asia dollar bonds issued in Singapore have the following features: they are listed in the SES; Singapore financial institutions are represented in the management, underwriting and selling group; the issues are mainly placed in Asia.

As regards the impact on industrial financing it is noteworthy that the Asia dollar bond market can be tapped only by large industrial corporations including those from developing countries. Such companies have often significant project-related funding needs and can derive benefits from diversifying funding beyond the domestic capital markets. These companies are normally quoted and actively traded on the local stock exchange. Companies from developing countries of the region have increasingly been able to tap international capital markets which comprise foreign bonds and Asia currency bonds. It is, however, not easy for a developing country's company to issue bonds abroad since it is (i) generally more difficult to place and sell such bonds as compared to issues by developed country's companies, (ii) corporate disclosure is mostly insufficient, (iii) accounting standards differ and lag behind those applied in the industrialized countries, and (iv) terms and pricing of securities issues require the approval of the authorities of the company's home country in most cases. International issues from developing countries' companies are useful to raise foreign exchange and, more specifically, to tap funds of international institutional investors. Alos, in some cases, flight capital could be repatriated, since investors from the country who hold assets abroad are familiar with these companies and the environment they operate in.

IV. ALLOCATION OF INDUSTRIAL INVESTMENT CAPITAL AND THE ROLE OF CAPITAL MARKETS IN ASIA AND THE PACIFIC

In the previous chapter the various sources of industrial financing were discussed. Domestic sources are most significant as in virtually all countries of the region the bulk of domestic investments are financed from national savings. Domestic resource mobilization and, even more important, efficient alloca ion of available domestic resources are the backbone of industrial financing. External sources, on the other hand, play an important role in supplementing the national efforts because of existing resource gaps and foreign exchange gaps. Among the external financing sources, foreign direct and portfolio investments are generally gaining importance over commercial bank lending and ODA.

Efficient domestic capital markets play a crucial role in mobilizing domestic sources and in attracting external sources of industrial financing. This is most obvious for portfolio investments which are directly allocated through domestic capital markets. While this is not the case for FDI, also the latter is clearly facilitated by efficient financial markets allowing foreign investors to raise complementary capital in the host country. ODA and, to some extent, funds from off-shore markets find their way into the domestic financial system through refinancing of commercial banks and DFIs.

The following chapter provides a broad overview of the institutions active in financial markets and of the structure and performance of capital markets in selected countries of the region.

A. Main Actors and Mechanisms

1. General Aspects

There is a broad array of actors in financial markets in Asian developing countries. Commercial banks have traditionally been the most important financial institutions providing (formal) industrial finance in the region. Development finance institutions have supported government development strategies, partly in collaboration with commercial banks, partly through direct financing of industrial enterprises. Moreover, a number of specialized innovative financial intermediaries which emerged in developed countries can now be found in Asian developing countries as well. These include investment banks, venture capital funds, leasing companies, contractual savings institutions and investment trusts. These institutions are briefly described below. Venture capital funds will be dealt with in greater detail in section A.4. since they are an interesting alternative financing mechanism for a certain type of enterprises whose potential crucially depends on the development of equity markets.

The development of securities markets and gaps in the services offered by commercial banks have led to the emergence of **investment and merchant banks**[*] in a number of Asian countries. Particularly in India, Thailand, Malaysia, the Philippines, the Republic of Korea and Hong Kong the authorities have successfully promoted active securities markets and traditional merchant

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[*] The main difference between the European merchant banks and the U.S. type investment banks is that the latter are excluded from commercial banking and more active as brokers in secondary markets and also in money market operations. Diversification of business has, however, led to much the same type of new activities of both types of banks.

banking activities. Domestically-oriented investment and merchant banks are typically active in securities underwriting, secondary market operations, money market operations, corporate advisory and investment portfolio management. Securities underwriting is the core business of investment and merchant banks, as it is the single most important means of raising large sums in the primary market on long-term basis. Investment and merchant banks and brokerage firms can also play an important role in promoting secondary markets. Strong secondary markets enhance the liquidity of securities and reduce price fluctuations, both important aspects of primary market development. Mostly due to regulatory and tax obstacles only very few Asian countries such as the Philippines and Republic of Korea have active primary and secondary money markets. In money markets, short-term negotiable instruments such as treasury bills, government bonds, certificates of deposit, banker's acceptance and commercial papers are placed and traded. With their analytical skills and intimate knowledge of the market, investment companies provide also corporate advisory service. Since the prevailing family or clan type of enterprises are often reluctant to disclose information, such activities are still in their infant stage. Portfolio management advice has become a further business activity since institutional investors such as insurance companies, pension and mutual funds have emerged in a number of countries of the region with fast growing securities markets. Generally speaking, investment banking requires a different approach and is more management- than asset- intensive. Whereas commercial banks are risk avoiders which lend on the basis of credit analysis and collateral, investment banks put emphasis on growth, management and cash flow.

Contractual savings schemes such as life insurance and pension funds have developed in some Asian developing economies in recent years. Unlike industrialized countries where contractual savings account for more than one third of total domestic savings they have so far played only a very limited role in savings mobilization in most Asian developing countries. Apart from low income levels, government regulations and adverse tax legislation inhibit the growth of such schemes. Often, government insurance monopolies discriminate against private companies and portfolios have to be invested in government bonds. Contractual savings schemes could play a much more useful role in providing long-term finance to industry in view of the commercial banks' inclination to short-term lending. Foreign institutional investors have, however, discovered the emerging securities markets in the region and related portfolio investments have gained importance as vehicle for attracting foreign capital (see III.B.2.).

Leasing companies are another type of financial institution that has successfully been established in Asian developing countries, partly with the initiative or support from DFIs in the case of the Korean Development Finance Corporation. In developing countries, "financial leasing" through which the lessor purchases equipment for the lessee's use is most common[9]. Rental payment over the stipulated period amortizes the full capital outlay plus interest cost and some profit. The advantage of leasing is the separation of legal ownership and economic use which enables the lessee to acquire equipment without collateral. The lessor hence relies on the lessee's capability to generate a cash flow to service the lease payment rather than on his assets and capital base. Leasing provides an alternative source of medium and long-term finance and increases competition in financial services. Particularly small and medium enterprises with a weak capital base and limited collateral

[9] The other important form is "operating lease" with a period of lease shorter than the useful depreciable life of the asset.

can get access to equipment finance through leasing. In more advanced countries with an existing capital goods industry such as the Republic of Korea, leasing supports domestic manufacturers which compete against imports partly financed by subsidized foreign credit. For funding their operation, most leasing companies depend on the securities market and wholesale banking if they are independent institutions, or on parent and associated banks if they are affiliates. For leasing to become a real alternative for equipment financing a legislative, regulatory and tax environment is required which does not discriminate in favour of other types of financing. Cross-border leasing has been dominated by U.S. and U.K. based transnational banks and their affiliated leasing companies. They provide primarily financial services to their domestic exporting companies and are often a back door into markets that are otherwise closed for commercial banking (P. Wellonis et al. pp. 83 ff.).

In the Asia and the Pacific region, the volume of leased assets reached US $10.96 billion in 1989, including US $3.1 billion, US $2 billion, US $2 billion and US $1.5 billion in the Republic of Korea, China, Hong Kong, and Indonesia, respectively. In Hong Kong, Malaysia and the Republic of Korea leasing business has reached fairly sophisticated levels. More than 40 per cent of the total value of equipment for domestic use in Hong Kong was financed by leasing in 1989. In Malaysia, leasing grew to 15 per cent of fixed capital formation during the first half of the 1980s while the number of companies involved in leasing business increased to 250 (UNIDO 1992, p. 175).

Investment, mutual and unit trusts have the potential to emerge as major market player in Asian developing countries provided the securities markets develop a sufficient degree of depth. Investment trusts for individual investors in diversified equities have been established in various Asian developing countries such as the Republic of Korea, Taiwan Province and the Philippines. Unit trusts and mutual funds have also been launched.

The various actors and mechanisms presented below cannot always be clearly distinguished as they often overlap in their operations: commercial banks and DFIs are active in venture capital financing; SMI-financing schemes are partly implemented by commercial banks; and venture capital funds and SMI financing schemes are sometimes very close in their operation and address similar target groups of enterprises.

2. Commercial Banks

Among the various financial institutions, the commercial banks play a dominant role in industrial financing in virtually all Asian countries. In assessing the role of banks in credit allocation the activities of transnational/foreign banks have to be distinguished from those of domestic commercial banks. Depending on the degree of the former's representation, they maintain representative offices, branches, subsidiaries, joint ventures with local banks or minority financial holdings. Foreign banks originally established themselves in developing countries to finance foreign trade and support foreign direct investments and hence followed their customers abroad. Multinational firms and large local companies are therefore the major clients, while foreign banks are not normally interested in small and medium sized enterprises and in the rural sector. Hence competition between foreign and local banks has remained limited in most Asian countries since both groups serve different customers and foreign banks are more involved in wholesale than in retail banking. However, the liberalization and deregulation of financial sectors may open up new opportunities for foreign banks to enter into direct competition with local banks in the countries concerned.

Transnational banks play a crucial role in financing large industrial investments including FDI through syndicated bank lending and export financing of machinery and complete industrial plants. This type of credit is normally handled by the headquarters of internationally operating banks outside the country in which investment takes place, and shall therefore not be dealt with in detail.

The activities of foreign banks are usually strictly regulated and confined to a small segment of the market. They are e.g. often banned from taking in sight deposits and opening branches outside the capital. The total of deposits and credits accounted for by foreign banks is therefore very low in most countries of the region except in Hong Kong and Singapore. Their business is concentrated more on short-term credits based on short-term deposits with limited maturity transformation and they play only an insignificant role in financing of investments by the private and public sector. The subsidiaries refinance themselves on the international inter-bank and intra-bank market i.e. through other subsidiaries of the same bank located in international financial centers or through their headquarters. However, this refinancing window is one of the factors that makes foreign banks attractive for the host country, because it increases the country's access to foreign exchange (Germidis et.al. pp. 49 ff.).

Venture banking has remained a marginal business for transnational commercial banks in Asian developing countries. Direct venture banking, i.e. direct investment in the equity of a non-financial company is mainly directed towards the market of a bank's home countries or selected countries of the developed world. Venture capital is typically provided to small high-risk high-return commercial activities. It includes not just capital for financing investments but also advisory and brokerage services to support financing. Banks are generally reluctant to engage in direct venture banking since its administration is cost-intensive and requires special expertise. So far, legal conditions also inhibit direct venture banking in most Asian countries. However, with the future growth of stock markets in countries of the region, the opportunities and prospects for future involvement of transnational banks in venture banking are positive.

However, indirect venture banking, i.e. investment of own funds in an intermediary which then takes the equity position is often undertaken by banks. This can be a development finance institution, a venture capital fund or a consortium bank. The advantage is a greater spread of risk among various ventures and a wider range of possible operations than in direct venture banking. Governments are often actively involved in the operation of the intermediary, e.g. a local development finance company, mostly as dominant shareholder. Taiwan Province provides an interesting and successful example for private-public co-operation in venture banking. The government-owned Bank of Communication (BoC) provides technical evaluation and management help to ventures, and the private Chinese Development Corporation follows BoC and makes medium- and long-term loans as well as equity investments. There are also intermediaries that operate wholly or largely in the private sector with the host government setting only the rules for competition. Foreign banks are mostly joint venture partners with local banks in such intermediaries. A unique form of intermediary for Japanese banks which has played a significant role in Asia are the "sogo shosha", the Japanese trading companies. They raise working capital from the banks and provide risk capital and lend to entrepreneurs and established firms with the aim to integrate them into their global trading and marketing network. Apart from capital they provide managerial and marketing support and function sometimes as matchmaker to bring in external financiers (Wellonis et al. p. 61).

The domestic banking sector in countries of the Asia and Pacific region is as diverse as the respective economies and a detailed picture would require a case-by-case analysis (see Annex I). Therefore, only the main trends and characteristics shall be addressed here. Commercial banks play a dominating role both in mobilizing savings from private households and in extending credits to the industrial and other sectors in virtually all countries of the region. In the Philippines, for example, financial assets held by banking institutions represent approximately 90 percent of the total. In Thailand and India, commercial banks' assets represent 64% and 76%, respectively, of the total assets held by the financial sector. Through their lending operations, commercial banks play a key role in capital markets. Although the share of long-term loans in their portfolio in most cases is relatively small, the volume of these funds can be significant. In Sri Lanka, for example, loans with a maturity of 5 or more years represented 13.7 per cent of total loans outstanding in 1987. In absolute terms, this amount was significantly higher than the total assets of the three national DFIs combined. Only 13 per cent of the long-term loans were, however, extended to the industrial sector.

In most cases, there is a marked degree of concentration in the domestic banking sector with the dominance of a few large commercial banks over many small local banks. The presence of large banks is generally higher in urban areas than in rural areas, although rural banking has, for example in India, much improved and has partly displaced the non-formal financial market (ADB 1990, pp. 187 ff.). In Indonesia, the commercial banking sector is dominated by national foreign exchange banks consisting of five state banks and 10 private banks. In 1989, 78 percent of total assets of all deposit money banks were held by these banks. Until the reform of the financial sector of 1988 the oligopolistic structure was supported by tight government control and restrictions on entering the market, opening new branches, interest rates and on the lending structure. Time deposits at state banks had been subsidized and state-owned companies had to place their deposits at these banks so that the dominating position of the large state banks was secured. With the 1988 reform, regulatory barriers to entering the market and to opening new branches were lifted. Competition among banks was enhanced and segmentation of the market reduced. Until beginning 1991, 64 new domestic banks including 17 joint ventures were founded and 550 new branch offices opened. The Philippines provide another example of a highly oligopolistic structure with a high degree of control over entry into the markets. Five large commercial banks dominate the sector and 25 small banks supplement their services. Only the largest of them, the Philippine National Bank is state-owned, but the government holds minority shares in some other private banks. The entry into the system is highly restricted and competition is low and reflected in high interest rate spreads. In Thailand, four large banks account for approximately two-thirds of the assets, loans and deposits of the commercial banking sector. The prevailing market structure has, in most cases, historical reasons, yet apart from some LDCs, the banking sector in most countries of the region has reached a development stage that would allow more inter-bank competition.

Until recently, the governments of the region have tended to be strongly and directly involved in commercial banking with many banks being state-owned or governments holding a stake in the large banks. The wave of deregulation and liberalization that has swept through Asia (as well as other regions) during the 1980s has also seized the financial sector of many countries. The more advanced among them, particularly within ASEAN, Taiwan Province and the

Republic of Korea are leading this trend. With the introduction of new financial instruments, the emergence of new non-banking financial institutions which are less restricted in their business and the internationalization of banking, the distinction between bank and non-bank institutions has become blurred in some countries. The development of capital markets and the deregulation of bank business has pushed ahead the integration of financial markets also at the national level and has supported a trend towards the emergence of universal banks. Some countries of the region such as the Republic of Korea and the Philippines have actively promoted this trend. Far reaching reforms of the financial sector have been implemented in the Republic of Korea, Malaysia, the Philippines, Indonesia, Sri Lanka and Taiwan Province. Other countries such as Thailand and India are considering and designing reform programmes.

Indonesia effected a comprehensive reform of the financial sector in several steps starting in 1983. Until 1982, the system was characterized by interest rate ceilings imposed on state banks and differentiated credit ceilings on individual banks including private and foreign banks. The most comprehensive regulation concerned a system of liquidity credits at subsidized interest rates which was extended to banks to refinance low-interest rate loans to priority sectors. The financial system lagged behind the real sector with an M3/GNP ratio as low as 18% (which includes i.a. insurance funds). Although domestic savings accounted for some 30% of GDP during 1973-83, these were mainly government savings arising from oil revenues. When the oil price declined it became necessary to encourage household savings to finance investments. The first two stages of the reform were implemented in June 1983 and in 1984. Through the 1983 reform ceilings on bank credit were eliminated, the liquidity credit categories were gradually narrowed and most state banks' interest rates were deregulated. The 1984 reform step was more of a follow-up on the first step and introduced rediscount facilities and new money-market instruments. With the 1988 reform, regulatory barriers to entering the market and to opening new branches were lifted. Public enterprises were allowed to place up to 50% of their deposits outside the state banks. Commercial bank interest rates were deregulated and credit ceilings replaced by a system of reserve money management. At the same time minimum capital standards were introduced and reserve requirements for all bank liabilities unified. The reform was amended in March 1989, commercial banks' net position in foreign exchange being limited to 25% of their own capital. Simultaneously, ceilings on commercial banks' foreign gross indebtedness were eliminated. The reform of the financial sector was further refined in January 1990. As mentioned before, the reform enhanced competition among banks and reduced the segmentation of the market. The enlarged scope for private banks led to a buoyant response and their business has expanded partly at the expense of state banks whose share in deposits has since been falling.

Along with the positive impact of the reform, also a number of problems have arisen. The rapid expansion of commercial banks has led to a crucial shortage of qualified staff and management which has increased the risk of insufficient credit analysis and resulting loan defaults. The rapid increase in bank lending to the corporate sector has resulted in a deterioration of the quality of loan portfolios. At the same time, the emergence of securities markets has given the traditional borrowers, the large business conglomerates, the opportunity to reduce their exposure to banks by raising money from other sources. In March 1991, a number of corrective regulations were launched by the financial authorities which include limits on net foreign currency holdings of banks, a timetable to meet international capital adequacy standards, and improved bank supervision.

In the **Philippines**, a number of reform steps were taken at the beginning of the 1980s. They were aimed a.o. at encouraging long-term financing by commercial banks and at enhancing competition within the sector. Interest rate ceilings were lifted and reserve requirements on all deposit liabilities of commercial banks gradually scaled down. The reform also introduced "expanded commercial banking" (ECB), i.e. the authority of commercial banks to function as an investment house and to undertake equity finance of non-allied enterprises directly or indirectly through underwriting. At present, eight commercial banks and two government banks have received this status. For various reasons, the ECB system's intended goal of fostering long-term investment activities has not been achieved. The banking sector continues to be subject to various restrictions imposed on its operations, e.g., 25% of commercial assets have to be provided as loans for agricultural purposes or to beneficiaries of agrarian reform measures. Domestic banks can operate foreign currency deposit units and some banks have also gone international. Competition has not significantly increased since the reform, entry barriers to the banking system have rather been increased and capital requirements for commercial banks raised.

The **Republic of Korea** has implemented a gradual reform since the beginning of the 1980s. Between 1981 and 1983, the government divested its shareholding in commercial banks operating nation-wide and lowered entry barriers to the banking sector including for foreign banks. With the revised General Banking Act (late 1982) various regulations on the operation and management of banks were abolished, but monitoring of bank management and credit allocation was continued. The non-bank financial institutions in particular benefitted from the reform and the number of investment and finance companies increased rapidly. At the same time, the distinction between bank and non-bank institutions became blurred since commercial banks could now enter into operations in security markets. Various new financial instruments were introduced to promote the development of short- and long-term financial markets. Interest rate control has been modified several times during the 1980s, but interest rate ceilings have been maintained except in special markets such as the corporate bond market. The policy of direct intervention is still evident in such matters as credit ceilings, personnel decisions, etc.

Sri Lanka's financial reform of 1977 removed restrictions on interest rates and granted more freedom to banks to determine lending rates to final borrowers. At the same time, monetary expansion was reduced and the exchange rate unified and allowed to float. The reform enhanced competition in the sector since more banks, particularly foreign banks and deposit-taking non-banks, could enter the market. Foreign currency banking units were subsequently established which could accept foreign currency deposits from non-residents and transact with foreign enterprises in the free trade zone. Government interventions were not abandoned but made more selective. M3/GDP increased significantly, from 40% in 1977 to almost 50% in 1985, but M2/GDP only increased from 28.2% in 1977 to 29.3% in 1986. Segmentation of credit markets persisted, although the flow of long-term credit increased after the reform.

The above examples show that financial sector reforms were designed and implemented in different ways ranging from the cautious approaches of the Philippines and Sri Lanka, over the gradual reform process in the Republic of Korea to the more radical liberalization in Indonesia. Although the effect on interest rates, financial sector growth and competitiveness was positive in all countries that have implemented reform programmes, the effect on the availability of term credit, the corporate financial structure and the quality of bank portfolios was different for the individual countries and not always as intended. In Indonesia, for example, volatility of interest rates and maturity mismatch of loans and liabilities of commercial banks prevented an expansion of term credits. Soaring interest rates also had an adverse impact on the quality of bank assets. In Indonesia and the Philippines, the high gearing ratio of the corporate sector prevalent before the liberalization increased further and made the enterprises more vulnerable to interest rate changes.

