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ECONOMIC TURMOIL IN ASIA: PROSPECTS FOR FDI FLOWS

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The economic and financial crisis that has plagued Asia since mid-1997 has left in its wake dramatic declines in output, large falls and volatile exchange rate changes, worsening poverty, and widespread social unrest owing to rising unemployment, among others. Yet it is important to remember that there are other effects that this crisis had left behind. These are the real economic dimensions of the countries that have made them achieve sustained growth rates in the past decades.

These real factors are the outcomes of and were influenced by structural changes in the region itself, which in turn have created the environment defining the pace and pattern of foreign direct investment into the affected countreis. These range from the domestic policy actions taken by governments to the transformation of the Japanese economy as a driving force for FDI. Much of this structural change in the environment for FDI in the region appears to be irreversible. It is in this context that the prospects for FDI in the region and into the affected economies seem to be positive.

1. Introduction

When the Asian financial crisis manifested[1] itself in Thailand in mid-1997and quickly spread to other affected countries, the common view was that the fundamentals remained strong to weather the crisis. Subsequently the prevailing interest was to understand the root causes of the crisis and to fashion appropriate policies not only for recovery but to avoid a similar future contagion. Invariably, the identified causes ranged from a narrow peg of the exchange rates to lack of transparency and prudential regulations among banks. Moreover, the crisis was the

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[1] There is an argument that the makings of the Asian crisis started even before June 1997 when the Thai baht was devalued. Some authors trace its beginnings as far back as the adjustment and devaluation of the Chinese yuan in 1994. See, for example, Ichimura and others (1998).

occasion for calling attention to the weaknesses of the financial systems of the affected countries wherein there existed close relationships between the government and institutional credit. Indeed the crisis was partly triggered by cronyism and corruption and there was lack of effective governance among the institutions concerned.[2] In the tradition of the sequencing issues, the crisis highlighted the "disorder" by which the capital account has been liberalized without the concomitant underlying set-up in place namely banking reforms, standards, and transparency.[3]

The crisis also spawned the proliferation of studies, conferences, and papers looking into its causes and effects (e.g., Montes, 1998; Hill, 1998; Moreno and others, 1998; Kawai, 1998). These have traced the history of the crisis, the underlying causes, and the alternative approaches to its response. The more formal of these posit that private sector behavior with respect to foreign funds borrowings behave as if there was an implied government guarantee in case of exchange losses and thus there is a tendency to overborrow when the exchange rate is fixed (e.g., Krugman, 1998; McKinnon and Pill, 1998). Following a financial liberalization, the boom and the implicit insurance induces foreign investors to exposure in emerging markets lulled by the available reserves. What can not be explained is why panic took place when the crisis began.

The immediate reaction to the crisis was a bailout of sorts by the IMF, which in turn imposed stringent conditions on the economies of these countries. Yet it appears that the crisis is far from over and the early prospects of recovery may not be forthcoming. Disappointment with the IMF approach has doused the possibility of immediate return of confidence and resumption of capital flows. However one has to distinguish the kinds of capital that are expected to return to the region and the factors that affect them.

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[2] The fact of the matter is that cronyism and corruption have been in these affected Asian economies long before the crisis hit them. They were therefore not the primary or proximate causes of the crisis to erupt.

[3] The classic order of liberalization literature did not really take into account the necessary institutional mechanics (capitalization standards, prudential regulations, etc., among others) but the larger sequence between the current account and the capital account in the Balance of Payments. McKinnon (1991).

Instead of pursuing the common thread of the roots of the crisis and how they can be corrected, this paper will attempt to re-locate the issue of recovery in the context of the flows of FDI into the region. The argument here is that the environment for FDI remains stable and continues to be formidable for the region in spite of the crisis.

The next section examines what the crisis is leaving behind. Some of the basic foundations, which have been responsible for driving the region to high growth paths, remain. The crisis has not destroyed these capacities nor changed their behavior. These fundamentals are what may carry the region to earlier recovery than otherwise. In the third section we look at the structural environment for FDI. Several policy directions that have been carried out before remain critical in determining the flows of FDI into the region, which include the package of liberalization reforms in the Asian countries arising from the Plaza Accord. Similarly, the structural transformation in Japan's trade and industrial sector weighs heavily in attracting FDI from that country. The fourth section considers the prospects for FDI flows into the region. Among them are the private sector views with respect to the resurgence and sustainability of private capital, forecasts by international agencies, the U.S. response, and the implications of lower levels of investment approvals. In the final section of the paper some conclusions are drawn up.

2. What the Crisis Left Behind

The surge of capital flows into the Asian region in the nineties associated with capital account liberalization was mainly in the form of portfolio investments and debt capital (through banks and non-bank financial institutions) instead of FDI. Thus much of the growth in the region during this time may have been driven by (private) debt capital. For example, the Institute for International Finance (IIF) reports that of the $44.8 B net private flows into the five affected economies in the Asian region (Indonesia, South Korea, Malaysia, Philippines, Thailand) in 1993, only $4.5 B were in net direct equity investment and the rest were in portfolio equity investments, net lending by commercial banks and other private creditors (IIF, 1998). By 1996 the total net private flows into these countries amounted to $97 B of which only $6.2 B were in net direct equity investments. By the end of 1997, net private flows indicated an outflow of $11.9 B but with FDI increasing slightly. These private capitals from abroad therefore augmented domestic private sector resources.

