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# EQUITY FINANCING OF EAST ASIAN DEVELOPMENT

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## ABSTRACT

This paper begins with an account of the main factors underlying the surge in foreign portfolio investments in emerging markets that began in the late 1980s, with a particular focus on East Asia. We relate these investments to the overall determinants of investors' portfolio choices and evaluate the implications for the choices faced by government and private-sector decision makers in developing nations. The paper argues that, notwithstanding recent events, the long-term potential for attracting portfolio equity into developing countries remains great, with inflows to any specific host country depending mainly on its ability to pursue stable, outward-oriented economic policies. But recent events underline that overall market conditions also play a role that neither investors nor policy makers can safely ignore. Aftershocks from the Mexican peso crisis in 1994 and the Thai bhat crisis in 1997 rapidly extended into equity as well as bond markets and produced adverse consequences throughout the developing world, and beyond. For a short time following the peso crisis, new flows even into Asian markets came to an abrupt halt. Likewise, markets in Eastern Europe and Latin America soon contracted the 1997 "Asian flu." These vivid demonstrations of market contagion established that host countries, including those like Hong Kong with an exemplary policy environment, need to exercise caution in their reliance on mobile foreign capital. Moreover, discussion of the special circumstances in Mexico in 1994 and Thailand in

1997 has overshadowed a larger truth: even prior to 1994, up to half the variation in bond and equity flows from the United States to developing Latin America and Asia was attributable to factors external to individual host nations, although the sensitivity to such external influences was much smaller for Asia than for Latin America Thus, another question we address concerns the overall macroeconomic consequences for host countries of large and potentially volatile portfolio inflows. Finally, the paper evaluates the future role of developing-market equity issues in investor portfolios. While we see a continuing and even perhaps expanded role for portfolio equity financing of economic development in Asia and elsewhere, we argue that the unusually high rates of return experienced by early investors in some emerging stock markets are unlikely to be repeated because they reflected premia associated with incompletely integrated capital markets. Also, because the increased role of internationally mobile capital in emerging markets tends to link market conditions there to financial markets elsewhere, the diversification benefits of holding emerging-market equities are likely to be reduced, although not entirely eliminated, as emerging markets mature.