In most countries of the region including the ones that conducted financial sector reforms, governments continue to strongly intervene in financial markets and to regulate the activities of commercial banks. Governments of many Asian developing countries tend to intervene in financial markets because of the dilemma of a narrow tax base and the consequent dependence on the financial system to generate revenues. Monetary expansion is a widely used means of raising budget revenues. When capital markets and interest rates are fully liberalized, deficit financing becomes more expensive, and funds of insurance companies and pension funds can not easily be usurped.

Prudent control and intervention in financial markets is justified in a number of cases. Particularly when domestic capital markets are small and in an infant stage, far- reaching liberalization of cross-border capital flows makes the interest rate level sensitive to foreign exchange movements. In case of macro-economic instabilities, this may lead to high and volatile interest rates. The success of a financial sector reform depends much on macro-economic and particularly price stability, and the latter cannot be achieved if monetary expansion is used as a means of government budget financing. When the banking system is highly oligopolistic liberalization may not necessarily result in the desired effects of enhanced competition.

With the deregulation of the financial sector the instruments of monetary policy have to be refined. So far, direct control of credits and interest rates with various restrictions imposed on the business of commercial banks have helped to control inflation and the expansion of monetary aggregates. These tools are to be replaced by more sophisticated indirect instruments such as open market policy. Many commercial banks have difficulties in coping with the rapid growth induced by deregulation policies. During a period of rapid expansion there is a growing risk of building up a stock of bad debts while many banks are chronically undercapitalized. This is the more relevant the more banks are undercapitalized before the sector is deregulated. In India, for example, capital and reserves on the average cover only 1.5% of the outstanding loans whereas in Pakistan the capital/asset ratio is 4%. In view of the growing linkages between world financial markets which facilitate the transmission of external shocks, many governments of the region try to enforce the compliance of commercial banks with the capital/asset ratios stipulated in the Basle Accord of central banks.[10]

The share of commercial bank credits allocated to the manufacturing

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[10] Basle Accord: Based on the proposal of the "Basle Supervisor's Committee" attached to the Bank for International Settlements the Group of Ten Central Bank Governors endorsed the "International Convergence of Capital Measurement and Capital Standards" in July 1988. The standards were subsequently recommended to all countries and a growing number of governments have been adapting their own domestic supervisory arrangements to conform with the Accord.

sector varies from country to country depending a.o. on the significance of DFIs for the sector. In Malaysia, credit extended to the manufacturing sector has increased from 19.5% of total credit in 1988 to 21% in 1989, which is still slightly less than the share of manufacturing industries in GDP. In Thailand, about 25 per cent of total credits supplied by the banking sector plus IFCT and finance and securities companies in 1989 was extended to the manufacturing sector. This share in total credit increased from 18.4% in 1980. Loans to the Hong Kong manufacturing sector were about 7% of the total amount of loans and advances for domestic use. In Singapore, loans and advances extended to the manufacturing sector accounted for a modest 14.7 per cent of the total amount in 1989 as against the sector's contribution to GDP of about 30 per cent. In Taiwan Province approximately one-quarter of loans and discounts were extended to manufacturing firms. Although commercial banks dominate industrial financing in virtually all Asian countries, the share of manufacturing industries in total bank lending generally tends to be lower than the GDP share of the sector.

Commercial bank credits to small-scale industries are not well developed. As mentioned above, commercial banks are discouraged from lending to SMIs because of relatively high unit costs due to higher costs of administration, including firm and project assessment. Therefore, the central banks often refinance SMI windows of commercial banks under preferential terms. Malaysia, for example, tries to address the particular needs of SMIs through specific targets set for commercial banks. The Bank Negara Malaysia reported for 1989 that commercial banks met the target of MS$300 million for extending loans to small-scale enterprises. Additionally, the Credit Guarantee Corporation Malaysia Berhad (CGC) plays a role in promoting the growth and development of small-scale enterprises, which are defined as registered businesses with net assets of up to M$500,000. A new guarantee scheme known as the Principal Guarantee Scheme was introduced in April 1989 to assist small-scale enterprises with no collateral or inadequate collateral to obtain the required credit facilities from the commercial banks and to lessen the bank's risk in lending to this priority group. Under this new scheme, the CGC guarantees 70 per cent of the portion of credit facilities extended by the lending institutions that is not covered by the available collateral under the bank's normal lending practices. The total amount of guarantee approved in 1989 was M$78.5 million.

The particular financing problems of SMIs and the mechanisms used to meet their needs deserve a more detailed analysis. Therefore, chapter IV.A.4. below deals with venture capital funds and chapter IV.A.5. with small- and medium-scale enterprise financing schemes.

3. Industrial Development Finance Institutions (DFI)

Together with commercial banks DFIs have traditionally been the most important source of industrial finance in Asia and the Pacific. Particularly in the LDCs they play a significant role since high risks and lack of profitable ventures make long-term credits unattractive to commercial banks. Usually DFIs provide finance on concessional terms to priority industries with difficult access to financial markets. Most development finance institutions in Asia and the Pacific provide their services to all sectors of the economy including agriculture and physical infrastructure, but there is a marked concentration of DFI activities on industry. In some countries specialized DFIs were established to address primarily the needs of manufacturing industries and in particular of small and medium-scale industries.

The characteristics and functions of DFIs often overlap with those of other financial institutions such as venture capital funds and commercial banks, and in the more advanced countries of the region even stiff competition between these institutions has developed over the last decade. The principal task of DFIs is to provide long-term finance and other complementary assistance not primarily on the basis of immediate profitability, but on the basis of long-term viability. In most countries, they are the main source of long-term finance as commercial banks tend to concentrate on short-term credit. Unlike commercial banks, DFIs do not normally accept deposits and hence cannot create money but serve as transfer agents for funds channeled to priority sectors. In fact, the range of activities of DFIs depends to a large extent on the institutional structure for promoting industrial development and the development stage of a country.

DFI-government relationships differ across the countries of the region, ranging from state ownership and direct management involvement to full autonomy and private ownership. However, strong links with the governments prevail in most countries of the region. DFIs have traditionally acted as agents of government-formulated development plans and, within this framework, provide finance to designated priority sectors and sub-sectors as well as state-owned enterprises. For their capital base most DFIs have typically relied on equity held by the government, central bank and other government institutions such as pension and provident funds. The major sources of refinance for DFIs and specialized banks (SBs) usually include: (a) government budget appropriations; (b) central bank funding or refinance facilities; (c) funding from international development organizations and bi- and multi-lateral aid agencies; and (d) in some cases deposits. In Indonesia, the Republic of Korea, Singapore, and Taiwan Province, the DFIs and SBs also engage in traditional commercial banking activities, gaining access to deposits from individuals as well as government and state agencies. DFIs and SBs usually have little incentive to raise funds on domestic and international bond markets. This is due mostly to the availability of subsidized funds from governments, central banks, or international development organizations at rates lower than competitive market interest rates. However, subsidized funding is a mixed blessing for DFIs and SBs. Their dependence on government and central bank funding serves as a serious constraint for the growth of their lending activities. It also makes them less autonomous financially. Therefore, it is important that DFIs and SBs be encouraged to float local currency as well as foreign currency bonds. There are developments in this direction in India, the Republic of Korea, and Singapore.

Only very few DFIs are entirely funded by private capital. Private DFIs often receive government contributions to their initial capital endowment and concessional loans of similar character as, for example, the Pakistan Industrial Credit and Investment Corporation. A wider dispersion of ownership and broader capital base will increase the credit ratings improving access to capital markets, and will permit a more diversified portfolio of investments. This requires reasonably attractive returns to investors. Several DFIs in the region such as the Korean Development Finance Corporation and DFIs in Singapore, Taiwan Province and the Philippines were able to pay good dividends to shareholders.

The DFIs play a wide variety of development roles usually under the guidance of the central banks. Lending areas vary from one country to another. In most countries, in addition to long-term finance, various services such as technical and management training, information exchange, business counselling, seminars and workshops etc. are offered. DFIs are often involved in achieving broader economic goals which include the promotion of capital or securities markets, decentralization of industries, entrepreneurship development and assistance in formulating policy measures.

Turning now to the experience of individual countries, the following section briefly highlights the structure of DFIs in some countries of the region, and discusses the scope of their activities and a number of typical problems confronting them.

- The manufacturing sector of the **Indian** economy is served by an extensive network of DFIs. The IDBI is positioned at the top of this network. The IDBI was established in 1964 and it is wholly owned by the Indian government. It provides financial resources to other DFIs by providing facilities for refinancing industrial term loans and bill discounting. The DFIs under IDBI's umbrella include the IFCI, ICICI, IRBI, state financial corporations, and state industrial development corporations (SIDCs). Additionally, the LIC, UTI, and GIC serve as institutions providing term loans to key industries.

- The **Indonesian** network of development banks consists of one state development bank, the Bank Pembangunan Indonesia (BAPINDO), 26 local development banks, and one private development bank. One of the state commercial banks, Bank Negara Indonesia, specializes in granting credits to the industrial sector.

- In the **Republic of Korea**, the government has been directing resources for economic development through an extensive network of six SB and three DFIs. The SBs are: (a) the Citizens National Bank set up mainly for home owners and small enterprises; (b) the Korea Housing Bank for the finance of low-income housing; (c) the National Agricultural Cooperatives Federation for banking services to farmers; (d) the National Federation of Fisheries Cooperatives for banking services for fishermen and fisheries-related manufacturers; (e) the National Livestock Cooperatives Federation for livestock farmers and related manufacturers; and (f) the Small and Medium Industry Bank for financial support of small- and medium-size businesses. The three Korean DFIs include: (a) the Korea Development Bank (KDB) supplying long-term credit to strategic industries; (b) the Export-Import Bank of Korea for financing export-oriented industries; and (c) the Korea Long-Term Credit Bank (KLTCB) extending medium- and long-term loans for the purchase of equipment and for working capital.

- Six DFIs in **Malaysia** provide term loans for large-scale projects in various key sectors. They include: (a) the Malaysian Industrial Development Finance Bhd. specializing in the development of the manufacturing industry; (b) the Industrial Bank of Malaysia providing long-term financing to high-technology firms and exporters; (c) the Development Bank of Malaysia mainly serving the bumiputra in manufacturing and trade; (d) the Borneo Development Corporation providing funding for industrial development in Sabah and Sarawak; (e) the Sabah Development Bank granting medium- and long-term financing to agriculture, forestry, and manufacturing in the Sabah region; and (f) the Agriculture Bank of Malaysia.

- Three specialized government banks serve as development financial institutions in the **Philippines**. They are the Development Bank of the Philippines, the Land Bank, and the Philippine Amanah Bank. The Development Bank of the Philippines is the largest and most influential development bank extending long-term loans for high priority development projects.

- The Development Bank of **Singapore** spearheads long-term industrial credit activities in Singapore. Occasionally, it serves as an equity investor. It is also active in commercial and merchant banking activities. Like many other commercial banks, it is an active player in offshore banking activities.

- Of 16 domestic banks in **Taiwan Province**, several banks also serve as development banks in various sectors of the economy as designated by the government. For example, the Bank of Communications is the major source of term loans for the manufacturing sector and the Export-Import Bank of China for export-oriented industries. The government established eight medium-size business banks throughout the country to provide funds to small and medium-size business enterprises.

- The most important DFI in **Thailand** is the IFCT. It was established in 1960 to take over the role of its failed predecessor, the Industrial Bank. Its main objectives are: (a) to assist in the establishment, expansion, and modernization of industrial enterprises in the private sector; and (b) to encourage and bring about the participation of private capital in such private enterprises as part of the development of the capital market.

Along with rising levels of industrial development, the role of IDBI, the leading DFI in **India**, increased proportionally. Approximately US$11.9 billion (or about 60 per cent of the cumulative term loans disbursed as of 1988) to various industries in India are provided by the IDBI, followed by IFCI (11 per cent), ICICI (16 per cent), UTI (7 per cent), state financial corporations (16 per cent), and SIDCs (9 per cent). The total amount of funds required by DFIs in 1987 amounted to US$4.85 billion. Major sources of funds for DFIs in India are: (a) borrowing through the issue of bonds and debentures (21.27 per cent); (b) borrowing from the government and RBI (6.14 per cent); (c) borrowing from foreign sources (8.20 per cent); and (e) repayment of principal and interest income (48.12 per cent). It is encouraging to note that internal sources of funding accounted for almost one-half of tne total funds needed and that DFIs' reliance on the local capital market was substantial (21.27 per cent) and increasing, about 45 per cent of total funds demanded by IDBI being met by the issue of bonds and debentures in 1989. DFIs have been instrumental in developing the Indian securities market. Besides extending term loans, DFIs underwrite and directly subscribe to shares and debentures of industrial enterprises. They also provide bridging loans against public issues of equity shares to selected companies that need assistance in the primary market.

ICICI's operations are very similar to those of IDBI, but it places more emphasis on merchant banking activities. Like IDBI, a large portion of its funding requirements are met by borrowing from international development organizations and the issue of bonds and debentures in the local capital market. These two sources of funds accounted for about 80 per cent of total funds required by ICICI. Recently, it began to tap the eurocurrency market to raise funds, even though the magnitude of borrowing is currently insignificant. Long-term loans are a dominant item on the asset side, accounting for approximately 80 per cent of total assets of ICICI. ICICI's merchant banking activities are well known in the Indian capital market through loan syndication and issue management. At present, it is playing a leading role in establishing the OTC market for start-up companies. IFCI's operations are not that much different from ICICI's. Its loan portfolio accounts for about 85 per cent of its total assets, and it borrows heavily from international development organizations and the local securities market.

DFIs in **India** face several problems. First, their operations are almost identical due to the lack of specialized areas of lending activities among themselves. To avoid wasteful duplication of activities, DFIs rely on regular inter-institutional coo.dination. Frequently, they arrange consortium lending for large-size projects. It is noted, however, that the consortium lending has resulted in lack of effective follow-up of funded projects or organizations. A recent study by the Asian Development Bank cited consortium lending as one of the reasons why there were many non-performing loan projects.

Second, DFIs have relatively small capital bases to justify a large amount of borrowing. As a result, DFIs tend to provide financial support to large industrial firms to minimize credit risk, while overlooking small- and medium-size enterprises. DFIs' involvement with venture capital funds is insignificant, compared with their overall loan portfolios. They also tend to avoid equity participation which is considered riskier than debt financing.

Third, DFIs have started borrowing heavily in the local securities market by issuing bonds and debentures, which is a positive development in the sense that they rely less on borrowing from the RBI or the Indian government. Unfortunately, their newly issued bonds and debentures carry low yields, not reflecting credit market conditions and the credit standing of the issuers. As a result, private-sector investors do not invest in these bonds and debentures. Most of these issues are allocated to various financial institutions and very little secondary market activity is noted.

Fourth, healthy competition among DFIs must be encouraged for improvement of operating efficiency. At present, all DFIs are directed to offer the same lending rates. Liberalization of government control of interest rates will be needed to foster competition among financial institutions.

In **Indonesia**, development banks are small except for BAPINDO. Claims on private enterprises and individuals amounted to US$1.89 billion or 71.96 per cent of total assets of the Indonesian DFIs comprising BAPINDO, 26 local development banks, and one private bank. Major sources of funds were: (a) borrowing from the BI (US$802.45 or 30.54 per cent); (b) demand, time, and savings deposits (US$903.73 or 34.39 per cent); and (c) a capital base of US$417.92 or 15.9 per cent. Two viable sources of funds, long-term bond issues and borrowing from international development organizations, are not utilized by BAPINDO and other development banks at the present time. Many industrial companies usually rely on the roll-over arrangements of short-terms loans due to the lack of long-term loans available either from commercial banks and development banks. This method of financing should be discouraged, and development banks should restructure their sources of funds.

The SBs in the **Republic of Korea** were established in the 1960s. Functioning as deposit money banks, they were intended to complement traditional commercial banks, but with special strategic areas of lending activities. They have been expected to perform the following functions: (a) to attract foreign resources through loan financing; (b) to mobilize domestic savings; (c) to allocate resources as called for in the government development plan; and (d) to assist in the development of the securities market. Loans and advances of the six SBs accounted for 56.45 per cent of total assets at the end of 1989. It is interesting that this percentage is higher than that of commercial banks (37.93 per cent), which implies that SBs' asset portfolio is more concentrated. Deposits accounted for 60.45 per cent of total liabilities. This figure is also higher than that of commercial banks (37.93 per cent), which indicates SBs' success in mobilizing savings in competition with commercial banks. Compared with commercial banks, the relative amount of borrowing from the BOK and government was larger. In general, SBs have been successful in providing necessary funding according to the government's priorities. The only disappointment with SBs' operation is that they did not make a significant contribution to developing the Korean capital market other than by issuing certificates of deposit and debentures.

Of the three DFIs in the Republic of Korea, the KDB and the KLTCB specialize in long-term financing for key sectors of the Korean economy. The KDB has been instrumental in development financing since its inception in 1954. The KLTCB was established in 1980 to extend medium- and long-term loans for the purchase of equipment and, occasionally, for working capital. The Export-Import bank of Korea is more specialized than the other two DFIs in that its main business is the financing of exports.

A few issues and problems are noted regarding the six DFIs' funding activities in **Malaysia**. First, their financial support of the manufacturing sector has so far been relatively modest. Approximately 41 per cent of all loans were allocated to the agricultural sector, with only 19 per cent allocated to the manufacturing sector in 1987. The remainder was divided among real estate and construction, commerce, and others. Second, the DFIs' equity participation needs to be increased. Third, the DFIs' funding for small-size projects has been insufficient. One of the largest DFIs, the Malaysian Industrial Development Finance Bhd. has three subsidiaries established to extend credits to and provide technical advice on small- and medium-size projects, but their contributions have not been as substantial as desired.

In **Thailand**, IFCT is the only specialized financial institution providing project-based, long-term capital. The IFCT is a small institution with total assets of US$1.15 billion or 1.31 per cent of total assets in 1989 held by the major institutions in the Thai financial system. Term loans accounted for 62 per cent of IFCT's total assets. The IFCT actively raised funds from the Thai securities market through the issuance of bonds and debentures. Bonds and debentures accounted for about 35 per cent of IFCT's total liabilities. An equally important source of funds is borrowing from foreign financial institutions, which provided about 33 per cent of IFCT's total funds. One of the most successful projects undertaken by the IFCT was the establishment of the MFC, which was licensed to conduct the mutual fund business on a monopolized basis for almost 15 years. In addition to extending term loans to the manufacturing sector, the IFCT formed a joint venture company, Thai Oriental Leasing, to pioneer the first leasing business in Thailand. The Thai Factory Development Company was established by the IFCT in 1977 as a joint venture with the United Kingdom's Commonwealth Development Corporation and a German development assistance agency. It builds modern factories for sale to investors on a deferred payment or long-term lease basis. Because of its extensive borrowing in foreign currency, the IFCT suffers substantial foreign exchange losses as foreign currencies appreciate relative to the baht.

In general, many development banks face a financial dilemma arising from their often government-prescribed investment policy. Comparatively low lending rates and loan provision based on politically determined social priorities rather than on profitability has left many DFIs in the region with a portfolio of non-performing assets. The Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangstha (BSRB) provide examples for extremely low recovery rates of loans to public and private sector enterprises. Recovery of BSRB from the latter group remained at a low 16% in 1986/87, but both banks have since improved their performance under pressure of foreign financiers. In many cases, frequent recapitalization to prevent collapse puts a heavy burden on government budgets and makes alternative sources virtually inaccessible. A portfolio of non-performing assets renders it also more difficult to tap foreign financing sources since regional and international development banks and bilateral donors have enforced higher standards in recent years.

With concessional capital flows from traditional sources stagnating while the scope for funding private sector activities widens, Asia's DFIs have been urged to raise more funds from commercial sources. Against this background DFIs may become more significant actors in domestic and international financial markets. Better access to international markets requires, however, that DFIs improve their performance and the quality of their portfolios.

4. Venture Capital Funds (VCF)

Above all in the USA (California and Massachusetts) the VCF-concept developed rapidly over the last two decades. The US version of VCF is highly technology ("silicon valley") oriented and aims at addressing the financing needs of young enterprises intending to transform a technological innovation into a marketable product. Such technological innovations are increasingly produced by small rather than large companies, partly due to the dynamics of the technological change itself. One typical example is the proliferation of software houses in the developed countries in the wake of the emerging specialized and highly segmented demand for computer software that could not be met by the hardware manufacturers.

Thus, the basic idea behind venture capital funds is to provide equity capital for financing the start-up and growth of small enterprises with new ideas and technologies. Together with the risk capital, the know-how for building up an enterprise and developing a market is provided. The venture capitalist therefore makes a substantial contribution to the value of the growing enterprise and his profit arises more from the capital gains that he realizes through the exit than from the income earned on the investment. A characteristic feature is the intensive involvement into the management without seeking to operate the business. The relationship between the venture capitalist and the innovative entrepreneur has a long-term basis (5 to 10 years) and is decisive for the success of the business; much depends on mutual trust and fruitful collaboration. Venture capital corporations support entrepreneurs through management teams to reduce the uncertainties associated with new and risky undertakings. The development of a growing company typically goes through certain phases from the research and development stage to start-up and growth and ultimately to maturity. During the research and development phase the risk and failure rate tends to be very high, but the need for capital is still limited. Venture capital funds can play a key role already at this stage when access to capital is extremely difficult.