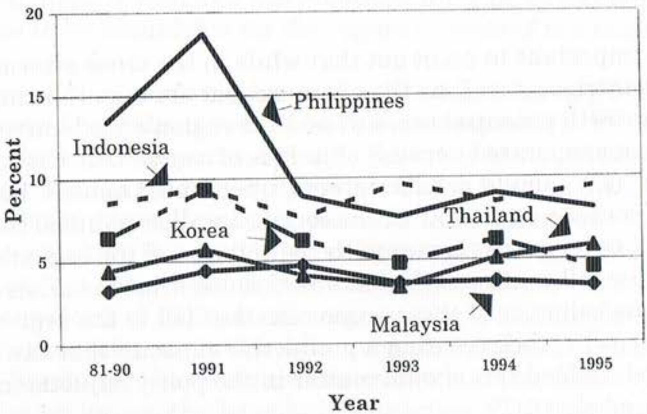
It is important to point out that while in the crisis aftermath the affected countries as well as the entire region are experiencing recessions, the growth potential remains and the region's productive capacities have not evaporated because of it. It is of course true that one sees the "waste" (e.g., empty condominiums, unoccupied houses, buildings, malls, golf courses, etc.) around, the social as well as political costs, and widespread poverty that comes with the collapse of the region's economies, and the toll continues. Yet in a real sense what the crisis has left behind is the behavior of these economies that led to the region's solid economic growth track creating a productive capacity that can quickly turn around. Indeed this should matter in the policy adjustment of the region (more below).

First of all, macroeconomic parameters of the affected economies in the nineties show that both inflation and government budgetary deficits were responsibly managed. This is shown by the convergence of inflation rates and the movement of overall surplus (deficit) of the central government during the period between 1990 and 1995. Figures 1a and 1b track the changes in consumer prices and overall government surplus or deficit as a percent of GDP, respectively. Notice the divergence in early nineties and a narrowing of the five country numbers by 1995. There may be some incomparability of the data[4] here yet the trend reflects fiscal stability not profligacy; monetary discipline and conservatism not irresponsibility.

Second, the region has pursued a sustained industrial development drive and has therefore seen a rising share of industry to the overall economy. Figures 2a and 2b show this capacity in the five affected economies. The former is the real growth rates of manufacturing value added between 1990 and 1995. Notice that, with the exception of

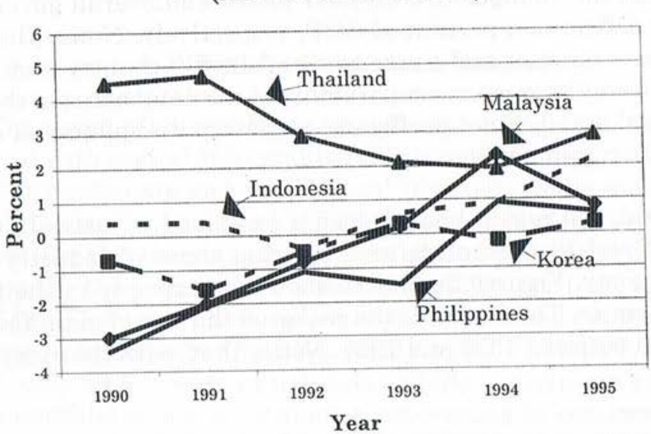
[4] There are notorious problems for example associated with what government expenditures are included, how state enterprises are treated and what constitutes comparable fiscal years.

Figure 1a.
Changes in Consumer Price Index



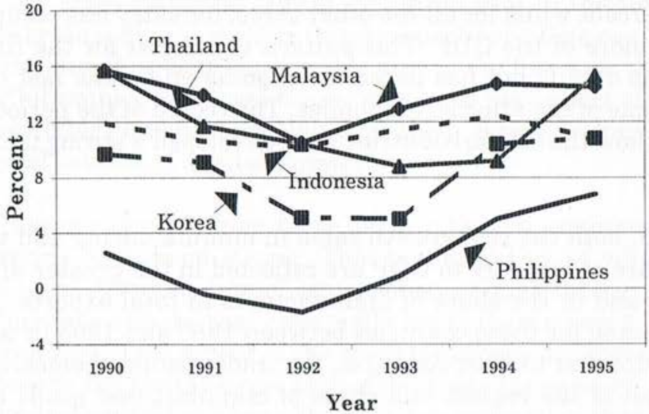
Source: ADB

Figure 1b.
Overall Surplus (Deficit)
(As Percent of GNP)