Outside the USA, venture capital funds have expanded in Europe, Japan, some Asian NIEs and advanced developing countries. In Europe the concept of venture capital has been slightly reshaped since only a fraction of funds is provided to firms during the start-up phase; instead, the bulk is used for expanding existing ventures. Venture capital corporations in Europe have generally received a strong financial support from governments to initiate and supplement private initiatives.

Since the beginning of the 1980s venture capital corporations have been established and impressively grown in a number of Asian developing countries such as the Republic of Korea, Taiwan Province, the Philippines, Singapore and Hong Kong. In most developing countries of the region, however, the key factors are missing, that have led to the rapid growth of VCFs in the developed countries. The growth of these economies is generally not yet technology-led and therefore the financing of high-tech small enterprises plays a relatively minor role. Moreover, in the Asian context the involvement of third parties is often viewed with suspicion and debt is generally favoured over equity. Since the financing needs of enterprises are different from developed countries, the original concept has in fact undergone a modification in the Asian countries where it has been applied. Often the concept has been watered down to mere financing programmes for small enterprises. Whereas in the USA high-tech start-up companies are the prime recipients of venture capital, in most Asian countries mature companies benefit from this financing form, funds often being provided for the expansion of firms with a proven track record. Start-up investment schemes, where they exist, are often driven by foreign investment. There is furthermore a strong inclination to tap risk capital from family and friends rather than from the market, and this is particularly true in the case of business start-ups. However, as a number of successful examples show, venture capital funds can play a significant role in Asian developing countries.

In the **Republic of Korea** venture capital corporations have developed with strong support from the government. The creation of the Korea Technology Advancement Corporation (KTAC) which is linked to government sponsored research institutes dates back to 1974. Its major function has been to link research organizations with business and entrepreneurs to support the translation of research and development into practical application. The Korea Technology Development Corporation (KTDC), the country's largest VCF, was established in 1981 and provides financial support for the development of new and the improvement of existing technologies, products and processes. The Korea Development Investment Corporation (KDIC), a venture capital fund in the original sense, was established in 1982. It provides equity and/or equity-type investments to technology-intensive small and medium industries. The Korea Technology Finance Corporation (KTFC) provides loans for R&D costs and initial commercialization of new technologies. It started its operations in 1984. Since 1987, when the government launched a new legislation the number of venture capital corporations started by security companies, individual companies and local chambers of commerce has strongly increased. The main thrust of venture capital firms has so far been to help small industries to adapt foreign technology rather than developing new technologies. Apart from KDIC, the VCF are typically financed with traditional loans rather than equity. In general, the venture capital industry, with easing government restrictions and sufficient funds, is beginning to blossom. By the end of 1989, the venture capital pool reached approximately US $900 million.

In **Taiwan Province**, VCF have also been used as policy instrument to acquire foreign technology rather than as a mere financing mechanism. Since the "Regulations Governing the Administration of Venture Capital Investment Enterprises" in 1983 introduced far reaching tax incentives, the market has been one of the fastest growing in Asia, although the government kept narrow limits on the funds by restricting them to designated strategic industries. So far the bulk of the funds has gone into computers and electronics, but the government seeks to channel them also to other strategic industries such as aerospace, new materials, biotechnology, environmental products and electro-optics. As in the Republic of Korea, VCF are to support a technology-based industrial development. By the end of 1990, 20 VCF had been set up and had invested into more than 200 enterprises.

In the **Philippines**, a new law on VCF was promulgated in 1980 to stimulate the establishment of VCF. Equity financing extended to small- and medium scale enterprises active in certain designated industries was promoted. By 1988, 16 VCF had been established under government owned/ controlled corporations and commercial banks. Funds have, however, been heavily concentrated in loans rather than equity financing and the principal income of VCF has been derived mainly from government securities and money market placements. The principal problems that beset the industry are similar to other Asian developing countries: a strong bias of commercial banks against small and medium enterprises as well as against un-collateralized financing and the reluctance of small enterprises to accept equity financing in order to keep control of their venture.

Singapore and **Hong Kong** have fast growing and sophisticated venture capital markets. In Singapore, VCFs were introduced at the beginning of the 1980s and have adopted mainly an outward looking strategy. By the end of 1989 the venture capital funds held an investment pool of over US $350 million. Since 1986, venture capital business has been promoted through tax incentives and legislative concessions. Hong Kong has given no government support and tax incentives to VCFs. However, with approximately US $1 billion under management by Hong Kong's venture capital industry this is the largest pool among the Asian developing countries. The regulatory freedom as well as developed capital markets have supported the growth of VCF. It is estimated that only 10 to 80 per cent of these funds are invested in Hong Kong itself. Thailand has a small but steadily growing venture capital market that develops in the wake of its growing stock market and strong foreign investments.

In general, the expansion of VCF with almost US$ 10 billion under management in the Asia-Pacific region in 1990 has not been very rapid. Two thirds of this amount is managed by about 160 capital firms of Japan and Australia. VCF could contribute more to cross-border capital flows than they do now. So far, international flows of such funds have mostly taken place among industrialized countries and particularly to the dynamic USA venture capital industry. For developing countries this source has generally been difficult to tap for various reasons. First, the strong involvement of the venture capitalist in the management of the enterprise concerned faces cultural boundaries and reluctance from entrepreneurs in virtually all Asian developing countries. Second, the shortage of local skills in managing ventures is especially acute in developing countries. Third, the risk associated with projects in developing countries is generally greater than in developed countries, particularly since a long-term commitment of the venture capitalist is required before capital gains can be realized. Accordingly, current income from the investment is relatively more important for VCF operations in Asian developing countries than in developed countries.

In many countries of the region, there are additional problems for venture capitalists as regards the realization of profits. One determinant is the tax policy of the host country. In many Asian countries there is a tax on capital gains and multiple levels of taxation that create an adverse environment for venture capital funds. The realization of profit through exit may also be hampered by the absence or small size of stock markets. Complicated registration procedures and high costs impede the access of small and medium enterprises to listed stocks. Because of underdeveloped stock markets exit strategies other than initial public offering therefore play a more significant role. In partner and/or management buy-outs the entrepreneur buys back the company in time, based on a mutual business plan that a.o. stipulates a premium. If the partner is unable or unwilling to buy back the business a third-party purchaser, of en a so-called "mezzanine venture capital company" entering more mature ventures mid-stream, may be found in a private placement. As a number of venture capital funds throughout Southeast Asia begin to mature exit strategies become more and more important and also will determine international flows of venture capital.

In summary, Asian VCFs have shown to be highly profitable in most cases and have received strong impetus from foreign capital inputs. The opportunities for venture capital, however, arise more from the lack of existing financing for small and medium industries and the concentration of traditional industrial financing on large companies than from the promotion of new technologies developed and introduced in the market by small companies.

5. Small- and Medium-scale Enterprise Financing Schemes

Small- and medium-scale enterprises are the main pillar of industrial development in virtually all Asian developing countries. They deserve, in view of their contribution to building up an industrial base, the governments' particular attention. Small- and medium-scale industries generally employ more labour and have a much wider regional dispersion than large firms and are therefore better suited for alleviating poverty and bringing about regionally balanced growth. As in developed countries, small firms are the seedbed of industrial entrepreneurship from which a few successful ones grow into medium and large companies. A sound industrial size structure hence requires many healthy small companies. In 1985, small and medium enterprises e.g. accounted for 95% of establishments in Bangladesh, 70% in Indonesia and 80% in the Philippines. They are mainly to be found in textile and garments, wood and furniture, food processing, leather products, fabricated metals, rubber and plastics, pottery, and printing and publishing industries (Chowdhury 1990, pp. 28 ff.).

In most countries of the region large industries have so far benefitted more from the rapid export growth and could therefore expand faster than small firms. Against this background, various support schemes have been designed to serve the particular needs of SMIs. Financing is a crucial bottleneck for the start up and growth of small firms in virtually all countries of the region. SMIs typically rely on their own savings and loans from friends and relatives during the start up phase. Institutional credit (mainly from commercial banks) only starts to play a role as firms become larger. Money lenders and other informal credit markets traditionally also provide finance for the expansion of cottage industries and small firms. Reinvested earnings are the major source of funds for fixed capital, followed by institutional and non-institutional sources. As firms grow, dependence on reinvested profits decreases and institutional and special credit institutions, including credit guarantee schemes, contribute more significantly to finance.

SMIs have, for various reasons, little access to resources of the formal financial sector. High transaction costs make lending to small units less attractive for commercial banks. Credit monitoring requires an extensive branch network with relatively more staff per asset unit than credit for larger firms. High transaction costs are shifted to the borrower so that credit costs are often higher than the return and hence the inducement to borrow is small. On the other hand, less monitoring leads to higher defaults and lower recovery rates. Therefore, both government and private commercial banks tend to ask for extensive reporting and high collateral. In Bangladesh, for example, it was observed that collateral requirement regularly exceeded the loan amounts, often up to 120 or 130%. SMIs are typically poor at accounting and have in most cases no proven track record. Very limited fixed investments moreover make it impossible to provide sufficient collateral for securing the credit, and a potential small firm does not receive financial support even if the project is feasible. The dilemma of SMI financing is that the smaller a company the more does a bank try to have the loan secured through collateral, but the less is the company in a position to meet these requirements.

In order to alleviate the particular financing problems of small companies, special SMI financing schemes, mostly on preferential lending terms, have been established in most countries in Asia and the Pacific. The most common scheme of subsidized loans is a "small business window" through which commercial banks provide funds which the central bank refinances at a low rate of interest. The low interest is intended to compensate the lending bank for higher risks and transaction costs and to keep the rate charged to SMIs at a reasonable level. Another common form of SMI financing are credit guarantee schemes in which commercial banks are encouraged to extend credit at easy terms to small firms; this credit is guaranteed to cover the higher risks. Both forms of credit are supplied through commercial banks which generally have the advantage of a wider branch network than DFIs. Commercial banks remain, however, often reluctant to extend credit even through such special schemes. Therefore governments resort to direct interventions and prescribe certain credit targets for SMIs; 5% of the commercial banks' portfolio in Bangladesh, for example, has to be held with small and cottage industries. To alleviate the collateral requirement, supervised credits have become a common form of supplying machinery and other equipment on a hire-purchase basis in some countries. Often the entrepreneur is able to pay the installments out of the additional earnings from new equipment. Supervised credit ensures that the entrepreneur uses the credit for the originally envisaged purpose (Nanjundan 1990, pp. 18 ff.). In many countries of the region DFIs are directly involved in SMI financing schemes, e.g. the Bangladesh Shilpa Bank, the Development Bank of the Philippines and the Development Finance Corporation of Sri Lanka. However, most DFIs have not been very successful in channeling funds to SMIs because of their limited branch network and the high transaction costs.

The obstacles being faced by small and cottage industries are usually multi-layered. Financing schemes designed to address small firms are therefore often combined with extension services, training, and physical infrastructure such as common facilities centres and industrial estates. Such packages have better chances of achieving success than isolated measures. A good example for an integrated approach to SMI promotion is the "Spark Plan" launched by **China** in 1986. The Plan emphasizes the establishment of rural industries based on agricultural and mineral resources. Within the framework of the "Spark Plan" scientific and technological projects are being carried out in the countryside in pursuit of introducing new technologies towards raising the quality of products and enhancing the efficiency of township- and rural-based industries. Financing is provided as one component of the Plan.

In **India** small scale industries have been accorded priority status for more than two decades. SMIs have benefitted from various support policies such as reservation of certain industrial products for SMIs, marketing assistance and supply of scarce raw materials through the state-level small-scale industries development corporations. Under the credit guarantee scheme and the lending targets commercial banks have been encouraged to provide assistance on liberal terms to SMIs. The State Finance Corporations have been induced to provide term finance to small firms with refinancing from the Industrial Development Bank of India (IDBI) at preferential rates. Since the latter half of the 1970s the number of units which have benefitted from IDBI's refinanced credits has rapidly expanded, amounting to 121,000 in 1983 but this is still only a fraction of the total number of firms with borrower accounts at commercial banks (800,000 in 1980). A National Equity Fund Scheme for SMIs was formulated in 1987 jointly by IDBI and the government to provide equity type finance to small enterprises without security, including collateral.

Indonesia operates a large number of credit schemes for small and medium enterprises. Under the Department of Industry's Project for the Guidance and Development of Small Industry an integrated approach has been adopted. A whole package of support services which includes upgrading of equipment and skills and financing schemes is provided. The Small Investment Credit Scheme and the Working Capital Credit Scheme extend loans on concessional terms through the branch offices of the five major commercial banks. This programme was partly backed up by soft loans from the World Bank.

In the **Philippines** the Industrial Guarantee Loan Fund plays the principal role in SMI financing. Since 1973 concessional loans are extended with financial help from IBRD and USAID to small and medium businesses. In 1983, 60% of the credits were channeled through four aid programmes: the Central Bank - Industrial Guarantee Loan Fund, the Small and Medium Industries Lending Program of the Development Bank of the Philippines, the Industrial Guarantee Loan Fund and the Export Industry Modernization Program. There is an array of support programmes that range from extension services provided through Small Business Centers in various regions to trade fairs and supply of marketing information. Despite the various support programmes financing has remained a critical bottleneck for many SMIs.

An innovative approach to financing SMIs through a Small Enterprise Equity Development (SEED) scheme is being envisaged now by the Development Bank of the Philippines (DBP).[11] The SEED programme aims at established small and medium enterprises with good growth potential particularly in export manufacture which are at a critical stage of their expansion. Such firms typically face a financing gap during the growth phase after a successful start-up. Due to a weak equity base and insufficient collateral their expansion is effectively limited by their self-generated savings and access to informal credit markets. The Development Bank of the Philippines as the lead sponsoring institution intends to establish the SEED Fund with participatory contribution from bilateral and multilateral financial institutions and from private investors to address such financial needs. It is intended to build up the equity base of the target enterprises by providing primarily (non-voting) preferred stocks. This is to ensure adequate returns for the Fund's investment without disrupting the entrepreneur's control of the venture. At the same time, technical assistance in the areas of technology usage, financial planning, marketing and product development etc. is offered to the entrepreneur. The selection of suitable SMIs and the willingness of potential entrepreneurs to accept outside equity capital would be critical for the success of the Fund. The Fund rules provide for the convertibility of preferred into common stocks in case of continuing default on the fixed dividends so that outside control comes with business failure. The objective of the Fund would be reached when the preferred shares are repurchased by the SMI or otherwise divested (DBP 1990, pp. 1 ff.).

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[11] In designing and launching the SEED Programme, UNIDO is providing technical assistance to DBP.

6. Non-formal Financing

In reviewing the various actors and financing mechanisms in the Asian context the heterogenous informal sector with its large diversity of credit arrangements should not be neglected. The significance of non-formal mechanisms for industrial financing is difficult to assess since very limited research has been done in this field. The available findings suggest that non-formal financing is an important complement to formal financing as a source of working capital for small and cottage industries in Asian developing countries. There are also indications that informal hire-purchase and leasing companies may be an important source of finance for fixed investments, e.g. for second hand machinery (Ghate, 1988, p. 67). The bulk of such small-scale financing goes, however, to agriculture, trade, housing and consumption expenditure and less into industries. The basic characteristics of informality are a high degree of flexibility in interest rates, collateral requirements, maturity period and debt rescheduling and the prevalence of face-to-face deals. Informal credit markets operate outside the purview of regulations on capital, reserve and liquidity requirements, ceilings on lending and deposit rates, mandatory credit targets and audit and reporting requirements that are imposed on the formal sector. The informal credit sector is extremely heterogenous and lenders can be friends and relatives, input dealers and output traders, equipment suppliers, professional money lenders, pawnbrokers and mutually organized groups such as rotating savings and credit associations. In most cases the clients are personally known to the lender which reduces the transaction costs of informal credits. (ADB 1990, pp.190 ff.).

In general, lending rates are higher in the informal than in the formal sector. Although transaction costs in the informal sector are comparatively low they form a substantial part of the credit costs given the predominantly small amounts that are borrowed. Despite the fact that informal finance is generally more costly than formal credits there is a high demand in virtually all Asian developing countries except the four NIEs where access to formal financing has much improved. Other elements of a loan package often compensate for the higher interest rates as compared to formal credits. Such elements are quick disbursement and easy contact with the lender, fewer collateral requirements and a high flexibility in repayment scheduling. Informal lenders tend to rely to a larger extent on own funds than formal sector institutions but certain types of lenders do also accept deposits and thus intermediate between savings and investments.

Informal credit markets contribute to stimulating net savings by offering higher returns on deposits than the formal sector, on the basis of their flexibility in borrowing rates and lower transaction costs. Within the framework of credit associations and credit unions small amounts are mobilized which would otherwise in most cases be spent on consumption. Also to the extent that intermittent and regular lenders provide own funds that would otherwise lie idle net savings are effectively mobilized.

However, informal credit markets can also have undesired effects for which they are traditionally regarded with ambivalence by most governments. Money lenders have a bad reputation for usury in most countries particularly when markets are not competitive and monopoly rents can be obtained. Informal sector lending is sometimes channeled into sectors with extremely high private but low social returns such as speculation in land etc. Central banks often regard the informal sector as undermining the effectiveness of their credit and monetary policy. Informal lenders escape regulations with respect to depositor security and prudent management which are imposed on the formal sector. There seems to be an optimal degree to which depositor security and prevention of usury should be pursued without affecting the macro-economically positive impact of informality (Ghate 1988, pp. 69 ff.).

There are strong indications for at least some Asian countries that informal credit markets interact with the formal sector. Linkages apparently exist in both directions. In some countries there is evidence that the formal sector taps informal sector intermediaries for funds. But funds also flow from the formal to the informal sector e.g. when banks replenish funds of moneylenders or credit associations. The informal sector reacts to some extent to the quality and availability of services offered by the formal sector and to monetary policy particularly with respect to interest rate ceilings. In areas where the formal and informal sectors compete interest rates can drop to market rates and usury can be avoided or at least limited.

While it can be assumed that both sectors overlap in certain areas of the credit market where they substitute each other, formal finance is generally better adapted to the needs of large and medium scale industries and informal finance is better in reaching the small and micro entrepreneurs in the unorganized sector (ADB 1990, p. 190). To that extent it plays a useful role in industrial financing and should therefore at least not be hampered by overly strict regulations. As the example of the GRAMEEN Bank of Bangladesh shows, the formal sector could learn from and take over some of the mechanisms of informal credit markets to improve small industries financing schemes.

Financial dualism is likely to become less pronounced as the formal sector is being progressively liberalized. When interest rates can move closer to market rates and there is less direct control over credit allocation, the position of the formal sector vis-à-vis informal lenders is strengthened. In most Asian countries, the formal sector has been drastically expanded (rural banking) and has partly displaced informal lenders in areas where they compete. On the other hand, the Philippines provide an examples where the informal sector has regained lost ground due to the decreasing resources available to the formal sector in the wake of the economic crisis beginning of the 1980s (PIDS 1989, pp. 14 ff.).

B. The Development of Securities Markets

In the following section, a detailed stock-taking is undertaken of the emergence and status of securities markets in the region. For many reasons, securities markets deserve particular attention as mechanisms for allocating capital for long-term financing. The analysis so far has already given some indications of the growing significance of securities markets. They play a critical role in many dimensions of industrial financing:

- stock markets help to broaden the equity base of growing industrial enterprises and hence reduce their dependence on bank credit;

- the corporate bond market provides long-term finance which is insufficiently offered by commercial banks;

- DFIs can refinance their activities from securities markets and hence reduce their dependence on subsidized funds from governments and central banks;

- for managers of venture capital funds, functioning stock markets provide an easy exit opportunity to realize profits from the investments undertaken;

- foreign portfolio investments are attracted by mature and well-performing stock markets;

- privatization of public enterprises is facilitated through large stock markets;

- the bank-oriented financial system becomes more competitive; and

- monetary policy gets more leeway when the financial system is progressively deregulated.

Although a remarkable growth of the Asian securities markets has been observed in recent years they have, with few exceptions, remained underdeveloped. Securities markets will become a much more important segment of the financial market as economies reach a higher level of industrial development. Therefore, their prospects and constraints are reviewed below in detail, on the basis of the experience of selected economies in the region.[12] Primary and secondary markets are reviewed separately, although they are tightly linked to each other. (The technicalities of their regulatory structure are reviewed in Annex II of this report.)