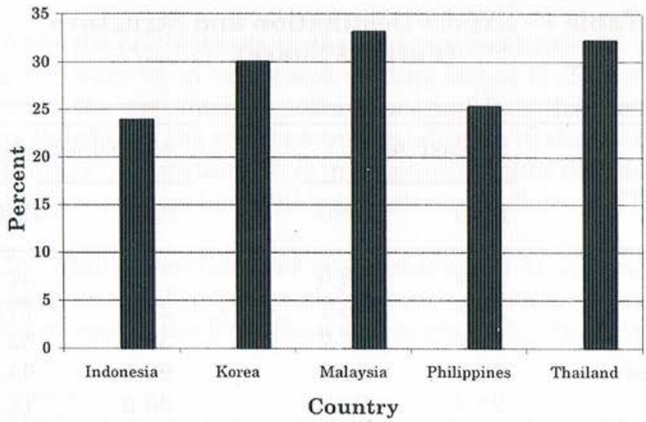
Source: ADB

Figure 2a.
Manufacturing Value Added Real Growth Rate



Source: ADB

Figure 2b.
Share of Industry to GDP



Source: ADB

the Philippines, manufacturing growth rates have narrowed by 1995. The latter shows the share of industry to GDP for 1995 for the five affected economies. Both Indonesia and the Philippines have shares below 30 percent while for all the other three, industry has occupied 30 percent or more of the GDP. This pattern is not just for the first five years of this decade but has in fact been going on for the last two decades for some of the affected economies. The record of the period 1990-1995 does show that these countries have developed a strong industrial sector.

Third, both the real growth rates in manufacturing and the significant share of industry to GDP are reflected in the greater diversity of markets and in the share of manufactures in total exports. A comparison is made for these countries between 1980 and 1995 in terms of export destination to East Asia (i.e., for trade among themselves and with the rest of the region) and share of manufactured goods to total exports. The results are shown in Table 1. Except for Thailand (which only had a marginal increase in exports to East Asia between 1980 and 1995), all the other countries expanded exports into the region by at least 50 percent. And with the exception of South Korea, there was a dramatic surge of manufactured exports between 1980 and 1995.

Table 1 - Export Destination and Structure (Percent Share)

	East Asia		Manufactures*	
	1980	1995	1980	1995
Indonesia	14.5	29.5	4.0	52.2
Malaysia	24.8	36.1	28.4	77.0
Philippines	14.2	22.7	39.6	82.7
South Korea	12.7	31.1	90.5	94.3
Thailand	23.9	25.3	38.5	74.2

Source: ADB, OECD *SITC 5-9

Finally, sustained growth has been associated with (or caused by) sustained expansion in gross domestic capital formation which in turn has been partly fed by gross national savings. Figures 3a and 3b depict the gross domestic capital formation rate in the five countries and the gross national savings rate,[5] respectively. One can see that capital formation has been comparable among the five with the exception of the Philippines. Moreover these rates have been short of the savings rates available domestically. Hence for them, foreign savings have been additional sources of capital formation.

It seems obvious from these data on the five countries that their foundations have been strong. This is a depiction of what has been termed sound "fundamentals" yet curiously enough these countries suffered currency attacks that eventually led to their current state of economic collapse. This aspect of the crisis requires a separate discussion. It suffices to say that the real side of the trade (as opposed to the asset side) fundamentals have been showing a deterioration that would have provided predictive indications of the distortions that required policy actions (e.g., the dramatic slowdown in merchandise exports growth in 1996 and the overvaluation of the currencies, among others). Although several other fundamental weaknesses have been raised such as weak financial systems, lack of prudential regulations, non-transparent governance, and corruption, these have been *status quo* even before the onset of the crisis.

What the crisis leaves in the region constitutes the mechanisms of early recovery by growing and trading out of it. This of course assumes that the appropriate policies are in place that recognizes the need for viability of the trade sectors in addition to the recapitalization of the financial institutions. It is in this context that the inability of the present policy approaches doubly threatens the flows of FDI as well.

The Philippines however does not seem to fit squarely into these behavior of strong "fundamentals" in part because its numbers are often outliers among the five affected countries. This can be prominently

[5] The data here come from the ADB Key Indicators of Developing Asia and Pacific Countries and have comparable definitions but there are nuances in the individual country components.

Figure 3a.
Gross Domestic Capital Formation

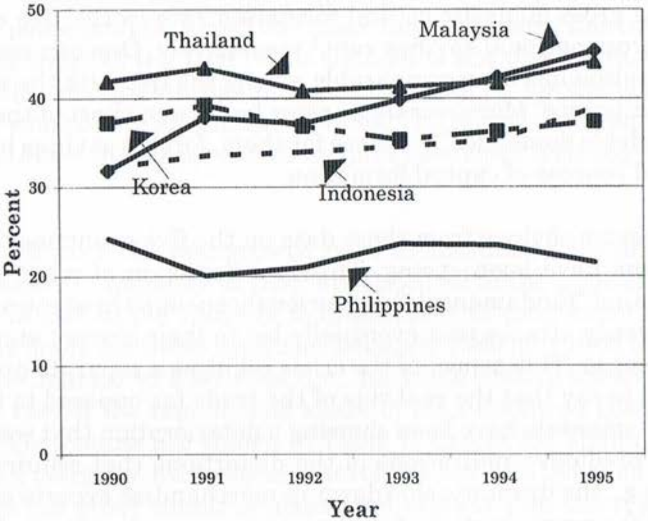
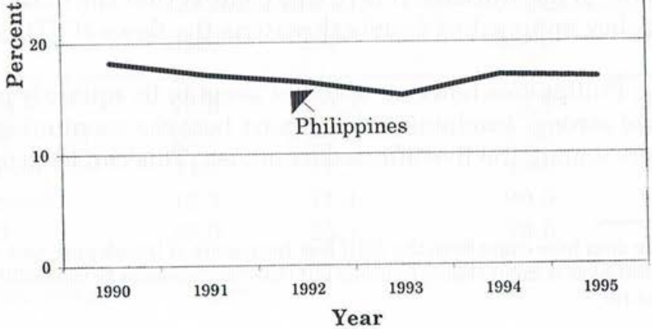


Figure 3b.
Gross National Savings Rate



seen in the figures presented above. For example, the country's manufacturing behavior, national savings, and domestic capital formation rates do not easily converge with the other four countries. That it has been equally vulnerable to the crisis (though to a lesser degree) suggests that strong fundamentals in the above sense do not provide automatic immunity (see Alburo, 1998). More concretely, what the crisis has left behind in the affected economies are the immediate capacities to rebound given the right policy mixes. But the behavior presented and the seeming exception of the Philippines does not suggest a train of causality one way or the other.

3. Structural Environment for FDI

The Asian crisis can be viewed as a short-run disturbance to a long-run scenario of growth characterized by greater interdependence in the global economy. The structural conditions of the world economy and thus its characteristics have been shaped by many factors. But for the elements that affect investments in the region, some events are worth noting. One is of course globalization itself manifested starkly by the free movement of capital across boundaries. In fact the crisis is often traced back to globalization as its root cause. More generally, as barriers to trade have come down, as communications and information technology eliminate physical distances, and as there is convergence of markets, there is greater integration among countries. The global environment for trade has therefore become more interactive, and the action of one country affects all the rest. Whether in fact the regional crisis has been caused by globalization or not can not be answered here. For sure it may have facilitated a faster flow of capital.

Globalization however is more than the freer flow of capital across national boundaries. It has stimulated increased efficiency in the global allocation of resources, as firms move production processes to maximize wider markets. It has allowed greater mobility of labor thereby expanding services. It has triggered dramatic changes in some countries such as the sweeping reforms of previously non-market economies to a market orientation, deregulation being carried out in many countries, all-out privatization in international commerce, and continuing trade liberalization.

On a sub-global level, developments in Japan offer a glimpse of the environment for FDI into the region. There are several ways that this could be approached. One is to trace Japanese FDI and the place of the Asian region in the flows of capital. Another is to see the interconnection between trade and investment with Japan. Then it is possible to look into the sectoral incidence of Japanese FDI and whether they are consistent with the country's trade and industrial structure. What is more paramount however is whether the structural changes in Japan itself which has fed the FDI into the Asian region are firmly rooted and irreversible in the long-run.

Since the Plaza Accord wherein Japan's currency significantly appreciated the structural transformation of Japan seems to have undergone two stages. In the initial period (1986-1990), the outward movement of Japan's industrial adjustment (through FDI into the Asian NIEs and ASEAN) remained home-centered wherein components and parts were brought back for processing and eventual global distribution. Moreover much of the leading-edge production activities were still located in the home country. In the subsequent stage (1991 onwards) however a new phase of "localization" has taken place in the context of the further globalization of Japan's industries. This has been helped along by other push factors that were prevalent in the nineties.[6] This phasing is not clear-cut but it is instructive to see the progressive transformation of Japan and why it is an important development in the global environment for FDI (Ozawa, 1996).

The original notion of a "flying geese" pattern of trade and industrialization casts countries and economies in some kind of a formation where countries move from one type of pattern (e.g., labor-intensive production and trade) into a higher pattern (e.g., technology-intensive production and trade) in the process allowing other countries to assume advantages that have been vacated. Thus as Japan climbed up the industrial ladder it passed on to others what was left behind. In this sense outward FDI was simply an outcome of its own restructuring and can

[6] For example high investment costs in new production facilities has induced transnational corporations to enter into more joint ventures to share both costs and risks. This is illustrated in the electronics industry as Simon and Jun (1995) note.

be called "comparative advantage recycling" the movement across borders being incidental. For this reason this phase has been commonly criticized as a "hand-me-down" or "Salvation-Army-store" industrial recycling wherein Japan continues to wear "new clothes: read upscale clothing industry" while other countries concentrate on labor-intensive standardized clothing and garments outputs. In other words, there is some definable pattern of comparative advantage across countries and what matters is which country possesses the endowments to reap first-mover benefits which over time progresses into new arrangements. Japan's overseas production (triggered by FDI) was "discards," "second-hand" or "recycled" activities.

In more recent times, overseas production seems to be an integral part of Japan's increasingly globalized industry. There is now little distinction between global- and home-focused production. In fact it may be the case that overseas production is the new backbone of Japanese industry. One evidence of this is the increasing share of shipments by overseas ventures and shipments from Asia relative to home production. For 1994, for example, machinery production overseas averaged half of home production and in the case of VTRs, and TVs, overseas production exceeded home production (ibid.). This has probably accentuated in the late nineties. Another evidence is the creeping displacement of the NIEs by ASEAN for certain standardized products as Japanese imports shift and along with them FDI. Of course along with this is also a dynamic shift away from ASEAN into China or Vietnam for other products in an ever-fluid overseas production arrangements. Finally there is evidence of gradual shift from home-based input procurement to localized sourcing of inputs, from a basic "knock-down" operation to integrated production overseas. While the local procurement ratio (number of firms buying inputs locally divided by the total number of firms responding) by Japanese ventures in the U.S. and Europe are over 50 percent, it is in the range of 25 percent in ASEAN. However there are indications from surveys that local procurement is rising.