1. Primary Market Activities

The primary market mobilizes individual savings for productive activities of the public and private sectors, while the secondary market facilitates the exchange of securities among investors. The primary market cannot function properly without an efficient secondary market which, in turn, requires the efficient operation of the primary market. In the countries reviewed here, securities are available in the form of common equities, preferred stocks, rights issues, warrants, public-sector bonds, corporate bonds, and convertible instruments. Rights issues and warrants gained popularity in recent years as a hybrid form of equity financing.

Primary market activities in the selected countries can be characterized as follows: (a) the corporate debt market has not been fully developed largely due to the dominance of commercial banking in the credit market and government control over the interest rate structure; (b) government securities tend to dominate primary markets, with the exception of Hong Kong; and (c) hybrid forms of financing such as rights issues, warrants, and convertible debt have become popular in countries with well-developed equity markets.

In **Hong Kong**, the total amount of newly raised capital in 1989 amounted to US$2.78 billion. Of this amount, common equity shares, including rights offerings, accounted for US$2.05 billion or 74 per cent. The remainder was almost equally divided among investment companies securities (US$270 million), debt securities (US$256 million), and warrants (US$204 billion). Several interesting points can be noted about the primary market in Hong Kong. First, the market for government securities is insignificant largely due to the budget surplus of the Hong Kong government. Second, corporate debt securities have gradually gained popularity even though the absolute magnitude of debt

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[12] These include Hong Kong, India, Indonesia, Republic of Korea, Malaysia, the Philippines, Singapore, Taiwan Province and Thailand.

securities is less than one per cent of the market capitalization of the Hong Kong securities market. Third, warrants were introduced for the first time in 1989 and were accepted readily by the public. Fourth, foreign companies issued approximately 20 per cent of newly raised capital in 1989, indicating Hong Kong's role as a regional or international financial center.

In **India**, US$0.62 billion in equity capital was raised in 1989, along with US$2.67 billion through the issue of corporate debentures and US$3.09 billion in investment companies shares. The combined total represents approximately 17 per cent of India's total market capitalization. Approximately 80 per cent of corporate debentures are convertible issues. One encouraging aspect is that the smaller equity issues of up to US$1.76 million (or Rs. 30 million, which is the legal minimum for listing on the stock exchanges) continue to constitute a sizable segment of the new issues market. According to the Securities and Exchange Board of India (SEBI), these issues accounted for more than 70 per cent of the total number. In addition, a total of US$2.64 billion was raised by new issues of public sector bonds. Including public sector bonds, the total amount of resources raised from the Indian capital market in 1989 was US$9.08 billion, an 80 per cent increase over the previous year. Unfortunately, public-sector bonds have little impact on the Indian securities market because they are not widely owned by the general public. Approximately two-thirds of government securities are held by commercial banks to meet the statutory liquidity ratio imposed by the RBI, while 20 per cent are held by the RBI itself.

Rights offerings and convertible bonds became popular instruments in the primary market in many countries, including the Republic of Korea, Malaysia, and Singapore. Korean private corporations raised a total of US$31.82 billion in 1989. Rights offerings amounted to US$16.37 billion or 51 per cent of the total, followed by common equity with US$5.22 billion (16 per cent) and corporate debt securities with US$10.24 billion (32 per cent). Approximately 80 per cent of debt securities are convertible issues. The primary market in Malaysia is also dominated by rights offerings. Of the total amount raised in 1989 (US$914 million), rights offerings accounted for 86 per cent or US$784 million. The remainder were common equity issues. In Singapore's primary market, a total of US$1.77 billion was raised in the form of common equity (US$202.91 million), rights offerings (US$366.03 million), and corporate debt securities (US$1.20 billion).

The above brief overview of the primary market activities suggests that many factors inhibit the supply of securities to the securities markets. These specifically include:

- First, the non-securities markets in most countries of the region are better organized than the securities markets. Thus, industrial firms in the region usually rely on short-term borrowing from various financial intermediaries as their major source of financing.

- Second, tax incentives for going public are not strong enough to overcome the traditional preference for family ownership and the fear of financial disclosure required by publicly-owned firms. Additionally, the pricing formula employed by the regulatory agencies fails to reflect the value of assets and earnings potential of the issue company.

- Third, the underwriting business is not competitive because there are not many privately owned merchant banks, while a few financial institutions designated by the government monopolize this service.

- Fourth, the dominance of the public sector has been a major factor hampering the supply of securities to the market.

There is, furthermore, a number of factors contributing to the lack of demand for securities:

- First, the lack of adequate investor protection may be cited as the main reason why the demand for securities in the market is insufficient.

- Second, the controlled interest rate structure very often distorts the efficient allocation of resources, making investment instruments offered by non-securities market financial intermediaries more attractive than investments in common equities and corporate bonds.

- Third, the demand for securities could be significantly increased if institutional investors were encouraged to play a greater role in the market.

2. Secondary Market Activities

a. An Overview

At the end of 1989, a total of 8,117 companies was listed at the organized stock exchanges of the nine selected countries, with a total market capitalization of US$609 billion. This was approximately 66 per cent of the aggregate GNP at current prices (see Table 14). This ratio is comparable to the New York Stock Exchange's 58 per cent, but it is much lower than the Tokyo Stock Exchange's 156 per cent. The ratio of annual turnover to market capitalization was 195 per cent. This figure is misleading, however, because of the unusual trading volume at the Taiwan Stock Exchange (TSE) with a 408 per cent turnover ratio. Excluding Taiwan Province (whose turnover volume accounted for 81 per cent of the selected countries' total), the ratio of annual turnover to market capitalization drops from 195 per cent to 60 per cent. This adjusted figure is comparable to the ratios computed for the New York and Tokyo markets, 51 and 55 per cent, respectively.

The total number of listed companies in the region cannot be taken at face value, as it is inflated by a large number of untraded companies in India. India reported 6,250 listed companies, or 77 per cent of the selected countries' total. Although a large number of companies are listed at the Indian stock exchanges to take advantage of lower rates of corporate income tax, many of them are not traded at all. The 10 most actively traded stocks accounted for more than 50 per cent of the total trading volume and the top 25 companies for more than 70 per cent. Very often, new companies raise funds in the Indian market before they begin operation. A lack of proper quality control over the listing process and the unavailability of sufficient financial information may explain the illiquidity of the remaining listed securities. As a result, no more than 800 companies in India may be considered as safe investments according to the securities industry's unofficial estimate. Only 621 large non-financial, non-public companies are monitored annually by the Reserve Bank of India (RBI) for their financial performance. The number of listed companies was the second highest in the Republic of Korea (626), followed by Hong Kong (298), Malaysia (251), and Taiwan Province (181). Only 56 companies were listed at the Jakarta Stock Exchange (JSE) of Indonesia.

Table 14. Stock exchange estatistics of selected Asian developing countries, December 1989

	Hong Kong	India	Indonesia	Rep. of Korea	Malaysia	Philippines	Singapore	Taiwan Prov.	Thailand	Total
Number of Listed Companies	298	6,250	56	626	251	144	136	181	175	8,117
Total Market Capitalization (US$ billion)	77.6	38.2	2.5	140.5	39.8	11.6	35.9	237.0	25.9	609.0
Annual Turnover Value (US$ billion)	34.6	32.0	0.5	119.3	6.9	2.3	14.1	965.8	14.7	1,190.2
Annual Turnover Value/ Market Capitalization	44.6	83.9	21.2	84.9	17.3	19.5	39.3	407.5	56.6	195.4 (a)
Market Capitalization/ GNP	140.5	14.8	2.9	67.7	112.5	27.2	120.7	155.6	39.5	66.0 (a)

Note: (a) Value-weighted average
Source: Fact Books from the Region's Stock Exchanges.

Although Taiwan Province had a moderate number of listed companies, their combined market capitalization is the highest in the region at US$237 billion, or 156 per cent of GNP. The Republic of Korea's market capitalization was US$141 billion, or 68 per cent of GNP. Hong Kong, Malaysia, India, and Singapore followed with US$78 billion, US$40 billion, US$38 billion, and US$36 billion, which represented 140 per cent, 113 per cent, 15 per cent, and 121 per cent of GNP respectively. Indonesia's market capitalization is US$2.51 billion, which was less than three per cent of GNP. Slightly higher ratios are observed for the Philippines (27 per cent) and Thailand (40 per cent). On the basis of the ratio of market capitalization to GNP, it may be concluded that the role of securities markets in Indonesia, India, the Philippines, and Thailand has a large scope for further expansion.

Taiwan Province's ratio of annual turnover volume to market capitalization was 408 per cent, while Malaysia reported the lowest ratio of 17 per cent. It appears that the observed ratios are an inverse function of transaction costs, which include brokerage fees, stamp taxes, exchange taxes, and registration fees. For an investment of US$100,000, transaction costs in Taiwan Province are on average only 150 dollars or 0.15 per cent, whereas Malaysian investors have to pay US$1,400 or 1.40 per cent. In fact, Malaysia is one of the most costly markets for trading in the region, while Taiwan Province is the least costly.

b. Industrial Financing

The selected countries have a highly diverse economic structure as evidenced by the figures on industrial origin of GDP (Table 15). The contribution of the primary sector to GDP was insignificant in Hong Kong, Singapore, and Taiwan Province, ranging from 0.4 per cent to 5.4 per cent in 1989. Both the Republic of Korea and Thailand showed a modest contribution of the primary sector to GDP, 10.8 per cent and 19.9 per cent, respectively. In contrast, the primary sector's share of GDP was significant in Indonesia, India, Malaysia, and the Philippines, reflecting the relative importance of agriculture and mining and quarrying in these countries. It is not surprising that the secondary sector's contribution to the GDP of Republic of Korea and Taiwan Province was the highest among the nine countries under review with 43.4 per cent and 43.2 per cent, respectively. India and Indonesia showed the smallest contribution, 21.4 per cent and 24.1 per cent. Below, the contribution of securities markets to industrial financing is reviewed for the nine selected countries.

A significant imbalance is noted when GDP by industrial origin is contrasted with market capitalization by industry at the Stock Exchange of **Hong Kong** (SEHK). While the manufacturing industry's contribution to GDP was 20.35 per cent, manufacturing firms accounted for only 5.80 per cent of the SEHK's total market capitalization. The SEHK's market capitalization by industry is summarized below in Table 16 (as of December 1989).

Table 15. GDP by industry origin for selected Asian developing countries, 1989

	Hong Kong	India (a)	Indonesia (b)	Rep. of Korea	Malaysia	Philippines	Singapore	Taiwan Prov.	Thailand
Primary Sector	0.41	33.28	35.70	10.84	30.55	25.16	0.46	5.37	19.92
Agriculture	0.35	30.53	24.09	10.22	20.25	23.45	0.34	4.93	16.90
Mining	0.06	2.75	11.61	0.62	10.30	1.71	0.12	0.44	3.02
Secondary Sector	27.73	21.36	24.13	43.39	30.70	31.56	36.95	43.19	32.05
Manufacturing	20.35	19.20	18.52	31.25	25.60	24.96	29.69	35.67	24.41
Utilities	2.47	2.16	0.60	2.43	1.85	2.24	2.03	3.01	2.56
Construction	4.91	5.80	5.01	9.71	3.25	4.36	5.23	4.51	5.08
Tertiary Sector	71.86	45.36	40.17	45.77	38.75	43.28	62.59	51.44	48.03
Trade	24.63	12.49	17.33	11.86	10.59	19.48	17.59	14.91	15.84
Transportation & Communications	9.10	6.56	5.78	6.98	6.66	5.01	13.47	6.22	7.29
Finance	18.61	8.37	6.45	10.70	9.07	7.03	29.71	17.23	7.69
Public Administration	14.55	6.12	6.77	7.32	11.41	6.03	1.81	9.95	3.84
Others	4.97	6.01	3.84	8.90	1.03	5.39	-	3.12	13.36

Notes: (a) As of 1987
(b) As of 1988

Source: Key Indicators of Developing Asian and Pacific Countries, Volume XXI (July 1990), Asian Development Bank.

Table 16. SEHK's market capitalization by sector, as of December 1989

Classification	Number of Companies	Market Capitalization (US $ million)	Per Cent
Finance	39	11.46	14.77
Utilities	9	14.02	18.08
Properties	89	20.33	26.21
Consolidated Enterprises	73	23.36	30.11
Industrials	66	4.50	5.80
Hotels	14	3.09	3.99
Others	8	0.81	1.04
Total	298	77.57	100.00

Source: Stock Exchange of Hong Kong.

Note that utility companies are over-represented in the Hong Kong market, accounting for almost one-fifth of total market capitalization, whereas their contribution to GDP is only 2.5 per cent. These are usually large enterprises for which the stock exchange is an important financial intermediary.Hong Kong's industrial production activities on the other hand are concentrated in areas such as wearing apparel; plastic products; electrical and electronic goods etc., which are dominated by small- and medium-size companies, and the organized market in Hong Kong has not been a major avenue for raising capital for them. An institutional framework for an over-the-counter market and/or a second board should be introduced for small-size industrial companies to provide access to securities markets.

A recent study by the Industrial Development Bank of India (IDBI) based on 401 manufacturing firms shows the sources of funds in 1989 (Table 17).• It

Table 17. Profile of financing sources of Indian manufacturing firms, 1989

Sources of Funds	Amount (US$ billion)	Per Cent
Internal	2.31	51.3
a. Paid-Up Capital	0.05	1.1
b. Reserves and Surplus	1.11	24.7
c. Depreciation	1.15	25.6
External	2.19	48.7
a. Paid-Up Capital	0.16	3.6
b. Long-Term Borrowing	1.03	22.9
Debentures	0.32	7.1
Borrowing from Banking Institutions	0.71	15.8
c. Short-Term Borrowing	1.00	22.2
Total	4.50	100.0

Source: Industrial Development Bank of India.

emerges that most funds were made available by commercial banks and development finance institutions. The contribution of the securities market was extremely limited. Summing up debentures and paid-up capital from external sources, it appears that an approximate maximum of 10 per cent was generated from the securities market. In fact, this situation is typical of developing economies in the Asian-Pacific region.

The household sector is traditionally a surplus unit in the Indian economy. Gross savings in financial assets of the household sector have usually ranged from 10 to 12 per cent of GNP since 1982, reaching 12.3 per cent in 1989. The bulk of the resources of the household sector was directed to banks (45.3 per cent), government (11.2 per cent), and life insurance funds and pension funds (24.8 per cent). Investment in shares and debentures plus the Unit Trust of India (UTI) units amounted to only 7.2 per cent of the total gross savings of the household sector (Table 18). The breakdown has changed very little over time. The Indian securities market will have to catch up with commercial banks and other financial institutions in order to increase its share of household savings.

Table 18. Household savings in India, 1989

Classification	Amount (US$ billion)	Per Cent
Gross Savings in Financial Assets	US$23.8	
a. Currency		11.1
b. Bank Deposits		40.4
c. Non-Banking Deposits		4.9
d. Life Insurance Funds		7.0
e. Provident/Pension Funds		17.8
f. Claims on Government		11.2
g. Investment in Shares and Debentures		4.2
h. UTI units		3.0
i. Trade Debt (Net)		0.4
Total		100.0
Financial Liabilities	US$6.0	
Net Savings in Financial Assets	US$17.8	

Source: Reserve Bank of India.

The **Korea** Stock Exchange's (KSE's) market capitalization of manufacturing companies far exceeded their reported share of the country's GDP. Korea's secondary sector accounted for 60.54 per cent of total market capitalization in 1989 as opposed to 43 per cent of the secondary sector's contribution to GDP. Below, the market capitalization by industry is summarized for 625 companies listed at the KSE (Table 19).

The Republic of Korea has a fairly large bond market both for government bonds and corporate bonds. At the end of 1989, the total amount of listed bonds at the KSE amounted to US$63.99 billion, which was slightly less than one-half of the market value of common equities. Of this amount, corporate bonds accounted for 33 per cent or US$22.65 billion. In the past, Korean manufacturing firms relied heavily on debt financing. As the equity market has developed steadily, the amount of debt financing has declined. According to KSE's survey, the average equity financing ratio of 486 listed companies in 1989 was 33.2 per cent, compared to only 19.8 per cent in 1983.

Table 19. Market capitalization by sector in the Republic of Korea, 1989

Classification	Number of Companies	Market Capitalization (US$ million)	Per cent
Primary Sector	10	666.09	0.47
Fishing	7	488.52	0.35
Mining	3	177.57	0.13
Secondary Sector	465	84,043.24	59.82
Foods & Beverage	41	2,069.49	1.47
Textiles, Wearing Apparel & Leather	64	3,678.18	2.62
Wood & Wood Products	7	608.88	0.43
Paper & Paper Products	22	1,151.72	0.82
Chemicals	103	12,206.33	8.69
Non-Metallic Minerals	16	2,998.32	2.13
Basic Metals	33	9,595.30	6.83
Fabricated Metals & Machinery	130	23,075.31	16.42
Other Products	6	291.87	0.21
Electric & Gas	1	19,693.00	14.02
Construction	42	8,674.84	6.17
Tertiary Sector	151	55,780.27	39.70
Wholesale & Retail	50	7,248.31	5.16
Transportation & Storage	14	2,143.78	1.53
Communication	1	216.86	0.15
Finance	73	44,491.91	31.67
Insurance	12	1,671.57	1.19
Recreation	1	7.84	0.00
Total	626	140,489.66	100.00

Source: Korea Stock Exchange.

Summary statistics on financial assets held by individual investors in the Republic of Korea as of 1989 indicate the increasing role of the securities industry (Table 20). Individuals' holdings of securities amounted to US$55.19 billion or 26 per cent of total financial assets. Individual investors also participated in the securities market indirectly through investments in life insurance and pension funds, which represented 18 per cent of the total.

Market capitalization by industry for all 251 companies listed at the Kuala Lumpur Stock Exchange (KLSE) of **Malaysia** is summarized in Table 21. Industrial firms represent approximately two-thirds of total market capitalization, compared with a 30.70 per cent contribution of the secondary sector to GDP. This figure is based upon summary statistics available at the end of December 1990 rather than December 1989, since the 1989 figures included 53 Singaporean companies that were delisted from the KLSE.

Table 20. Financial assets held by individual investors in the Republic of Korea, 1989

Classification	Amount (US$ billion)	Per Cent
Currency and Demand Deposits	8.72	4.11
Time Deposits	96.61	45.56
Life Insurance & Pension Funds	37.99	17.91
Securities	55.19	26.02
Short-Term Securities	5.33	2.51
Long-Term Securities	27.67	13.05
Equity	22.19	10.46
Others	13.56	6.39
Total	212.07	100.00

Source: Korea Stock Exchange.

Table 21. Market capitalization by sector in Malaysia, 1990

Industry	Market Capitalization (US$ million)	Per Cent
Industrials	33,282.66	68.52
Finance	4,751.52	9.78
Hotels	472.38	0.97
Properties	3,514.86	7.24
Oil Palm	3,584.53	7.38
Tins	645.24	1.33
Rubber	2,156.80	4.44
Unit Trusts	124.41	0.26
Second Board	42.84	0.09
Total	48,575.24	100.00

Source: Kuala Lumpur Stock Exchange.

Major sources of funding for Malaysian manufacturing firms listed in the stock market are indicated in Table 22. The relative share of equity financing increased from 51.24 per cent in 1985 to 59.46 per cent in 1989 of total funding for Malaysian manufacturing firms.

Table 22. Sources of funding for manufacturing firms in Malaysia, 1989
(percentage)

Sources of Funding	Year 1985	1987	1989
Short-Term Debt	30.96	28.69	27.63
Long-Term Debt	17.80	17.26	12.91
Equity	51.24	54.05	59.46
Total	100.00	100.00	100.00

Source: Kuala Lumpur Stock Exchange.

The extremely low debt-equity ratio of listed companies should, however, not obscure the fact that the bond market is still underdeveloped in Malaysia. Few of the firms not listed in the stock market have easy access to the bond market, which is to a large extent usurped by government bonds.

Market capitalization of **Philippine** industrial companies was US$2,744 million in 1989 or 23.64 per cent of the total (Table 23). The overall contribution of the secondary sector to GDP was 31.56 per cent, which implies that industrial companies were under-represented in the Philippine securities market. The financial sector accounted for more than half of total market capitalization, indicating a significant imbalance in the development of the local capital market.

Many Philippine corporations exhibit a high dependency on debt financing with an average debt ratio of 70-75 per cent. Because of the tradition of family ownership and the lack of investor confidence in the securities market, equity capital is not considered an important source of funds by many industrial firms. Banks extend credits despite the high risk of default. The most undesirable corporate practice is the use of short-term borrowing from banks for long-term investment. Many corporations engage in short-term borrowing so as not to be locked into long-term obligations at high interest rates.

Table 23. Market capitalization by sector in the Philippines, 1989

Classification	Number of Companies	Market Capitalization (US$ million)	Per Cent
Industrial	39	2,743.56	23.64
Mining	40	846.59	7.29
Oil Exploration	23	193.15	1.66
Finance	20	6,358.23	54.78
Communication	6	904.57	7.79
Real Estate	6	439.21	3.78
Hotels	5	13.32	0.11
Others	5	108.00	0.93
Total	144	11,606.63	100.00

Source. Makati Stock Exchange.

The Stock Exchange of **Singapore** (SES) reported market capitalization by industry as of December 31, 1989. Unfortunately, market capitalization of industrial companies only is not readily available (Table 24).

Table 24. Market capitalization by sector in Singapore, 1989

Classification	Number of Companies	Market Capitalization (US$ million)	Per Cent
Industrial and Commerce	83	18,595.36	51.76
Finance	21	9,137.96	25.44
Hotels	17	2,904.75	8.09
Property	15	5,286.43	14.72
Total	136	35,924.50	100.00

Source: Stock Exchange of Singapore.

High debt ratios are also common in other Asian countries, particularly in Japan, Korea, and **Taiwan Province**. The average debt ratio of TSE-listed companies was 83.60 per cent in 1988, which was slightly lower than the 86.18 per cent observed in 1987. Although the return on assets (= net profits/total assets) was only 3.40 per cent, the return on equity (= net profits/net worth) was magnified to 20.72 per cent by extremely high financial leverage. The growth of stock markets has been supported by a buoyant public demand for corporate stocks.

Financial assets held by households in Taiwan Province in 1989 indicate that time and savings deposits with banks and investment in corporate common equities are equally important financial assets. The two items accounted for 28.65 and 28.89 per cent of the total assets, respectively. Lending to other households was surprisingly large, representing 12.48 per cent of total assets. This indicates the popularity of privately arranged financing in the Chinese community.

The ratio of market capitalization to total bank deposits in **Thailand** was 58 per cent in 1989, compared with only 25.0 per cent in 1988. This indicates the Stock Exchange of Thailand's (SET's) rapid growth relative to the commercial banking sector. The Thai government has implemented policies to promote equity financing by industrial firms, including tax measures. Listed companies pay a 30 per cent income tax rate as opposed to a 35 per cent rate paid by unlisted companies. The effective period of business tax exemption on the sale of securities has been extended to the end of 1990. Only listed companies are allowed to issue debentures and commercial papers, and to offer rights issues. However, the prohibition against issuing debt instruments by unlisted companies had the unintended effect of promoting the credit business of commercial banks because many private corporations tend to rely more on the short-term debt financing available from this source.

The remarkably high level of equity financing of Thai industrial enterprises is indicated by the financial leverage of selected manufacturing industries listed on the SET (Table 25).

Table 25. <u>Financial leverage of selected manufacturing industries in Thailand, 1988</u> (percentage)

Industry	Debt Ratio	Total Debt/ Equity	Long-Term Debt/Equity
Food & Beverage	71.59	252	19
Automotive	61.38	159	6
Electric Equipment	50.98	104	12
Packaging	60.16	151	35
Textiles	50.25	101	9

<u>Source</u>: The Bank of Thailand.

From the reported statistics, the importance of short-term debt financing is evident. It is further obvious that the long-term bond market has yet to be developed for industrial financing.

c. Automated Trading System

Automation of securities markets can bring both benefits and costs. An automated trading system enhances market efficiency through timely dissemination of financial information; strengthens international competitiveness through better operating efficiency; improves market surveillance by alerting the organized exchanges and regulatory bodies to any unusual movements in securities prices; and increases trading volume through computerized order-routing, matching, price determination, and clearing and settlement. Unfortunately, with enhanced trading volume and operating efficiency, the magnitude of systemic risks as well as market volatility also increase. To contain the systemic risks at a manageable level, the regulatory bodies must pay attention to many issues, including: (a) capital adequacy of securities companies; (b) circuit breaker systems; (c) margin regulations; and (d) block trading.

With the exception of India, Indonesia, and the Philippines, stock exchanges in the other selected countries have been modernizing their operational trading facilities,as the summary below shows:

- The SEHK is currently considering the adoption of a completely automated trading system which will provide all the necessary features for automated matching, trade execution, and dissemination of company information to brokers and investors. The proposed system will be implemented along with a new centralized clearing system which is expected to be operational towards the end of 1991.

- The KSE introduced its automated trading system, SMATS, in March 1988. By the end of June 1990, the capacity of SMATS had been expanded to handle 94 per cent of the total trading volume. The new system now handles more than 250,000 quotations daily, but the planned augmentation will enable the system to handle as many as 1.2 million quotations per day by the end of 1994.

- KLSE's new system, SCORE, installed in November 1989, is a semi-automated trading system. Orders are routed to KLSE's matching room to be manually matched by KLSE staff.

- The SES introduced a new trading system, CLOB, in July 1988. This new system was initially introduced for SESDAQ transactions and cash transactions on the main board. Beginning in March 1989, this was extended to regular transactions of the main board securities. As a result, about 95 per cent of total transactions on the SES market were handled by CLOB. After all Malaysian companies on the SES were delisted, SES established an over-the-counter market known as CLOB International for trading in shares of the Malaysian companies, 12 Hong Kong companies, and one Philippine company. Trading on CLOB International is done through the existing CLOB system in operation.

- The TSE adopted its computer trading system, CATS, in August 1985 on an experimental basis. Beginning in September 1988, all the listed stocks were traded through CATS. CATS is semi-automated in the sense that the matching of buy and sell quotes is executed by the matching staff in the TSE matching room, while data transmission, data summaries, and file updates are performed by CATS. According to a seven-year computerization plan, TSE expects to connect 3,900 trading terminals, with a trading capacity of 2.3 million trades and a trading value of US$16.05 billion per day (the largest number of daily stock trades recorded in 1989 was approximately half a million with a trading value of US$7.34 billion).

- SET is in the process of introducing the automated trading system, ASSET, with a target completion of 1991.

India, Indonesia, and the Philippines rely on an open outcry system for the trading of securities. They are the only countries in the region reviewed here which will have traditional trading floors for the foreseeable future. It is not quite clear whether a completely automated trading system will be beneficial for these countries considering the trading volume and the limited financial resources available for exchange member companies. In India, the trading volume of the three stock exchanges in Bombay, Calcutta, and Delhi may justify the automation of the trading system, but the real benefits are questionable in other, smaller stock exchanges. In all three countries, there are many issues to be resolved before introducing an automated trading system. These issues are related to: (a) improvement of the financial and operational strength of securities companies; (b) improvement in regulatory processes; (c) introduction of a wider range of financial products; (d) problems associated with thin trading; and (e) improved primary market activities.

d. Unit Investment Companies and Managed Investment Companies

There are two types of investment companies: unit investment trusts holding a fixed portfolio of assets; and managed investment companies holding portfolios which are reallocated from time to time. Investment companies are further classified into open-end investment companies (or mutual funds) and closed-end investment companies depending upon redeemability. Unlike mutual fund shares, shares issued by closed-end investment companies are not redeemable and can be liquidated only through sale in the secondary market. Both mutual fund shares and securities issued by unit investment trusts are redeemable, and they are always worth the current market value of underlying net assets. All three forms of investment companies are available in the selected countries. They have a strong influence on the securities markets in Hong Kong, India, Republic of Korea, Malaysia, Singapore, and Thailand.

In **Hong Kong**, as of December 1989, there were more than 700 trusts authorized by the SFC, but only about 300 funds were actively marketed. In the Asian and Pacific region, Hong Kong is ranked second after Japan in terms of number and size of funds. Most of the trading in Hong Kong is for pure investment purposes, and not for financing of local manufacturing and production activities.

UTI of **India**, P. T. Danareksa of **Indonesia**, and the Mutual Fund Company (MFC) of **Thailand** were authorized to act as financial institutions monopolizing the investment company business. The UTI has been mobilizing a significant amount of resources in the local securities market and channelling foreign investment funds into the Indian capital market. The UTI is a joint venture of IDBI, the State Bank of India (SBI), and other financial institutions. The UTI had US$2.70 billion in assets in 1989, of which about one-third was in equity shares. Unlike the operation of UTI and MFC of Thailand, P.T. Danareksa's performance has not been very successful. Three reasons may be cited. First, Danareksa has maintained a policy of paying a guaranteed dividend of 18 per cent per year to investors. Second, the Indonesian securities market does not provide the kind of depth and breadth that justifies a substantial investment company business. Third, the general public does not have confidence in the local securities market. In all three countries, it appears to be a matter of time only before private mutual fund business will be allowed. In fact, there is no reason why the mutual fund business should be monopolized by government-supported institutions. With the introduction of private initiative in mutual fund business, the governments of the three countries should redirect the existing organizations to specialize in unlisted companies, OTC stocks, or small-size companies for their portfolio investment.

The **Korea** Investment Trust Company (KITC), the first management company specializing in the investment trust business, was established in 1974. At present, there are 14 management companies in the country, of which eight specialize in equity investment trusts while the remaining six are allowed to manage bond funds. At the end of 1990, investment trust companies held US$6.88 billion worth of equities and US$18.17 billion worth of bonds. These figures accounted for 6.27 and 21.9 per cent of the market capitalization of equities and bonds, respectively.

The **Malaysian** government established the National Equity Corporation with total assets of M$8 billion (US$2.96) and the National Unit Trust Corporation with total assets of M$4 billion (US$1.48) to enhance the economic welfare of the bumiputra. The two institutions receive priority placement of newly issued shares at discounted prices for the bumiputra. A relatively high yield on investment can be achieved easily through the privilege of discounted purchases of new issues, so there is no incentive for sound portfolio management. The two institutions tend to hold shares on a long-term basis, contributing to the "thinness" of the KLSE market. (The combined assets account for approximately 11 per cent of the total market capitalization of the KLSE.) Because of market thinness, there may be large fluctuations in stock prices. Private-sector unit investment trusts have existed since 1959 in Malaysia, but they have performed poorly. Unlike the government-owned unit investment trusts, private trusts face complicated procedures in the creation of unit trusts, high management fees, numerous restrictions on portfolios, and a limited sales network.

Four investment management companies have been active in **Taiwan Province** in mutual fund as well as closed-end investment company business. They are: (a) International Securities Investment Trust Company; (b) Kwang-Hua Securities Investment Trust Company; (c) National Securities Investment Trust

Company; and (d) China Securities Investment Trust Company. The four companies established four mutual funds and four closed-end investment companies raising a total of NT$26.5 billion (or US$1.01 billion).

The MFC was instrumental in attracting a large amount of foreign capital into **Thailand** through offshore (US$192 million) and onshore investment funds (US$220 million). Its total assets amounted to US$4.62 million. It manages 12 funds with US$621.53 million in assets and also manages 85 provident funds with combined assets of US$16.62 million.

e. Internationalization of Securities Markets

The internationalization of securities markets provides an alternative source of funds for industrial companies in the region. Numerous policy measures have been adopted by government authorities to help local companies tap foreign sources of funding. They include: (i) establishment of investment companies for foreign investors; (ii) direct foreign borrowing; and (iii) direct foreign participation in local securities markets. The four-stage plan for the internationalization of the Republic of Korea's capital market is a good example of the gradual opening of the region's securities markets. The plan proceeds according to the following stages:

- stage one: to authorize international investment trusts and to prepare for the opening of the securities markets;

- stage two: to allow foreigners to invest in Korean securities on a direct but limited basis;

- stage three: to gradually lift restrictions on foreign investment and to allow foreign offerings by domestic corporations; and

- stage four: to allow domestic investors to invest in foreign securities.

(i) Investment Companies

In October 1981, the **Korean** government approved the establishment of international investment trusts exclusively for foreign investors. Since that time, a total of US$595 million has been raised through 13 investment companies as summarized in Table 26.

Three investment trust companies (KPT, DAT, and SAIT) invest in both Korean and foreign securities in a matching scheme. Additionally, two closed-end investment companies, the Korea Fund and the Korea-Europe Fund, were launched in New York and London in 1984 and 1987, respectively. A total amount of US$260 million was raised. The investment policy of these two funds stipulates that at least 80 per cent of their net assets be invested in the securities listed on the KSE. The balance of the net assets is normally invested in short-term debt securities of the Korean government and other Korean financial instruments.

Table 26. International investment trusts established in the Republic of Korea

Funds	Issuer	Amount (US$ million)	Beginning Date	Termination Date
KIT	KITC	25	1981	2001
SIT	KITC	30	1985	2005
KSCT	KITC	2	1985	1996
KET	KITC	50	1990	2010
KPT	KITC	100	1990	2010
KT	DITC	25	1981	-
ST	DITC	30	1985	2005
KECT	DITC	3	1986	1997
DKT	DITC	50	1990	2010
DAT	DITC	100	1990	2010
KGT	CIMTC	30	1985	2005
KNT	CIMTC	50	1990	2010
SAIT	CIMTC	100	1990	2010
Total		595		

Notes: KITC = Korea Investment Trust Co.
DITC = Daehan Investment Trust Co.
CIMTC = Citizens Investment Management Trust Co.
KIT = Korea International Trust
SIT = Seoul International Trust
KSCT = Korea Small Company Trust
KET = Korea Equity Trust
KPT = Korea Pacific Trust
KT = Korea Trust
ST = Seoul Trust
KECT = Korea Emerging Companies Trust
DKT = Daehan Korea Trust
DAT = Daehan Asia Trust
KGT = Korea Growth Trust
KNT = Korea 1990 Trust
SAIT = Seoul Asia Index Trust

Currently, foreign investors are not allowed to invest in **Indian** securities with the exception of non-resident Indians. Two investment companies have been launched abroad for foreign investors for indirect access to the Indian market. Both of these investment companies have been launched by the UTI. The Indian Fund Unit Scheme was the first closed-end investment company listed on the London Stock Exchange. In August 1988, the UTI launched another mutual fund called the India Growth Fund in the U.S. market. India has been one of a few countries in the Asian and Pacific region which has maintained a closed-door policy, with the exception of a few government-directed measures. For example, only non-resident Indians are permitted to buy common equities on the Indian stock exchanges within specified limits. The overall ceiling on total investment has been set at 5 per cent, and individual non-resident Indians are not permitted to hold more than one per cent of the equity of a company.

A total of US$156 million was raised through the launching of four mutual funds of **Taiwan Province** securities in the overseas securities markets (Table 27).

Table 27. Mutual funds launched in Taiwan Province

Name	Amount Issued (US$ million)
Taiwan (ROC) Fund	81
Formosa Fund	25
Taipei Fund	25
Taiwan Trust Fund	25

Source: Taiwan Securities Exchange Commission

Due to the liberal policy towards foreign exchange control, a large number of both closed- and open-end investment companies have been investing in **Malaysian** securities since 1974. At the end of 1989, 44 investment companies held some Malaysian shares in their portfolios; the exact amount is unknown. In contrast with the Republic of Korea and Taiwan Province, most of these funds have been launched by the private-sector fund managers in the U.K., Japan, Hong Kong, and U.S.A.

In **Thailand**, the Mutual Fund Company (MFC) was established as a joint venture of Thai government institutions, including Industrial Finance Corporation of Thailand (IFCT), Government Savings Bank, and the International Finance Corporation of the World Bank. Its objective is to encourage broad public participation in the Thai securities market through mutual funds. In addition to managing domestic mutual funds, the MFC has been actively promoting foreign investment funds for foreign investors. Since 1986, the MFC raised a total of US$500 million using six onshore foreign investment funds, including the Thailand Fund (US$30 million), the Thai Fund (US$115 million), the Thai Euro Fund (US$75 million), the Thai Growth Fund (US$50 million), the Thai Prime Fund (US$155 million), and the Thai International Fund (US$75 million). The initial success of these onshore funds stimulated the launching of three offshore funds with a combined amount of US$167 million. They include the Bangkok Fund (US$42 million), the Thai Investment Fund (US$30 million), and the Siam Fund (US$95 million).

(ii) Direct Foreign Borrowing

Traditionally, direct foreign borrowing in the region was limited to government-owned corporations or development finance institutions. These allocated resources to priority sectors of the economy. As the economies matured, some governments relaxed this policy of directed credit allocation and allowed manufacturing companies in the private sector to borrow directly from overseas. The Republic of Korea provides a good example. Since 1986, the Korean government has allowed 10 local companies to issue convertible bonds to the amount of US$320 million. Because of the conversion feature, the issuers were able to pay relatively low interest rates on these bond issues. More recently, a total of US$120 million was raised by the issue of bonds with warrants, and the first depositary receipts of a local manufacturing company (to an amount of US$40 million)were placed on the Euromarket.

It is expected that similar arrangements will increasingly be seen in Indonesia, Thailand, Taiwan Province, and, in the near future, India.

(iii) Foreign Investment in the Region's Securities Markets

As outlined under III.B.2 above with respect to portfolio investments, most governments of the region have traditionally not allowed foreign investments in domestic securities markets. With the deregulation of financial sectors and the liberalization of cross-border capital flows an increasing number of countries have gradually relaxed the strict regulations:

- Foreign investors are allowed to own shares in listed **Indonesian** companies as a result of deregulation measures approved by the government in December 1987. A maximum of 49 per cent of the share capital can be held by foreigners.

- Beginning in 1990, **Taiwan Province** permitted foreign institutional investors, including banks, insurance companies, and fund management firms, to directly invest in the TSE-listed securities, up to a preliminary maximum limit of US$2.5 billion.

  Revision of the Securities and Exchange Law is underway to allow local securities companies to act as agents buying and selling foreign securities, to establish overseas branches, or to become members of foreign stock exchanges. To expand the outbound investment channels for residents, four securities investment trust companies are allowed to raise local capital (US$40 million each) for the purpose of investing in foreign securities. With the deregulation of foreign exchange control, residents of Taiwan Province have been allowed to remit up to US$5 million or its equivalent in other foreign currencies for the purpose of investment abroad since July 1987.

  Four mutual funds of foreign securities have been introduced to Taiwan Province securities market for local investors since 1988. The combined total value of these funds amounted to US$280 million.

- The **Korean** securities market is expected to be opened for foreign investors in 1992. In preparation for this new development, foreign securities companies are allowed to set up either branches or joint-ventures since the beginning of 1991. Foreign branches are allowed to operate in three main areas of the securities business - dealing, broking and underwriting - depending on the magnitude of their capital bases.

  The Korean government also relaxed foreign exchange controls to allow Korean institutional investors to hold foreign currency denominated securities. Each company is allowed to invest up to US$30 million.

- SET established an alien board in September 1987 to facilitate the trading of securities by foreigners for issues which had reached the maximum statutory or voluntary limit of foreign ownership. Foreign investment in **Thailand** amounted to B 97.28 billion (US$3.87 billion) or 15 per cent of total market capitalization in 1989. The introduction of American depositary receipts and international depositary receipts is under review.

- In October 1990, the SES created a new category of international membership to allow foreign securities firms to engage in brokerage business for both resident and non-resident investors in the **Philippines**. Transactions for resident investors must exceed S$5 million (US$2.63 million). SES signed a custodial agreement with the Japan Securities Clearing Corporation to facilitate book-entry settlement for trading in Japanese securities. The Manila Stock Exchange introduced two classes of shares, Class A and Class B. Foreign investors are allowed to buy and sell Class B shares but not Class A shares.

C. Recent Regional and Sub-regional Co-operation

Notable examples of recent regional and sub-regional co-operation for industrial financing are the ASEAN Finance Corporation Limited (AFC) and the Asian Finance and Investment Corporation Ltd. (AFIC). Both of these organizations were incorporated as part of a multilateral effort to provide merchant banking services to private sector corporations at the sub regional and regional level. Additionally, beginning in 1983, ADB began direct equity participation to supplement its lending operations to the public sector and to actively promote an expanded role of private-sector enterprises in the economic development of the Asian Pacific region. Under this programme, ADB can directly invest in the equity of relatively large private corporations, development finance institutes, or similar financial institutions. ADB has also been providing technical assistance for capital market development in the region.

The AFC was established in 1981 to finance ASEAN industrial co-operation projects and to provide venture capital to ASEAN entrepreneurs. Incorporated in Singapore, the AFC is the first joint venture by commercial banks in ASEAN, with an authorized share capital of S$120 million and a paid-up capital of S$100 million. The AFC shareholders are banks and financial institutions from the five original members of ASEAN, Indonesia, Malaysia, the Philippines, Singapore, and Thailand. The AFC is designed to provide equity and loan capital to ASEAN-based enterprises and to assist in promoting industrialization and overall economic development in the ASEAN region. Its priorities are (a) ASEAN Industrial Joint Venture (AIJV) projects; (b) projects under the ASEAN Industrial Complementation Agreement (AICA) and ASEAN Industrial Projects; (c) projects involving two or more ASEAN countries; (d) projects in one ASEAN country that promote intra-ASEAN economic co-operation; and (e) small- to medium-sized ASEAN financial institutions. The AFC is an important vehicle in attracting Japanese investment. The AFC owns 50 per cent (S$500,000) of the ASEAN-Japan Development Corporation, while the other half is owned by the Japan-ASEAN Investment Company. Additionally, the AFC developed institutional links with INTERACT, the European Economic Community group of government development finance institutions, through the AFC/INTERACT Joint Committee. Under the Framework Agreement with the Commission of the European Communities, the AFC serves as a conduit for an interest-free loan from the EC. The recipient of the interest-free loan in 1990 was a European-Malaysian joint venture for a feasibility study in a gold exploration programme in Pahan, Malaysia.