A more telling evidence of a Japanese globalized industry is the extent of upstream linkages in the form of frontier research and development (R and D) and engineering/design centers. There is no quantitative picture to depict that this is happening. But a number of illustrations tend to support this. There is the Sony Precision Engineering

Center in Singapore producing precision parts. There is the Matsushita Air-Conditioning R and D Center in Malaysia conducting product development locally. There are the various Japanese automakers introducing "Asian cars."

It is also interesting that even within the characteristics of Japanese FDI it is useful to single out the small- and medium-sized enterprises (SMEs) and how these have helped reshape the nature of the Japanese production system. In general SMEs have been investing in the Asian region in the manufacturing sector at a higher scale than all Japanese FDI. Moreover the major motive for SME FDI is the use of local labor in contrast to large firms for which the use of local labor as motive is smaller. Exports, particularly to Japan, are another important motive for FDI by SMEs. Thus while overall FDI from Japan may have increased, the significance of the SMEs is doubly important in the sense that they provide further support to the structure of the host countries in the region (Urata and Kawai, 1998).

From this brief description of the structural transformation that has taken place in Japan, it would appear that not only has it been widespread but that it now is irreversible. Such transformation is an important development in the FDI environment for the region. More specifically, in the context of the Asian crisis there are questions as to whether Japanese FDI would be forthcoming in the scale and character that has been seen, during and after the crisis. These invariably would have to rely on the structural environment for FDI in general.

Although FDI flows may be dictated more by real and structural factors, they would also be influenced by factors that affect capital movements as a whole. And to the extent that the region is not addressing the proximate causes of the financial and economic turmoil in the region, FDI may also be affected. The five countries are apparently undertaking serious policy reforms ranging from improvements in prudential regulations, clean-up of books in financial institutions, to conformity with international standards (e.g., BIS). Collectively, there are agreements for surveillance systems that include information sharing and policy consultations to prevent contagion. In the realm of FDI itself, the ASEAN has agreed to carry out the ASEAN Investment Area (AIA) as a first step towards investment regimes harmonization in the region.

Apart from these, there are also global institutional changes that are taking place that may affect the FDI environment. The move towards formulating global rules and disciplines for FDI instead of relying on bilateral investment agreements is gaining ground albeit encountering problems. This is the OECD-initiated Multilateral Agreement on Investments (MAI) which covers such areas as performance requirements, expropriation and compensation, dispute settlement, employment requirements, investment incentives, privatization and others under the multilateral general principles of national treatment and most-favored nation clause. A global MAI may have to wait for the expected review in WTO of the Trade-Related Investment Measures Agreement and the degree by which the ASEAN AIA can become an illustrative vehicle or alternative to the MAI.

4. Prospects for FDI Flows

Since 1993 and perhaps early in the nineties as capital liberalization took place in the Asian region, FDI flows as a proportion of net private flows have decreased significantly. In addition this behavior has been atypical from the behavior of FDI flows into emerging markets. Tables 2a and 2b show the external financing flows in all emerging markets and in the five Asian countries directly affected by the crisis, respectively. Notice that in 1994 direct equity investments in emerging markets were 42.8 percent of net private flows (Table 2a) compared with 12.4 percent share in the net private flows to the five Asian countries (Table 2b). By 1996 before the crisis exploded these shares dropped to 30.7 percent in emerging markets and a mere 6.5 percent in the Asian countries. There was clearly a dash for short-term financing flows into the Asian region.

The same tables lay out a forecast for 1998 of a stable flow of FDI amidst negative net private flows into the region with an overall positive net external financing brought about by a surge of net official flows principally via the international financial institutions bail-outs. There is an expectation of some resurgence of portfolio capital but a continued though declining outflows by private creditors (commercial banks and non-bank private creditors). These expected FDI flows have to be seen in terms of the likely substantive behavior of source countries given the structural environment noted in the previous section.

Table 2a - Emerging Market Economies' External Finance (Billion US$)

	1994	1995	1996	1997e	1998f
Current Account Balance	-70.2	-84.9	-92.6	-85.2	-71.2
External Finance, net	181.1	262.5	305.9	270.5	254.6
Private Flows, net	154.7	217.9	304.5	232.6	221.3
Equity Investment	93.6	104.8	127.0	148.2	149.8
Direct Equity	66.3	80.5	93.4	122.9	114.5
Portfolio Equity	27.4	24.3	33.6	25.3	35.2
Private Creditors	61.1	113.1	177.5	84.4	71.6
Commercial Banks	38.0	92.1	107.1	4.2	12.0
Nonbank Priv. Creditors	23.0	21.0	70.3	80.2	59.5
Official Flows, net	26.4	44.7	1.4	37.9	33.3
Int'l Financial Institutions	4.8	20.1	5.2	26.7	30.5
Bilateral Creditors	21.6	24.6	-3.8	11.2	2.8
Resident Lending/other, net	-65.8	-85.2	-129.8	-145.9	-97.2
Reserves excl gold (–=increase)	-45.4	-95.3	-85.4	-40.7	-96.2
Memo: Short-term credits, net	2.7	48.3	61.9	-12.2	-17.0

e = estimate; f = forecast
Source: Institute of International Finance

Table 2b - The Five Asian Economies: External Financing (Billion US$)