The AFIC was incorporated in August 1989 in Singapore as a merchant bank approved by the Monetary Authority of Singapore. Its authorized capital is equivalent to about US$200 million, of which about US$116 million has been issued. The AFIC's largest shareholder is the ADB which holds about 30 per cent of AFIC's share capital. The remaining share capital is held by 25 financial institutions including commercial banks, development finance institutions, trust banks, securities companies, leasing companies, and insurance companies in Asia, Europe, and North America. The AFIC's primary objective is to promote, facilitate, and support the establishment and growth of private enterprises in the developing countries of the Asian and Pacific region. The AFIC works closely with ADB, its shareholder institutions, financial institutions in developing countries, bilateral and multilateral agencies, etc. As of February 1990, a total of US$45 million was committed in the form of loans (US$39 million) and equity investment (US$6 million) in the developing member countries of the ADB. According to a sectoral breakdown, cement manufacturers received US$6 million, fertilizer manufacturers US$21 million, and the financial services industry US$18 million.

V. POLICY ISSUES AND RECOMMENDATIONS FOR IMPROVING INDUSTRIAL FINANCING

The analysis undertaken in this study suggests that the financing problems of industrial enterprises in the region will have to be tackled primarily at the national level. Although there are typical bottlenecks common to many Asian countries, the improvement of financial institutions and the creation of efficient capital markets above all is a national policy concern. At the same time, many measures taken at the national level also have an impact on the region as a whole. This applies particularly to the liberalization of cross-border capital flows and the deregulation of financial markets. In this chapter, policy issues and recommendations for action to be taken at the national level are presented which are relevant to most countries of the region. Finally, the potential for regional co-operation in industrial financing is discussed in the broader context of regional economic co-operation and integration.

A. Changing Role of Industrial Financing

In many countries of the region, the industrial sector is being restructured, partly under government guidance, partly driven by changing market conditions and shifting competitive advantages. The newly industrializing economies are moving into higher value-added and technologically more sophisticated industrial activities. Past heavy protection of domestic markets in South Asian economies has resulted in a distorted industrial structure not in line with the countries' comparative advantages and factor endowments. Restructuring the manufacturing industries is a pressing need for these countries if they are to become internationally competitive. An integral element of the restructuring programmes in most countries is the growing role of private enterprises, both in the real and the financial sector. Deregulation programmes free private industries from overly tight regulations, privatization of public enterprises aims at transforming the often dominating public sector into dynamic private ventures.

As part of these regional trends and the growing global demand for investment capital, demand for industrial financing in the region will become stronger than ever, both in quantitative and qualitative terms. A dynamic financial sector is therefore required which is able to respond to the changing economic environment and the new requirements. Otherwise, there is a danger that financing institutions and financial instruments lag behind industrial modernization and will become a critical bottleneck for the progress of industrial restructuring.

It was shown in this study that external financing is important in many respects. It fills domestic resource gaps and allows an increase in industrial investments and hence in the national product even if domestic resource mobilization is insufficient. FDI helps to transfer technology and know-how, portfolio investments help to improve the corporate equity base and to develop the local securities markets. ODA can support know-how transfer and investment in strategic sectors with high social rates of returns but low return on investment and long gestation periods. Tapping external sources will, in short, play a crucial role in industrial financing, and the increasing competition for international capital is one major reason why domestic financial systems must be modernized. Yet in most countries external sources can only marginally supplement domestic investible resources, and the mobilization and efficient allocation of these requires more dynamic financial markets.

Dynamization and modernization imply new roles and functions for both governments and financial institutions. As regards the new role of governments, the supervision of banks, non-bank institutions and the various financial markets becomes more important than direct intervention. Instruments for monetary policy are also to be modified away from direct control and intervention. With progressing deregulation of financial markets open-market-policy, for example, becomes a more important tool. In turn, this requires mature secondary securities markets. In addition, increasing international mobility of capital calls for more co-operation and coordination among governments, since monetary policies have an impact beyond the boundaries of the individual countries and financial shocks can be rapidly transmitted across global markets.

Financial institutions will have to respond to a number of typical financing problems that in the past have hampered industrial development in the region. These include:

- Lack of access to long-term capital: commercial banks which dominate the financial sector do not extend sufficient term credit to industrial enterprises. The corporate bond market is underdeveloped and does not yet provide an alternative source of financing. Industrial enterprises often finance long-term investments with short-term borrowing from various intermediaries.

- Insufficient access of SMI to industrial financing: the financing needs of small- and medium-scale enterprises require special attention. Their access to commercial bank credit is limited and securities markets are virtually inaccessible for them. SMIs therefore depend on special financing schemes, often administered by DFIs, and on the informal market. As SMIs tend to be more dispersed than medium- and large-scale industries, better SMI financing would also serve to strengthen regional development.

- Bias against new companies: commercial banks favour firms with an established credit record to avoid extensive investigations and to keep transaction costs low. New and innovative firms often face unsurmountable difficulties in obtaining credit during their start-up and growth phase.

- Low equity base of industrial companies: the equity base of industrial enterprises tends to be narrow. Outside financing is highly leveraged which makes enterprises vulnerable to interest rate changes and overly dependent on commercial banks. To overcome traditional family ownership and fear for disclosure better incentives in favour of equity financing are needed.

- Project selection for financing often does not follow strict commercial criteria, particularly when interest rates are regulated and below market rates. In many cases, financing is channeled to priority sectors which have no long-term viability. DFIs and commercial banks tend to carry a large portfolio of non-performing assets.

These obstacles to financing, particularly when foreign exchange is required, result in low investments and outdated capital stocks. Privileged borrowers such as state-owned and large companies with well-established names, firms with a long credit record or easily visible collateral receive (often subsidized) loans, while projects or firms that could offer potentially high returns cannot find sufficient finance. From the macro-economic point of view the allocation of scarce resources therefore remains sub-optimal.

B. Liberalization and Deregulation

At the macro-level, liberalization and deregulation of financial markets remain the most important policy issues. As outlined before, a number of Asian countries (notably Indonesia, Republic of Korea, Malaysia, the Philippines, Sri Lanka and Taiwan Province) have implemented gradual but far-reaching reforms of their financial sectors. Deregulation and liberalization in these countries are aimed at increasing competitiveness of the financial sector, improving efficiency and mobilizing domestic resources. Intermediation costs are expected to decline, availability of term credit to increase and corporate financial structures to improve.

The effectiveness of financial sector reforms depends on a conducive macro-economic environment. Price stability and general macro-economic stability are particularly important preconditions for successful financial sector reforms. While real interest rates in all countries mentioned above became or remained positive after deregulation, real and nominal interest rates soared to unprecedented levels in imperfect oligopolistic credit markets and/or under conditions of high or fluctuating inflation rates, as for example in the Philippines and Indonesia. High interest rates have in turn resulted in increasing loan defaults by industrial firms, which are particularly vulnerable when highly leveraged and dependent on bank credit.

Certain structural features make deregulation of financial markets more difficult in developing countries. Unlike in the industrialized countries, the financial system in many developing countries of the region plays a special role as source of government revenue because of the narrow tax base and lack of expertise in tax administration. This takes the form of inflation tax imposed through monetary expansion, reserve requirements imposed on banks, subsidized interest rates on public debt, and captive markets for bond financing. Liberalization of financial markets hence affects governments' budgets.

The liberalization of cross-border capital flows is directly linked to the deregulation of financial markets. Most developing countries resort to tight restrictions of cross-border capital flows when foreign exchange is scarce and macro-economic conditions, e.g. a high inflation rate, administered interest rates etc., may induce capital flight. Liberalization of capital controls has to be coordinated and harmonized with the deregulation of domestic financial markets. In economies with narrow financial markets simultaneous deregulation of interest rates and liberalization of capital control may result in high and volatile interest rates due to foreign exchange movements. Therefore, far-reaching relaxation of capital control measures requires a stable macro-economic environment and mature and flexible financial markets. A number of countries in the region have maintained high restrictions on capital movements to prevent uncontrolled outflow of foreign exchange yet these also discourage the inflow of foreign capital, particularly foreign direct investments and portfolio investments.

All this suggests that the design and phasing of deregulation programmes should be carefully worked out to ensure success. Deregulation of financial markets and liberalization of capital accounts have to be coordinated. The macro-economic conditions set certain limits to sweeping deregulation, stabilization has to precede liberalization. Although financial deregulation is generally desirable, it is not an objective in itself. Under certain conditions which apply in many Asian developing countries, it is a prudent policy to retain some control and regulations until financial markets are sufficiently mature and flexible and a significant non-banking sector has emerged.

Recommendations:

- Efforts at deregulating and liberalizing the financial sector should be continued with a view to ensuring a more efficient allocation of resources to productive investments. Countries which have not yet taken such initiatives should elaborate programmes which take account of the experience gained elsewhere in the region.

- The impact of past deregulation on the industrial sector should be studied and specifically the impact on terms of industrial financing and on access to industrial financing of different types of industries (public/private; large/small).

- Cross-border capital movements should be facilitated through reduction of restrictions particularly on capital inflows, specifically to tap the rapidly growing sources of financing within the region.

C. Training Requirements

The new, more autonomous role of the financial sector in many countries means that great demands are placed on the expertise of staff of financial institutions. Indeed, in countries such as Indonesia, human resource development has emerged as a critical bottleneck for the successful implementation of financial deregulation programmes. With the removal of government directives and guidance in credit allocation, there is a need to build up capabilities in the various financial institutions themselves for the assessment of the performance of industrial companies. This also includes the capability to put a company's development prospects into the perspective of branch-level trends, both in the domestic and external markets. Evidently, if industrial financing is to contribute to increasing an industry's competitiveness, it must be based upon a thorough understanding of the determinants of competitiveness.

Apart from bank managers, borrowers and lenders also public servants are inexperienced in dealing with a [illegible]etitive and liberal financial system. More sophisticated capital markets [illegible]e a deeper knowledge of new instruments and project evaluation. The new [illegible]le of governments involve new and refined tools of monetary policy which requires know-how yet to be developed in many, particularly less advanced countries in the region.

Recommendations:

- Special training programmes for industrial financing should be launched. This should *inter alia* involve:

  - creating awareness of the most important determinants of and trends in international, regional and national industrial restructuring processes;

  - monitoring of key-industrial sub-sect[illegible]

- carrying out and evaluating industrial feasibility studies;

- asset valuation of industrial companies, particularly in the context of privatization and/or rehabilitation programmes;

- knowledge of financing non-material investments (R&D), marketing, distribution etc.;

- understanding of the special financing requirements of small scale companies.

D. Strengthening Development Finance Institutions

The role and contribution of DFIs in the region varies considerably across the individual countries. In general, industrial DFIs in the region are well advised to reconsider their function in a rapidly changing environment that may challenge their traditional raison d'être. Deregulation programmes, a trend towards more market-based allocation in both the financial and, in view of the privatization of public enterprises, the real sector may question the traditional role of DFIs. Asian DFIs are now urged to orient themselves more towards market-based lending and borrowing principles. Although DFIs aim at financing segments of the industrial sector which have difficult access to other, market-based sources of investment financing, project selection and firm assessment should primarily be based on the expected profitability of the venture, even if DFI's lending operations cannot follow the profitability criteria to be applied by commercial banks.

As a purely market-based allocation of financial resources does not automatically result in a balanced pattern of industrial development, DFIs will continue to play a strategic role in industrial financing. This holds true for the least developed countries in particular. The activities of DFIs leave much room for expansion into equity financing of existing, viable companies - a field that is largely underdeveloped in most countries of the region. Furthermore, DFIs could become more involved in venture capital funds as this concept gradually develops in the region. Small and new and innovative firms need to be fostered in particular since commercial banks tend to avoid financing if the venture is considered too risky or unit costs are too high. The functions of DFIs should therefore, be defined in a way that they address these clearly identified bottlenecks and do not overlap with the banking sector which, in turn, should operate in a liberal market environment.

Recommendations:

- DFI activities should be focussed on clearly defined segments of industrial financing which are not or not sufficiently served by liberalized financial markets;

- To the extent that lending operations can be guided by profitability criteria, the refinancing of DFIs should be shifted from subsidized sources to market sources such as bond issues;

- DFIs should strengthen their equity financing operations particularly in small and medium enterprises and new and innovative ventures;

- Lending operations should be supplemented, more strongly than in the past, by technical and economic advisory services at the company level directly related to the financed modernization, restructuring, rehabilitation or expansion programmes.

E. Promoting Venture Capital Funds

Venture capital funds are relatively new in the Asian context. Where they have been established, the original concept has been modified, as the conditions under which VCF have to operate are different from the USA where the idea was born. The modifications have, however, often led to an alienation from the original purpose of VCF, which is the financing of new and innovative, mostly technology-oriented firms. Despite the fact that industrial growth of most Asian developing economies is not primarily technology-driven there is wide scope for the application of the concept. The target group of enterprises is obviously broader than in the industrialized countries including a.o. firms which aim at adapting and applying imported technologies and firms which utilize existing technologies for designing new marketable products. In practice, VCF have often gone into traditional SMI financing and have thus overlapped with special SMI financing schemes and DFI activities. Moreover, VCF managers have tended to be averse to investments considered risky and have consequently build up a portfolio of assets outside the designated target group. Because of the reluctance of entrepreneurs to accept equity financing, venture capital funds in Asian developing countries are required to broaden their financing instruments. In addition to equity financing which is stressed in the original concept of VCF, credit financing is to be included to support such entrepreneurs who want to keep full control over their ventures.

Recommendations:

- It should be ensured that existing VCF really serve the financing niche they are supposed to address rather than duplicating programmes of other institutions;

- The lack of qualified manpower is particularly pressing for VCF. Special training programmes should be launched for staff of both existing and newly established funds.

- Countries not yet operating but planning to establish VCF should carefully assess the experience so far gained with VCF in Asian countries;

F. Improving Small- and Medium-Scale Industry Financing

As outlined before, small- and medium-scale enterprises face systematic disadvantages in securing financing compared to large firms. Limited branch networks of banks and DFIs, high unit costs due to small credit size and difficult firm assessment and project appraisal as well as lack of collateral make SMI financing relatively expensive. Financial intermediaries often push interest rates on loans above the return on SMI's investments to recover high unit costs. Informal markets also charge high interest rates. The high level of interest rates clearly is an obstacle to investments. The particular financing needs of SMIs are thus not sufficiently served by the market-based allocation process. While there is much room for improving efficiency, special SMI schemes will continue to play a significant role even i. investment capital is primarily allocated through deregulated financial markets.

Recommendations:

- To support the development of small into mature, diversified companies, the need to provide equity capital to established, growing SMI should receive more attention:

- Special efforts should be undertaken to reach out to rural areas and correct the bias of most financing mechanisms/programmes in favour of SMIs in metropolitan areas;

- SMI owners should be trained in the preparation of bankable project proposals and more TA advisory services should be provided to them in connection with actual modernization/expansion finance; more and better training programmes in cost accounting should be offered.

- Special financing programmes should be launched with less collateral requirements;

- The ʟ le and existing advantages of informal financing markets should be recognized. Formal financing institutions should seek to offer competing financing mechanisms and incorporate those features into their operations which respond to the special financing needs of small rural companies.

G. Improving Securities Markets

Current securities markets in the region have attained different levels of development. They range from the relatively mature stage achieved in Hong Kong, the Republic of Korea, Malaysia, Singapore, Taiwan Province and Thailand to a somewhat less advanced stage in India, Indonesia and the Philippines and a nascent stage in Bangladesh and Nepal. In a number of countries securities markets do not exist at all. Apart from the relatively mature markets, securities markets in the region are typically facing the following problems:

- weakness of the securities industry infrastructure;
- a lack of investor confidence;
- a limited supply of and demand for viable securities;
- insufficient sophistication of financial intermediaries;
- strong governmental control over the financial sector through regulated interest rate structures; and
- inadequate operational facilities of stock exchanges and clearing and settlement systems.

The lack of depth and breath in the long-term debt market is a continuing concern of the countries in the region. Traditionally, an active market in government securities precedes the development of a market in corporate bonds However, many countries in the region have yet to develop long-term government securities markets. Newly issued government securities have made only a limited contribution to the stimulation of local securities markets because most governments securities have been absorbed by financial institutions which are legally required to do so; the coupon rates of these issues are kept at a low level without reflecting current credit market conditions; and the minimum denomination is typically too large for individual investors. On the other hand, lack of secondary markets has created little demand for government securities by investors. As a result, the ability of central banks to control the money supply through open market operations has remained limited.

India, Malaysia, and Thailand have recently established credit ratings on new as well as existing issues to enhance investor confidence and achieve efficient pricing. This also provides a screening device for investors which is even more important in view of the often insufficient financial information provided by the listed companies despite comprehensive securities industry regulations in many countries. Governments should assign the highest priority to improving the supervisory and regulatory processes to enhance investor confidence and to prevent abuses and undue delays frequently observed in connection with approval of new issues. The creation of adequate mechanisms to disseminate market information will reduce the possibility that the price of securities will be manipulated.

In addition to government issues, privatization programmes could help to stimulate primary market activities. Public enterprises can be used to promote the growth of primary and secondary markets by encouraging them to issue long-term securities which may be traded on the organized exchanges.

Although industrial production activities in the region are dominated by small- and medium-size firms, few efforts have so far been made to provide them with access to securities markets. Usually, these companies cannot meet stringent listing requirements imposed by the organized stock exchanges. Hence, the development of an over-the-counter (OTC) market should be given special attention. The OTC market may serve both start-up companies and existing small- and medium-size firms. A number of Asian countries such as the Republic of Korea, Taiwan Province, India, Indonesia and Malaysia have established OTC markets in recent years. Efforts to enhance their outreach to SMI should be stepped up, and the possibilities of creating efficient OTC markets in other countries should be explored.

The improvement of securities markets in the region requires that a number of other issues be tackled such as the corporatization of brokerage houses, the improvement of clearing and settlement systems, the issue of single or multiple stock exchanges, and other technical questions. These are not dealt with in detail in this study.

Recommendations:

- Securities markets should be made a more important source of long-term industrial finance. The creation of a conducive environment for the development of securities markets should be closely coordinated with the deregulation of financial markets. Tax incentives for privately-owned companies to go public should be improved to compensate for the potential loss of control and for greater disclosure requirements and greater regulatory scrutiny.

- Government budget financing and public enterprise financing should be utilized whenever possible as instruments to strengthen domestic securities markets.

- OTC markets for unlisted stocks should be established to provide a market for small- and medium size companies.

- Laws and regulations governing primary and secondary markets should be simplified and the often prevailing fragmentation of the regulatory structure be reduced. Complicated regulations which impede the operational efficiency of stock markets should be streamlined. The supervisory and regulatory processes should be improved to prevent abuses and undue delays frequently observed in connection with approval of new issues.

- Investor protection and investor confidence deserve high attention. Financial disclosure regulations and market supervision leave much room for improvement. Credit rating agencies should be established where appropriate.

- Training of stock market operators and staff of financial institutions involved in primary (underwriting) and secondary securities markets is required to improve the efficiency of these markets.

H. Potential for Regional Cooperation

In recent years, an increasing regionalization of the world economy can be observed. In Europe, the EEC will have completed a single market with a common tariff by the end of 1992. The envisaged establishment of the North American Free Trade Agreement will create another free-trade area. This formation of new trading blocs will have significant implications for Asia's export-dependent economies which rely much more on their trade with outside regions than vice versa. They have been the main beneficiaries of the rapidly growing world trade during the last two decades.

Simultaneously with the regionalization trends in other parts of the world, the integration of economies within the Asia and Pacific region has rapidly progressed. The growth of trade flows among the Asian NIEs, and between Japan, the NIEs and the Southeast Asian economies in the latter half of the 1980s has outpaced that of any other region in the world. This expansion has been accompanied and to a large extent induced by a phenomenal growth of intra-Asian investments. The integration process has taken place without significant institutionalized cooperation. Institutionalized economic cooperation within the small group of ASEAN countries has expanded but fallen short of expectations. Other groupings such as the recently established Asia-Pacific Economic Cooperation Forum and the South Asian Association for Regional Cooperation have had only limited impact on the process of economic integration. The characteristics of the growing trade and investment links within the region are a greater emphasis on manufacturing, a growing involvement of SMIs, and the incorporation of the hitherto commodity-based economies of Southeast Asia. The process of integration of manufacturing industries among the dynamic economies of East and Southeast Asia, however, has only marginally affected South Asia and the least developed countries of the region.