	1994	1995	1996	1997e	1998f
Current Account Balance	–24.5	–41.4	–55.2	–27.1	–30.6
External Finance, net	45.2	84.6	95.2	18.1	25.9
Private Flows, net	37.9	79.2	97.1	–11.9	–0.3
Equity Investment	12.1	15.4	18.7	2.1	16.4
Direct Equity	4.7	4.9	6.3	6.4	6.9
Portfolio Equity	7.4	10.5	12.4	–4.3	9.5
Private Creditors	25.8	63.8	78.4	–14.0	–16.8
Commercial Banks	23.4	49.9	55.7	–26.9	–19.8
Nonbank Priv. Creditors	2.4	13.8	22.7	12.9	3.0
Official Flows, net	7.3	5.4	–1.9	30.0	26.2
Int'l Financial Institutions	–0.4	–0.3	–2.0	22.5	23.2
Bilateral Creditors	7.7	5.8	0.1	7.5	3.0
Resident Lending/other, net	–15.2	–29.2	–21.6	–30.5	–4.6
Reserves excl gold (–=increase)	–5.4	–14.0	–18.4	39.5	–51.9
Memo: Short-term credits, net	7.3	40.4	38.5	–41.7	–42.8

e = estimate; f = forecast
Five Asian Economies: Indonesia, Korea, Malaysia, Philippines, Thailand
Source: Institute of International Finance

First of all, among other forms of capital it is FDI which is more stable, more influenced by long-term profitability and other considerations, depends on conditions of the real economy, and is not likely to pull out in the short-run. However given the option of other capital uses, FDI can always be temporarily held in short-term assets. Thus FDI looks at the broad environment of the economy, its policy setting, a host of supporting structures, the bureaucracy and regulatory conditions, and long-term profit expectations. The point is that while a climate of volatility in exchange markets may be expected to reduce portfolio flows, this is not necessarily a reason for a concomitant reduction in the volume of FDI either, especially those FDI closely tied with trade. This is shown by the wide swing in net private flows between 1996 and 1997 from a positive inflow to a negative outflow (Table 2b). But direct equity investment remained relatively stable.

This bottoming out of net capital flows is of course contingent on the crisis leveling off and Japan is able to contain its financial problems in a more stable exchange rate. The expectation of re-flows is also expressed by financial managers who see little debt capital relative to pure equity capital coming back to the region, more outright acquisitions by corporations from outside of Asia, and more long-term flows (Kim, 1998). Some economies would do better than others not because of attractiveness but because of changes in the capital accounts as some of the restructuring of existing claims involve more equity.

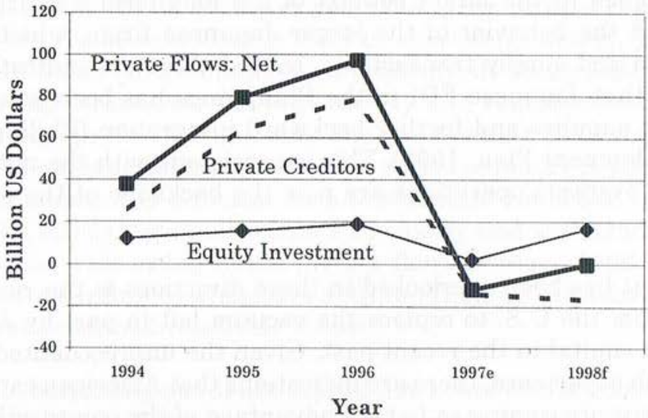
It has already been pointed out in previous sections that the transformation of the Japanese economy and its own adjustments to globalization suggest that changes in its production, trade and investment behavior are irreversible in the short and medium terms. The reconfiguration of Japan's trade and industrial structure which has dictated the flow and character of FDI suggests that more FDI will be forthcoming however modest.

This direction is supported by views coming from large Japanese transnationals that while investments (into the region) may not be as smooth as in the past, they will continue to increase, that in fact the devaluations, massive surplus of undervalued assets, and long-term reductions in the cost of doing business in Asia make for opportunities for investment (Kobe, 1998). This long-term perspective may not be true for all Japanese firms. It is possible that small and medium sized firms find it easier to relocate production back home in response to declining costs triggered by yen depreciation itself. But such decisions may have to be weighed in the larger context of the long-term scenario in the region and the behavior of the larger Japanese firms, which dictate production and supply transactions. Indeed there are indications, for example, that Japanese FDI in the Philippines has been going lately into input supplies and further backward integration (Philippine Export Development Plan, 1998). This is consistent with the notion that Japanese overseas operations are now the backbone of the Japanese industry.