Against the background of world-wide regionalization trends, the integration of the countries of the Asia and Pacific region into the world economy is likely to continue. As many Asian developing countries have greatly benefitted from liberal world trade, they will certainly aim at intensifying their links with the industrialized countries of Europe and North America. At the same time, countries in the region may pursue the active promotion of their own regional integration and cooperation. Yet the formation of an Asian economic bloc in the near future appears unlikely, as the region will continue to depend heavily on the markets and technology of industrialized countries for some time.

Irrespective of the level of institutionalized cooperation among the countries concerned, the market-driven integration of manufacturing industries in Asia is likely to continue. This will also stimulate the integration of financial markets in the region and increase the potential for regional cooperation in industrial financing. Thus co-operation in financing can support and reinforce the dynamic process of product market integration in the Asia-Pacific region.

Regional co-operation in industrial financing has essentially two dimensions. On an institutional basis, financing can be provided directly to those industrial enterprises which disperse production capacities to other countries of the region and in general to regionally cooperating companies. On a non-institutional basis, the mobility of capital, particularly in the form of FDI and portfolio investments, within the region can be facilitated through progressive liberalization of cross-border capital flows coherent with the deregulation of financial markets.

So far, there have only been a few institutional approaches at regional or sub-regional financing, notably the ASEAN Finance Corporation (AFC) and the Asian Finance and Investment Corporation (AFIC). AFC is linked to industrial co-operation among ASEAN- based enterprises and was set up to finance ASEAN industrial co-operation projects and to provide equity capital to ASEAN entrepreneurs. So far, AFC has fallen short of expectations. One reason for this is the slow pace of economic co-operation and integration of manufacturing activities within ASEAN which - due to weak demand for loans - has inhibited the growth of lending operations. Ventures involving at least two ASEAN countries have so far remained rare. Unlike AFC which in its lending operations is confined to the small group of ASEAN countries, AFIC targets the whole of Asia and the Pacific. At this stage, it may be premature to judge on the performance of AFIC since it was incorporated only in 1989. It is not the primary objective of AFIC to promote enterprise-to-enterprise co-operation within the region but to support the establishment of private enterprises along the lines of the International Finance Corporation (IFC).

The institutions providing direct financing to enterprises of the region have so far operated at a very limited scale. Although financial institutions based in the individual countries will continue to provide the bulk of industrial investment capital, there appears to be more scope for this type of co-operation which specifically aims at supporting the regional integration of manufacturing industries. For example, small- and medium-scale enterprises which have increasingly become involved in FDI are often less familiar with a foreign environment and are more risk-averse than large companies. Experience shows that they often feel more secure when intermediaries are involved and share the risk of new investments. The potential ' other segments of manufacturing industries where financing has emerged as a bottleneck for regional integration of manufacturing activities should be explored by both the existing transnational financial institutions and the national DFIs and commercial banks.

Further liberalization and deregulation of financial sectors at the national level will spur direct and indirect forms of investment. Liberal access of foreign investors to functioning securities markets can facilitate both intra-regional capital flows and industrial co-operation between private firms. The development of securities markets can play a catalyst function for tapping the excess savings available within the region and can receive, in turn, strong stimuli from foreign investments. Portfolio investments by Taiwan Province and Singapore, for example, have pushed up other stock markets in the region in recent years. In this context, measures aimed at harmonizing the legal standards for corporate accounting and disclosure and the convergence of legal frameworks for capital markets could be considered.

Most countries of South Asia and particularly the region's LDCs have so far been only marginal recipients of foreign investment flows. With a view to integrating them more strongly into the regional division of labour, the potential contribution of launching a regional investment guarantee scheme - possibly modelled on the Multilateral Investment Guarantee Agency (MIGA) under the World Bank - should be explored.

ANNEX I

Structure of the Commercial Banking Sector in Selected Countries of the Region

In **Indonesia**, the Bank Indonesia (BI), as the central bank, not only implements the monetary policy but also allocates credit to various priority sectors. The BI extends two types of credit: (a) credit to banks (known as liquidity credits); and (b) direct credit. Credit to banks represent BI's refinancing of the banks' loans to the borrowers when the loans meet the requirements of development objectives; direct credit is extended to some selected official entities and public enterprises to finance the implementation of government programmes.

Indonesia's financial system consists of deposit money banks, savings institutions and non-bank financial institutions. Deposit money banks are essentially commercial banks and include national foreign exchange banks, branches of foreign banks, one joint bank, and other private commercial banks. Development banks such as the Bank Pembangunan Indonesia (BAPINDO), regional development banks, and one private development bank should also be included, since these development banks also conduct commercial banking activities. Loans to both the private sector and the public sector amounted to about three-quarters of total assets, whereas the major sources of funds are various types of short-term demand and time deposits (about two-thirds of total funds) plus borrowing from the central bank (about 16 per cent of total funds). Two potential problems exist for deposit money banks with respect to their funding. First, the BI plans to reduce the liquidity credit to commercial banks as the oil revenue declines, and this will cause greater difficulty in securing sources of funding. Second, deposit money banks face the problem of maturity mismatch because most of the loans tend to have a long- or medium-term maturity while most of funding sources are short-term. To solve the problem of maturity mismatch, commercial banks are to be encouraged to issue long-term bonds to lengthen the maturity structure of the liability side.

The commercial banking sector in Indonesia is dominated by national foreign exchange banks (consisting of five state banks and 10 private banks). At the end of 1989, 77.99 per cent of total assets of all deposit money banks were held by national foreign exchange banks; 5.43 per cent by 10 foreign banks, including one joint bank; 8.98 per cent by private commercial banks; and 7.61 per cent by development banks which included BAPINDO, 26 local development banks, and one private development bank. Five state banks are assigned specialized fields of activities:

a.	Bank Rakyat Indonesia:	agriculture, fisheries, and rural development;
b.	Bank Ekspor Impor Indonesia:	foreign trade;
c.	Bank Negara Indonesia:	industrial sector;
d.	Bank Bumi Daya:	plantation and forestry;
e.	Bank Dagang Negara:	mining.

Additionally, BAPINDO specializes in financing development projects. Compared to private commercial banks and financial institutions, the state banks enjoy an advantageous position: (a) they have a nationwide branch network; (b) they have easy access to the refinancing facilities of the central bank; (c) all state-owned enterprises have to keep part of their deposits with these banks; and (d) since the deregulation of interest rates in 1983, they have been allowed to offer competitive interest rates on deposits.

The commercial banking sector in the **Philippines** is marked by an oligopolistic market structure and a high degree of control over entry into the market. Five large, strong banks dominate the system with many small, weak banks supplementing their services. Banking institutions include: (a) 30 commercial banks; (b) 143 private development banks; (c) 38 savings and loan associations; (d) 7 savings and mortgage banks; and (e) three specialized government banks. Non-banking financial institutions include investment houses, finance companies, securities dealers/brokers, pawn shops and lending investors which are registered money lenders. Financial assets held by banking institutions represent approximately 90% of the total; the remaining 10% are held by non-bank financial institutions. Commercial banks represent approximately two-third of the total assets of the financial system. Only the largest among the banks, the Philippine National Bank, is state-owned, but the government holds minority shares in some other private banks. The majority of domestic banks maintain a close relation to specific family business groups, most of which were founded between 1950 and 1965.

The financial system in **Malaysia** was modeled after the British system. In addition to the usual central bank's tasks, the Bank Negara Malaysia (BNM) is authorized to oversee the operation of the financial system, including: (a) variation in the reserve requirement; (b) adjustment in the liquidity ratio; (c) regulation of discounting; (d) administration of bank lending and borrowing rates; and (e) credit allocation. At the end of 1989, total assets of the financial system were distributed among various institutions as summarized below:

Table A-1. **Total assets of Malaysia's financial system end of 1989**

Classification	Amount (US $ billion)	Per Cent
Banking System	67.14	68.80
Monetary Institutions	51.90	53.20
Central Bank	11.80	12.10
Commercial Banks	40.10	41.09
Non-Monetary Institutions	15.24	15.60
Finance Companies	10.58	10.80
Merchant Banks	2.96	3.00
Discount Houses	1.70	1.80
Non-Bank Financial Intermediaries	30.44	31.20
Employees Provident Fund	16.87	17.30
Life and Other Insurance Funds	2.96	3.00
Development Finance Institutions	2.22	2.30
Savings Institutions	3.40	3.50
Other Financial Intermediaries	4.99	5.10
Total	97.58	100.00

Source: Bank Negara Malaysia.

At the end of 1989, there were 22 domestic commercial banks and 16 foreign banks in Malaysia. Total assets of commercial banks amounted to US$108.4 billion or 41.10 per cent of total assets of the entire financial system. Total deposits were US$25.64 billion, while total loans were US$24.84 billion. Their operation is supervised by the BNM in the areas of capital adequacy requirements, statutory reserve requirements, and liquid asset requirements. The Malaysian commercial banks make large profits by taking advantage of the existing gap between lending and deposit rates. Thus, they have become inefficient and bureaucratic, lacking creative management. The BNM is aware of this problem and has been gradually narrowing the gap to normalize the operation of commercial banks. The major source of funds is deposits which accounted for 55.76 per cent of total funds. Since 1979, commercial banks have been allowed to issue negotiable certificates of deposit and bankers' acceptances. Loans represented 56.74 per cent of total fund utilization.

Lending guidelines announced in March 1988 required that the commercial banks comply with the guidelines on lending to the bumiputera community, agricultural food production, and small-scale enterprises by March 31, 1989. As of the compliance date of March 31, 1989, loans to the bumiputera community accounted for 33.2 per cent of the total loans outstanding as of December 31, 1987, in excess of the minimum requirement of 20 per cent. The Bank Negara Malaysia also reported that commercial banks met the target of MS$300 million for extending loans to small-scale enterprises. Additionally, the Credit Guarantee Corporation Malaysia Berhad (CGC) plays a role in promoting the growth and development of small-scale enterprises, which are defined as registered businesses with net assets of up to M$500,000. A new guarantee scheme known as the Principal Guarantee Scheme was introduced in April 1989 to assist small-scale enterprises with no collateral or inadequate collateral to obtain the required credit facilities from the commercial banks and to lessen the bank's risk in lending to this priority group. Under this new scheme, the CGC guarantees 70 per cent of the portion of credit facilities extended by the lending institutions that is not covered by the available collateral under the bank's normal lending practices. The total amount of guarantee approved in 1989 was M$78.5 million.

Until 1970, foreign banks played a much greater role in domestic financing than in other countries of the region but they have since lost ground to the domestic banks. In 1964, 74% of the formal banking system's total assets were held by foreign banks (Skully 1984, pp. 110 ff.). Japanese banks have aggressively stepped into the market over the last decade. As in other countries of the region, the degree of concentration among domestic commercial banks is high but it has decreased during the 1980s due to stiff competition from small banks. The share of the five largest banks in total assets slipped from 76.2% in 1980 to 67.7% in 1989. The capital base of many commercial banks is relatively weak and the government introduced capital adequacy requirements with a minimum capital:asset ratio of 4% for domestic and 6% for foreign banks.

Based on strong industrial growth, long-term loans and loans to the manufacturing industries have expanded above average. Total credits extended to the manufacturing sector have been increasing rapidly. A total of US$5.20 billion was extended to the manufacturing sector or 20.94 per cent of the total credits outstanding in 1989 as against 19.5% in 1988. The financial sector in Malaysia has been gradually liberalized since 1978, but various guidelines concerning lending to priority sectors still exist.

The structure of the financial system of **Thailand**, categorized into banks and non-bank financial institutions, is summarized below:

Banks

a. The Bank of Thailand (BOT)
b. 30 Commercial Banks

   i. 16 Domestic Banks
   ii. 14 Foreign Banks

c. Government Savings Bank
d. Bank for Agriculture and Agricultural Cooperatives
e. Government Housing Bank

Non-Bank Financial Institutions

f. Industrial Finance Corporation of Thailand (IFCT)
g. 94 Finance Companies
h. 18 Credit Financier Companies
i. Small Industries Finance Office
j. 12 Life Insurance Companies
k. 1,357 Agricultural Cooperatives
l. 827 Savings Cooperatives
m. 357 Pawnshops

Commercial banks' assets were US$55.53 billion or 63.32 per cent of the total assets held by the financial sector. "Claims on Business and Household Sector" were the largest with a total outstanding amount of US$40.69 billion or 73.26 per cent of the total assets of commercial banks in 1989. Deposits amounted to US$42.28 billion. This amount represented slightly over three-quarters of the total liabilities. Borrowing from the Bank of Thailand was only US$1.60 or 2.88 per cent of the total liabilities. Deposits were composed of (a) demand deposits; (b) savings deposits; (c) time deposits; and (d) other deposits, including foreign currency deposits. The ratios of demand, savings, and time deposits to total deposits were 5.05, 32.19, and 61.92 per cent.

The mobilization of savings by commercial banks has been very successful. Among various types of deposits, time deposits grew at a faster rate than the other types as a result of the abolition of the interest rate ceiling on time deposits with maturities of more than one year. There are 14 foreign banks, but their market share in Thailand is insignificant. Deposits of foreign banks e.g. were only 2.58 per cent of the total deposits of commercial banks. The government places tight restrictions on their activities to minimize their impact on domestic banks.

About one-quarter of total credits supplied by the banking sector plus IFCT and finance and securities companies were extended to the manufacturing sector in 1989, whose relative share increased from 18.4% in 1980 and 23% in 1984. Mining, construction and utilities combined received slightly more than 6% of total credit. A large proportion allocated to the real estate business in the wake of recent land speculation.

The Thai commercial banking sector is dominated by four large banks the Bangkok Bank Ltd. (which is the second largest bank within ASEAN), Krung Thai Bank Ltd, Thai Farmers Bank Ltd. and Siam Commercial Bank Ltd. The combined assets, loans and advances, and deposits of the four banks accounted for approximately two-thirds each of the total assets, loans and advances, and deposits held by commercial banks. Twenty-six smaller domestic and foreign commercial banks compete for the remaining market share. The BOT had to provide a significant amount of financial assistance to smaller Thai commercial banks in the form of long-term soft loans because of their weak performance and inadequate capital bases. This was mainly done to protect depositors. In recent years, the performance of ailing commercial banks has improved.

In terms of ownership the government is not as deeply involved in the banking sector as in other countries of the region. It holds 90% of the second largest bank and minority stakes in a number of other banks. Most banks were established by Thai-Chinese trading houses and have maintained their early connections through equity links with major Thai-Chinese business families. This has influenced the lending operation of banks and effectively reduced competition. The government introduced certain ownership requirements in 1978 in order to reduce the high degree of concentration, but many banks could not comply with the regulations according to the set schedule. There is also a marked geographical concentration of banks in Bangkok where one third of all branches are located. The financial sector has generally lagged behind the rapid expansion of the Thai economy. Steps to deregulate and liberalize the financial sector particularly with respect to interest rates and operations in foreign exchange have already been taken and further steps in this direction are announced.

The Bank of **Korea** (BOK) was established in 1950 and serves as the bank of currency issue and as the main banker to the banking sector and the government. Under the Bank of Korea Act, the BOK is empowered to regulate interest rates on loans and deposits of banking institutions. It also has power to direct credit, to fix credit ceilings, and to establish guidelines on the efficient allocation of banking funds.

There are 11 nationwide commercial banks, ten local banks (one for each of the Provinces of Korea), and 68 foreign bank branches. A consolidated balance sheet of all commercial banks as of 1989 suggests that the sources of funds are mainly from deposits, borrowing from the BOK, and acceptances and guarantees. The share of demand deposits in the total deposits was about 39 per cent, which indicates that, to their advantage, commercial banks have access to a relatively inexpensive source of funds. Approximately 38 per cent of total assets were allocated to loans and discounts.

Table A-2 shows the relative size of each bank group. Note that 11 nationwide commercial banks dominate the banking sector.

Table A-2. Relative size of bank groups in the Republic of Korea, 1989
(percentage)

Classification	Assets	Deposits	Loans & Discounts
National Banks	70.46	77.95	72.39
Local Banks	15.70	20.45	15.61
Foreign Banks	13.84	1.60	[illegible].00
Total	100.00	100.00	100.00

Source: The Bank of Korea.

The market share of local banks and foreign banks is slightly less than 30 per cent of the commercial banking business in Korea. Foreign banks rely on inter-office loans as the major source of funds because of relatively limited access to deposits.

Mobilization of domestic savings has long been an important part of the Korean government's economic strategy. The government exercises tight control over not only interest rates but also day-to-day management of financial institutions, particularly commercial banks, even after the government privatized its stake in the large commercial banks in 1983. The policy of direct intervention in financial institutions is still evident in such matters as credit ceilings, personnel decisions, etc. This policy has the inherent danger of discouraging initiative and creativity as well as competition within the banking sector, and may lead to operational inefficiency.

Commercial banks have been facing stiff competition from non-bank financial institutions which were able to introduce new financial instruments with higher yields than bank deposit rates in the wake of the deregulation policy. At the same time the distinction between bank- and non-bank institutions is becoming blurred since commercial banks can enter into operations in security markets (OECD 1990, pp. 20 ff.).

The financial and monetary system of **Hong Kong** is unique in that there is no central bank. The traditional functions of a central bank are performed by two commercial banks, the Hong Kong and Shanghai Bank and the Standard Chartered Bank, and by the Monetary Affairs Branch (MAB) of the Government Secretariat. The two banks serve as note-issuing banks, while the MAB is responsible for managing foreign exchange reserves, open market operations, administering government securities market, and supervision of financial institutions. The Hong Kong government utilizes the Exchange Fund to maintain the linkage between the Hong Kong dollar and the U.S. dollar. Under this linked exchange rate system, market interest rates in Hong Kong move in parallel with the U.S. interest rates. The Hong Kong Association of Bankers has a statutory obligation to consult the government in determining interest rates applicable to Hong Kong dollar deposits with licensed banks.

Various forms of financial institutions exist in Hong Kong. They include: (a) banking institutions; (b) insurance companies; (c) unit trusts and mutual funds; and (d) brokerage houses. The banking structure in Hong Kong is a three-tiered system composed of: (i) 165 licensed banks; (ii) 36 restricted licensed banks; and (iii) 202 deposit-taking companies. Licensed banks provide normal banking services. They accept deposits of any maturity and size; grant loans and advances; discount trade bills and bankers acceptances; deal in gold, foreign exchange, and other securities; and provide business consultative services. Restricted licensed banks are investment banks or merchant banks. They take deposits of large denominations, underwrite securities, deal in foreign exchange and other securities, and provide financial advisory services in the issuance of securities and mergers and acquisitions. Deposit-taking companies are finance companies. Their services include taking deposits, granting loans to medium- to small-size businesses, factoring, and leasing. Licensed banks observe the interest rate rule of the Hong Kong Association of Bankers; this does not apply to restricted licensed banks and deposit-taking companies.

In general, the Hong Kong banking system is dominated by a few licensed banks such as the Hong Kong and Shanghai Banking Corporation, the Bank of China, and the Standard Chartered Bank, showing a classic example of an oligopolistic structure. With a few large financial institutions dominating banking business, small- and medium-size industrial companies tend to face difficulties in obtaining sufficient credit from the banking sector.

The structure of liabilities of the Hong Kong banking sector as of 1989 is summarized below. The second column reports consolidated figures for licensed banks. The third column reports figures for both restricted licensed banks and deposit-taking companies.

The size of the combined assets of restricted licensed banks and deposit-taking companies is about one-tenth of licensed banks. Note that the item with the greatest liability is "Due to Banks Abroad," which accounted for 60.45 per cent of total liabilities. This item represented only 40 per cent of total liabilities in 1980. Customers' deposits are the next important item with 24.20 per cent, followed by "Due to Banks in Hong Kong" with 10.59 per cent. The most important item on the asset side is "Due from Banks Abroad," which accounted for 51.09 per cent of total assets. This item was only 27 per cent of total assets in 1980. Thus, an increasing international role of the banks in Hong Kong is evident from this asset item as well as "Due to Banks Abroad" on the liability side. Approximately one-half of the total assets are accounted for by these items. The second important item was "Loans and Advances," which includes various types of loans to business firms and individuals. The structure of assets and liabilities of restricted licensed banks and deposit-taking companies is different from that of licensed banks, reflecting the nature of the business as merchant banks and finance companies. Customer deposits represent a less important source of funds, and borrowing from banks abroad is not as significant for licensed banks. The relative importance of "Loans and Advances" declined from 42.31 per cent in 1980 to 26.50 per cent in 1989. During the same period, investments in liquid assets such as "Floating-Rate Notes and Commercial Paper" increased from 1.47 per cent to 10.29 per cent of total assets.

Table A-3. Structure of liabilities of the Hong Kong banking sector, 1989

Classification	Licensed Banks		Deposit-Taking Cos.	
	Amount (HK$ million)	Per Cent (HK$ million)	Amount	Per Cent
Assets	3,874,346	100.00	373,118	100.00
Cash	5,467	0.14	12	0.00
Due from Other Banks in Hong Kong	446,508	11.52	76,459	20.49
Due from Banks Abroad	1,979,330	51.09	98,630	26.43
NCDs Held	17,641	0.46	10,140	2.72
Loan and Advances	1,173,005	30.28	98,894	26.50
Bank Acceptances	23,245	0.60	820	0.22
Floating-Rate Notes and Commercial Paper	54,679	1.41	38,379	10.29
Treasury Bills and Securities	71,763	1.85	20,213	5.42
Other Assets	102,708	2.65	29,571	7.93
Liabilities	3,874,346	100.00	373,118	100.00
Due to Other Banks in Hong Kong	410,255	10.59	112,115	30.05
Due to Banks Abroad	2,341,970	60.45	86,408	23.16
Customers' Deposits	937,654	24.20	70,004	18.76
NCDs Outstanding	31,019	0.80	2,878	0.77
Other Liabilities	153,448	3.96	101,713	27.26

Note: NCD = negotiable certificate of deposit

Source: Hong Kong Government Secretariat.

The total amount of "Loans and Advances" provided by the Hong Kong banking sector amounted to HK$1,271.90 billion (or US$162.81 billion). Of this amount, approximately one-half represented loans for use in Hong Kong; the remaining one-half were loans for use outside Hong Kong. Loans to the Hong Kong manufacturing sector were HK$46.27 billion or 7.03 per cent of the total amount of loans and advances for use in Hong Kong. A large portion of loans were used to finance real estate and property development.

Reflecting the fact that Hong Kong is an international financial center, 81 per cent of total liabilities and 80 per cent of total assets of licensed banks were denominated in foreign currency. The fact that funds can be easily channelled in and out of Hong Kong is a mixed blessing because the Hong Kong banking sector is vulnerable to political, social, and economic changes in Hong Kong, China, and the United States.

The **Indian** financial system is characterized by a complicated, multi-layered structure. With the Reserve Bank of India (RBI) at the top of the system, it is structured as shown below:

- Commercial Banks

  a. 273 Scheduled Commercial Banks

     i. 28 Public-Sector Scheduled Banks
     ii. 194 Regional Rural Banks
     iii. 51 Private-Sector Banks

  b 3 Non-Scheduled Commercial Banks

- Specialized Banks

  a. Export-Import Bank of India
  b. National Bank for Agriculture and Rural Development

     i. State Cooperative Banks
     ii. State Land Development Banks

- Development Finance Institutions

  a. Industrial Development Bank of India (IDBI)
  b. Industrial Finance Corporation of India (IFCI)
  c. Industrial Reconstruction Bank of India (IRBI)
  d. Industrial Credit and Investment Corporation of India (ICICI)
  e. 18 State Financial Corporations (SFCs)
  f. 26 State Industrial Development Corporations (SIDCs)

- Non-Bank Financial Institutions

  a. Investment Companies

     i. Unit Trust of India
     ii. Private Investment Companies

  b. Insurance Companies

     i. Life Insurance Corporation of India (LIC)
     ii. General Insurance Corporation of India (GIC)

c. Other Insurance Companies

i. Export Credit Guarantee Corporation of India
ii. Deposit Insurance and Credit Guarantee Corporation

d. Finance Companies
e. Leasing Companies

- Stock Exchanges

The RBI was established in 1935 as the central bank. Two DFIs, the IDBI and the National Bank for Agriculture and Rural Development (NABARD) (formerly the Agricultural and Rural Development Corporation), perform some functions which are complementary to the central banking functions by providing resource support to state-level development institutions. The operation of these two DFIs is closely coordinated by the RBI. For example, the IDBI is a wholly owned subsidiary of RBI, sharing a common board of directors, while one of the Deputy Governors of RBI serves as the Chairman of NABARD. Discriminatory interest rates and selective credit controls have been extensively used by the RBI to channel credit into priority sectors of the Indian economy. Typical credit policy instruments employed by the RBI include the cash reserve ratio, statutory liquidity ratio, and refinance support facility. Administered interest rates and directed credit policy, however, caused problems in the allocation of resources at the expense of the normal operation and development of the Indian capital market. Increasing government budget deficits add another dimension to the RBI monetary policy. The budget deficits are financed by the RBI through the purchase of Treasury bills and medium- and long-term government securities. Due to controlled interest rates, the government securities market has not become fully developed in India. Hence, while treasury bills and government securities are absorbed by designated institutions such as banks, provident funds, insurance companies, etc., the RBI continues to be the major holder of such securities issued by the Indian government. As a result, the emphasis of RBI's monetary policy is being shifted from credit control in the commercial sector to controlling the inflationary pressure caused by increasing government budget deficits. Assets of selected financial institutions are summarized in Table A-4 as of 1988.

Table A-4. Assets of selected Indian financial institutions, 1988

Institutions	Assets (US $ billion)	Per Cent
Scheduled and Non-Scheduled Commercial Banks	78.45	78.90
Specialized Banks	5.99	6.02
Development Finance Institutes	14.99	15.08
IDBI	8.41	8.46
ICICI	2.24	2.25
IFCI	1.80	1.81
SFCs	2.54	2.55
Total	99.43	100.00

Source: Asian Development Bank.

There are 276 commercial banks in India, including 273 scheduled banks and 3 non-scheduled banks. Non-scheduled banks are small institutions that do not meet the statutory requirements of the RBI. Scheduled banks fall into three categories: (a) public-sector banks; (b) regional rural banks; and (c) private-sector banks, including foreign banks. Although the number of public-sector banks is not large, they represent the dominant force in the Indian commercial banking system. Their market shares in terms of deposits and loans outstanding exceed 90 per cent of the total reported by all scheduled banks. Because total assets of all scheduled banks account for approximately three-quarters of India's financial system, the relative importance of public-sector banks is obvious.

Among the public-sector banks, the State Bank of India (SBI) is the largest. Over 90 per cent of SBI's capital is held by the RBI. There are seven associate banks of SBI. The SBI owns all or most of the share capital of these seven banks. All scheduled banks keep deposits with RBI in order to satisfy the 15 per cent cash reserve ratio, and hold large quantities of government and other approved securities to satisfy the 38 per cent statutory liquidity ratio requirement. Chronic budget deficits have forced the Indian government to raise the cash reserve ratio and the statutory liquidity ratio, causing the cost of funds for commercial banks to rise over time. Commercial banks are also required to lend to priority sectors at low interest rates dictated by the government, and this adds to their higher cost and reduces the scheduled banks' profitability. The uses of funds in the banking sector fall into two major categories: (a) loans and advances (38 per cent); and (b) investment in central and state government securities (46 per cent).

The entire structure of interest rates in India is determined by the RBI in consultation with the Ministry of Finance. The structure of lending rates in India is very complex because there is a wide range of interest rates which reflect neither the credit market conditions nor the risk of instruments issued. Some public-sector bonds carry extremely high yields that cannot be justified. This implies that one sector of the economy is subsidizing another, which is not conducive to development of a sound securities market. Traditionally, the monetary authority has enforced high interest rates on lending and borrowing activities, increasing the interest burden of the government, development finance institutions, and ultimately the manufacturing industry. Potential distortion and problems of misallocation of resources caused by the controlled structure of interest rates should not be underestimated.

The Monetary Authority of **Singapore** (MAS) is authorized to serve as a central bank in Singapore except for the issuance and management of public debt. It exercises close control over the banking and financial system, including securities and insurance companies. Unlike many other countries under study, the MAS does not control interest rates paid on deposits or charged for loans. Financial institutions consist of: (a) commercial banks; (b) the Development Bank of Singapore; (c) the Post Office Savings Bank; (d) finance companies; (e) merchant banks; (e) insurance companies; and (f) the Central Provident Fund.

There are 36 "full license banks," of which 13 are locally incorporated and 23 are foreign banks. These banks engage in normal banking activities. A total of 14 other foreign banks are licensed as "restricted banks." They engage in normal banking activities except for savings accounts and retail banking because they are not permitted to accept deposits of less than S$250,000. There are 76 "offshore" banks which engage in dealings in foreign exchange and offshore lending. Their local banking activities are severely limited because the minimum size of deposits or loans is S$30 million.

Two major sources of funds are deposits and borrowing from other banks. Deposits amounted to S$53.35 billion or 42 per cent of total funds available to the commercial banks, whereas borrowing from other banks was S$57.48 billion or 45 per cent of total funds in 1985. Reflecting the international scope of banking activities, about 70 per cent of borrowing from other banks was comprised of Asian Currency Units and loans from non-Singaporean banks. Likewise on the asset side, the amount due from other banks was S$57.24 billion, of which 74 per cent was through Asian Currency Units or from non-Singaporean banks. Loans and advances accounted for about 40 per cent of the total assets of commercial banks.

Loans and advances extended to the manufacturing sector accounted for a modest 14.72 per cent of the total amount. Considering that the manufacturing sector's contribution to GDP was about 30 per cent, the manufacturing sector deserves additional financing from the commercial banks. Loans and advances by industry classification as of 1989 are summarized below:

Table A-5. Loans and advances by industry classification in Singapore, 1989

Classification	Per Cent
Agriculture, Mining & Quarrying	0.16
Manufacturing	14.72
Building and Construction	12.75
Housing	8.85
General Commerce	24.53
Transport, Storage, and Communication	2.14
Non-Bank Financial Institutions	16.67
Professional and Individuals	13.83
Others	6.35
Total	100.00

Source: The Monetary Authority of Singapore.

The types of loans and advances extended to non-bank customers in Singapore include: (a) overdrafts; (b) term loans; (c) bills discounting; and (d) trust receipts. This composition of loan portfolios held by commercial banks shows a gradual shift towards term loans. Term loans accounted for 26 per cent of total loans and advances extended to non-bank customers in 1980, but increased to 53 per cent of the total in 1989. A substantial decline in overdrafts and bills discounting is observed, reflecting the slowdown in external trade.

The financial system of **Taiwan Province** is characterized by a high degree of specialization and segmentation resulting from the government's development policy. The Central Bank of China (CBC) performs the traditional functions of the central bank, including: (a) monetary and credit policy; (a) management of foreign exchange; (c) issue of currency; (d) fiscal agent of the government; and (e) supervision of financial institutions.

Financial institutions include:

Deposit Money Banks

a. 16 Domestic Banks;
b. 35 Local Branches of Foreign Banks;
c. Eight Medium Business Banks;
d. 74 Units of Credit Co-Operatives Associations;
e. 285 Units of Credit Departments of Farmers' Associations;
f. 23 Units of Credit Departments of Fishermen's Associations;

Other Financial Institutions

g. Eight Investment and Trust Companies;
h. The Postal Savings System;
i. 15 Life Insurance Companies;
j. 19 Property and Casualty Insurance Companies;
k. Three Bills Finance Companies;
l. Fuh-Hwa Securities Company; and
m. 26 Offshore Banking Units.

As of December 1989, total assets of deposit money banks amounted to US$252.9 billion or 63.49 per cent of the total assets, while other financial institutions held US$61.41 billion or 15.42 per cent. Total assets held by the CBC stood at US$84.02 billion, of which 94 per cent were foreign assets because of substantial foreign exchange reserves.

The 16 domestic banks as a group represent the dominant force in Taiwan's financial system. Their combined assets were US$172.90 billion or 43.41 per cent of the total assets of the entire financial system. Portfolio investments accounted for almost 16% of the total assets indicating a significant role in securities markets. Deposits amounted to US$116.54 billion or 67.41 per cent of total funds. Borrowing from financial institutions (including the CBC) was the second important source of funds. Total borrowing was US$25.54 or about 15 per cent of total funds. Loans and discounts on the asset side were US$109.24 billion which represented 63.18 per cent of total assets. Of this amount, approximately 80 per cent was extended to private enterprises and the remainder to government agencies and government enterprises. Several domestic banks have been serving as development banks in the areas designated by the government. The Bank of Communication is a development bank providing medium- and long-term financing to priority sectors. The Farmers Bank of China, the Land Bank of Taiwan, and the Cooperative Bank of Taiwan serve the agricultural sector. The Export-Import Bank of China specializes in extending trade-related financing to various industries. Foreign banks play only a marginal role and account for 2.33 per cent of the total assets in 1989.

Private enterprises received 40.19 per cent of total loans and discounts extended by domestic banks, while government enterprises received 8.42 per cent. Approximately one-quarter of loans and discounts were extended to manufacturing firms. The remaining 41.16 percent were reported by CBC to be loans and discounts extended to individuals but a substantial portion of this amount must have been used for manufacturing activities. However, no breakdown by industry is available.

Loans and discounts are of various types such as: (a) discounts; (b) advances on imports; (c) short-term loans and overdrafts; and (d) medium and long-term loans. The relative importance of medium- and long-term loans has increased, while short-term loans and overdrafts show a declining trend.

ANNEX II

Regulatory Structure of Securities Markets in Selected Countries of the Region

The unification of the Far East Stock Exchange Ltd., the Hong Kong Stock Exchange, the Kam Ngan Stock Exchange Ltd., and the Kowloon Stock Exchange in April 1986 and the market crash of October 1987 were two major events in the recent development of the **Hong Kong** securities market. Prior to the 1987 market crash, regulatory powers were divided in an ad hoc manner among the Securities Commission, the Commodities Trading Commission, and their executive arms, the Commissioner for Securities and Commodities Trading. There were no integrated structure, centralized management, and centralized financial resources. The Securities Review Committee, appointed in November 1987 by the Governor of Hong Kong, reviewed the operation and regulation of Hong Kong's securities industry and recommended that the two commissions and the commissioner's office be replaced with a single independent statutory body outside the civil service. Thus, the Securities and Futures Commission (SFC) was formed in May 1989 to serve as a "watchdog" to promote orderly securities and futures markets in Hong Kong. The future success of the new regulatory structure is dependent upon an effective and cooperative working relationship among the SFC, the SEHK, its 22-member Exchange Council, and the Hong Kong Futures Exchange. It is premature to judge the success of the new regulatory structure since it has only been in operation for two years.

Laws and regulations related to the **Indian** securities market include the Companies Act of 1956, the Capital Issues Control Act of 1947, the Securities Contracts Regulation Act of 1956, the Securities Contracts Regulation Rules of 1957, and the Securities Contracts Rules of 1986. The securities market is also subject to the regulations and guidelines of the Ministry of Finance and to the by-laws and rules of various stock exchanges. The Controller of Capital Issues (CCI) is responsible for new issues introduced in the primary market. The Stock Exchange Division of the Ministry of Finance is responsible for the activities of the secondary market under the Securities Contract Regulation Act. SEBI was established in 1988. The legislation making SEBI a statutory body is yet to be approved. It is expected that SEBI's role will be similar to that of the U.S. Securities and Exchange Commission. The recent establishment of the Credit Rating Information Services of India Limited (CRISIL) and the Stock Holding Corporation of India Limited (SHCIL) represented positive developments for the modernization of the Indian capital market. CRISIL's principal objective is to rate the debt obligations (including debentures, fixed deposits, short-term instruments, and preferred stocks) of Indian companies. However, companies are not obligated to obtain a credit rating for issuing debt securities. The rating of CRISIL is not related to particular debt instruments and is not an evaluation of the company as a whole. The main purpose of setting up SHCIL has been to introduce a book-entry system transfer of shares and to serve as a central depository body. Draft legislation to make necessary legal provisions for a full-fledged book-entry system is under review by the government.

The development of the **Indonesian** securities market was initiated in 1977 with an institutional framework built upon the Capital Market Executive Agency

(BAPEPAM) and P. T. Danareksa. BAPEPAM was created as a special agency under the Ministry of Finance to assume functions similar to the Securities and Exchange Commission of the United States and to administer and manage the JSE which was formally reopened in August 1977. At the same time, P. T. Danareksa, a government-owned investment trust company, was formed to implement the government policy objective of achieving equitable distribution of corporate ownership.

The **Korean** Securities Exchange Commission (SEC) was established in 1977 when the Securities and Exchange Law of 1962 was revised. The SEC formulates policies relating to both new issues and trading markets. The SEC is composed of nine commissioners. All decisions of the commission must be reported to the Minister of Finance who may override them if necessary. The Securities Supervisory Board is the executive body of the SEC. It implements the decisions made by the commission and supervises securities companies, the KSE, investment advisory companies, and other securities institutions. The Laws on Fostering the Capital Market of 1968 have been instrumental in developing the Korean securities market by providing tax and other incentives for listed companies and an employee share ownership plan. The KSE was restructured in 1988 as a non-profit membership organization.

Unlike in most other countries of the region, the overall regulatory structure in **Malaysia** does not follow the "one market, one agency" format. There are four regulatory bodies representing three Ministries of the Malaysian government. The Capital Issues Committee, under the Ministry of Finance, oversees the issue of securities and the approval of company share listings on the KLSE. The Registrar of Companies under the Ministry of Trade and Industry administers and regulates the Securities Industry Act. Listed companies conducting a public offering must register a prospectus and other disclosure documents. This office is also empowered to issue, renew, or reject licenses to dealers, dealer's representatives, and investment advisors. It also implements measures to protect the market from unfair practices. The Foreign Investment Committee under the Prime Minister's Department implements the guidelines on regulation of assets or interests, mergers or takeovers of companies and businesses, and is responsible for major issues on foreign investment. The Panel on Take-overs and Mergers oversees all takeovers and mergers to ensure that they are conducted in an orderly manner. Additionally, the issue of corporate bonds requires an approval from the Bank Negara Malaysia, which also has sole responsibility for government securities markets. Fragmentation of authority as evidenced in Malaysia can prove very costly in promoting the role of the securities market in industrial financing.

The regulatory role of the **Philippine** securities market is carried out by the Securities and Exchange Commission (SEC), which was modeled after the U.S. SEC. One of the most critical tasks facing the Philippine SEC is the unification of the two existing stock exchanges. The deadline for unification was March 1991, but this deadline passed without any significant institutional development. It is not an easy task to achieve, but its importance is recognized by all parties concerned. It took over 10 years before Hong Kong's four stock exchanges were merged. It must be pointed out that unification alone would not solve many of the problems facing the Philippine securities industry. Moreover, these problems cannot be solved by the Philippine SEC alone. There must be a systematic effort among the Ministry of Finance, the BOP, and SEC to coordinate fiscal, monetary, and regulatory policies to develop the securities market. At present, a new bill is pending at the Philippine House of Representatives. The main purpose of this bill is to restructure the existing SEC by creating a new regulatory body, the Capital Markets Development Agency, which will have an additional function of developing the securities market on top of SEC's traditional regulatory function. The Philippine securities market desperately needs to modernize its trading facilities and clearing and settlement systems. The Philippines is one of a few countries in Asia that does not have an automated trading system and still relies on a physical delivery system for trade settlement. Additionally, brokerage firms need improved financial strength, trained professional manpower, and communication facilities.

Substantial changes in government regulation of the securities market of **Singapore** were undertaken after the Pan-Electric Industry crisis in 1985. Six member companies became insolvent due to collapsed stock prices and exposure to forward contracts after the failure of the Pan-Electric Industries. The Securities Industry Act was revised in 1986 to strengthen the supervisory and regulatory functions of the Monetary Authority of Singapore (MAS) over SES's operation and the securities industry. The rules of SES were amended to place heavier emphasis on the capital requirements, financial structure, and monitoring processes of securities firms.

The Securities and Exchange Law of 1968 defines the regulatory framework of the **Taiwan Province's** securities market. The Securities and Exchange Commission is authorized to regulate the entire range of securities market activities, including: (a) supervision of the public offering and listing of shares; (b) supervision of the TSE, the Taipei Securities Dealers Association, securities companies, and securities underwriting and trading; (c) supervision of securities investment trust companies, securities investment consulting enterprises, securities depository business, and margin regulations. The Securities and Exchange Law was amended in January 1988 to improve financial accounting practices and to provide a necessary framework for the liberalization and internationalization of the securities industry. Under the supervision of the SEC, the TSE is in charge of the administration of the securities market. The TSE is organized in the form of a corporation. Private financial institutions hold 61 per cent of the total shares, and government-owned banking institutions the remaining 39 per cent. In addition to 181 listed companies with total market capitalization of US$237 billion, a total of US$8.40 billion in bonds was listed at the end of 1989. The listed bonds can be classified into three categories: (a) Treasury bonds with US$7.81 billion; (b) the Central Bank of China's savings bonds and certificates of deposit (CDs) in the amount of US$0.30 billion; and (c) corporate bonds in the amount of US$0.29 billion.

The SET of **Thailand** began operations in April 1975 as authorized by the SET Act of 1974. The SET is supervised by the Minister of Finance, who delegated this authority to the Bank of Thailand (BOT). Additionally, the Ministry of Commerce also has authority over the listing of new shares. A proposal for the establishment of a separate Securities Exchange Commission is under review so that the SEC would have regulatory authority over the securities market, while the SET would have operational responsibility for the stock exchange.

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