What has been overlooked in these directions is the rise of FDI coming from the U.S. to replace the vacuum left in part by Japanese and Asian capital in the recent past. Given the unprecedented American growth experience, there are indications that American capital and corporations are coming in to take advantage of the opportunities created by the crisis (Kim, 1998). And as foreign investment laws are modified in the Asian countries, the options for more sectoral presence become wider. Of course there are the European countries that are also likely to take advantage of equity participation and acquisitions arising from the crisis. Though debt capital is not likely forthcoming from any of the major capital sources, FDI is altogether another matter. In all, the combination of re-flows of capital towards FDI, the configuration of Japanese production relations, the likely positive response from U.S. investors, and other sources indicate that FDI will continue to flow however modest. Some of these flows may not turn out to be new money but conversions of private debt capital into equity.

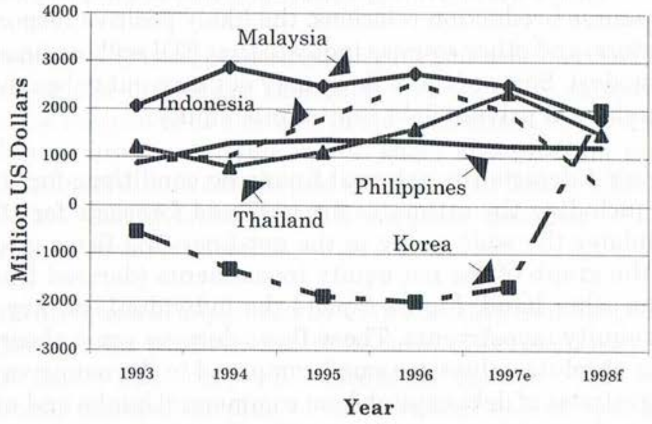
Figure 4 depicts the external financing conditions for the Asian countries including the estimates for 1997 and forecasts for 1998. The figure validates the wide swing in the net financing flows into the region and the graph of the net equity investments (derived from Table 2b). On the other hand, Figure 5 plots the individual country flows of net direct equity investments. These flows deserve some observations. First, their absolute values are small compared to the net private flows, to the magnitudes of debt capital from commercial banks and non-bank creditors, and portfolio investments. The latter is manifested in the foreign purchases of stocks in the stock markets. Second, South Korea

Figure 4.
Five Asian Economies: External Financing



Source: Institute of International Finance

Figure 5.
Net Direct Equity Investments



Source: See Figure 4

has not had a history of significant net foreign direct investments and the flows reflect the FDI by South Koreans to the rest of Asia. There is a forecast of a positive inflow by 1998. Third, FDI flows into the Philippines seem to be the more stable among the five countries affected by the crisis. Although the absolute amounts may be small, they appear to have been unaffected by the crisis. Fourth, there are in fact declines in the FDI flows into individual countries especially when compared to previous peaks. Nevertheless these flows are positive and may turn out to be higher depending on the direction of policy pursued in the region as well as in each of the individual countries. Recall that the ratio of FDI to net private flows into the emerging markets as a whole is relatively high when compared to the Asian countries prior to the crisis.

In addition to the factors enumerated above that may influence the direction and magnitude of FDI into the region, there seems to be more selectivity in decisions involving direct equity investments. This comes from the fact that the foreign investment approvals among the five Asian countries have dramatically declined in the first quarter of 1998 (UNCTAD, 1998). FDI approvals amounted to only \$7.6 B into the five countries which if extrapolated for the whole year would amount to \$30.4 B, about half of the average approved investments between 1994 and 1997 of \$60.8 B. This is immediately seen as a concern since this implies a drying up of foreign capital inflows. Yet of the approved \$7.6 B, some \$4.6 B were realized or became actual inflows into the region. It must be understood that investment approvals do not mean they become actual foreign capital inflows. The first quarter 1998 actual flows translate into a 60.5 percent realization rate. Note that the implied realization rate from FDI approvals in the Asian countries during the period 1994 to 1997 is 26.1 percent. One can interpret this sharp decline in approval also to more discerning FDI behavior i.e., seeking approvals only for those ventures with greater chances of viability. Assuming this to be so, even with a sharp decline in approvals but with a higher realization rate the actual may indeed be greater than the average of the past four years. Table 3a shows the record of FDI approvals in the Asian Five and the actual FDI flows from 1994 to 1997 and for the first quarter of 1998. For comparison purposes Table 3b shows the record of foreign investment approvals in the Philippines for the same period of time and the actual flows of FDI even if the two data sets are different.

Table 3a - Actual and Approved FDI Five Affected Asian Economies (Billion US$)

	Actual	Approved
1994	10.1	37.0
1995	13.7	63.9
1996	17.0	56.7
1997	16.4	61.8
1998Q1	4.6	7.6

Source: UNCTAD

Table 3a - Actual and Approved FDI Philippines (Million US$)

	Actual	Approved
1994	881	2,371
1995	815	1,872
1996	1,281	968
1997	1,053	1,991

Source: Board of Investments; Bangko Sentral ng Pilipinas

In summary, there are at least four dimensions that define the prospects for FDI into the region—a structural environment that is paced by global trade and Japan's trade and industrial transformation, investor emphasis on equity and conversion of debt to equity, U.S. as well as European interests in Asian stocks and direct equity participation after a wait-and-see stance, and more discriminating investment behavior with respect to applications for approval. These, manifested in quantitative forecasts, expert views, and global adjustments, all point to a direction where FDI will continue to flow into the region notwithstanding the Asian crisis. While there may be outflows from the region for other capital items, FDI is expected to remain stable and may expand modestly—with the Philippines appearing to experience the least disruption of inflows. But the region's adjustment and response will in part weigh importantly in the translation of these forecasts and factors into actual flows of long-term capital into Asia and the return of growth.

5. A Concluding Note

The economic turmoil in Asia is imposing a heavy cost to the economies and societies in the countries directly affected by the contagion and, via trade, on the rest of the region (and increasingly the world at large). Even if the immediate cause of the crisis may have been private sector driven, policy responses suggest the adjustment burden is widespread and on different sectors of society. Indeed, to the extent that there would be asymmetries in the burden of adjustment, the real cost of the crisis may ultimately be larger. The time path of the crisis also impinges on the severity of its costs and on those who carry the burden of adjustment. The recessions that have set in the region, the rising unemployment rates in the individual countries, and the widening incidence of poverty and social rift—these are among what the crisis is leaving behind. And since it still has to bottom out it will continue to take its toll in the region.

However, what must not be lost in this turmoil is that the crisis has also left behind the foundations of a strong economy, ingredients that were essential to the achievement of a long sustained growth in the last two decades. This paper presented evidence of these foundations marked by an overall responsible fiscal management, substantial industrial capacity strengthened by greater trade interdependence, and a track record of savings behavior that fed a robust investment path. Despite the fact that the misalignment of real exchange rates altered the relative prices of tradable and non-tradable (shown by the emergence of the bubble economy), the region's productive capabilities built through the years of savings and capital formation have remained.

Therefore, as recovery takes place and the region is reinvigorated, it would likely be that a turnaround is faster with the built in capacities and foundations still intact. Among those that would facilitate growth and trade resumption is FDI inflows. This paper has argued that both structural parameters and other factors in the investment environment point to continued modest but steady capital inflows. In addition, the reforms being carried out in the affected countries as a result of the crisis would tend to boost further the flows of FDI as closer integration is achieved. Indeed there is room for some acceleration in capital inflows given the small share of FDI to net private flows into the Asian region relative to all emerging markets. Of course some of these would simply be debt to equity conversions not necessarily new flows. Moreover there may be other consequences as ownership structures change, as foreign capital forges more inroads into the domestic economies of these countries and as integration spreads. But this is part and parcel of the recovery track. And as the region quickly regains strength there may eventually be reversals to the "undesirable" aspects of the crisis aftermath.

Unfortunately, the policy directions followed by the Asian affected economies have not abated the virulence of the crisis. If anything it seems that they have only unwittingly further exacerbated it. Fiscal stringency has shown to be more pro-cyclical rather than anti-cyclical given the fiscal surpluses in the affected countries (cf. Figure 1b above). As the crisis wore on and recession started, fiscal stimulus became more essential. Pursuing a regime of high interest rates to quell speculation and restore confidence was not quite effective in either objective but succeeded in further sapping up capital among financial institutions, and ruining what would otherwise have been viable enterprises. As expected this raised the magnitude of capitalization requirements not only for the originally affected banks and financial institutions but for the incrementally viable ones as well. In short, these policies prolonged the potential for early recovery from the crisis.

It may be recalled that these policy directions were part of the package that came with the infusion of capital resources from IMF-led support initiatives. Thus from a net outflow in the official accounts flow (Table 2b), there was a net inflow of $30 B in 1997 to compensate for the outflow by the private sector in these countries in exchange for prescribed policies. Yet it now appears that there is a growing sentiment on the efficacy of these policies and the search for alternatives. The credibility of the IMF and its policy package is now in question even if it may have bent over with regards government budgetary measures (as in the case of Thailand). Indeed many of the measures (e.g., debt restructuring, equity conversions, buy-outs, increase in foreign investment ceilings, etc.) would probably have taken place even without the IMF. Only bridge financing was critical (though there are also questions about it) in the course of the crisis. There now appears to be a room for alternative policy options to consider.

The crisis was an inevitable outcome of distortions in the international trade and financial markets arising from (perhaps premature) capital accounts liberalization. An exchange rate correction was necessary and did take place (even an overshooting). As a result of the correction in the relative prices of tradables and non-tradables, some markets collapsed and many projects became unviable. The task at hand is to trade and grow out of the crisis. Clearly a high interest rate regime and economic contraction is not an appropriate direction (though the trade sector inevitably realizes a surplus) given the real foundations the crisis has left behind. In fact this will simply worsen conditions as the trade sector is deprived of capital, viable enterprises crash, and the capitalization requirements escalate. Public profligacy was not endemic to the crisis but private miscalculation under an implicit guarantee.

On the other hand, a less restrictive fiscal and monetary stance would continue to support the capital needs of the corrected economy as growth re-starts fueled more by equity capital than debt, as conversions take place, and as the private sector resources are reallocated more efficiently. This does not mean that operations flaws that contributed to the crisis are set aside. On the contrary these should be vigorously addressed as well the core issues surrounding capital liberalization. Of course institutional support for bridge capital will be necessary. The option of an Asian Fund may be useful to consider that would not dilute the kinds of technical standards essential for its disbursements.

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