

CRONIES, CAPITALISTS, AND CONTROL: FOREIGN DIRECT INVESTMENT
REGULATION, INTERNATIONAL CAPITAL FLOWS, AND BANKING SECTOR
REFORMS

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ABSTRACT

Sarah Bauerle: Cronies, Capitalists, and Control: Foreign Direct Investment Liberalization,
Capital Flows, and Banking Sector Reforms
(Under the direction of Layna Mosley)

This dissertation argues policies toward foreign direct investment (FDI) are best understood as the product of domestic political coalitions led by local business elites that are conditioned on the local financing environment. Local firms support restrictive FDI policies when financial repression and loose global credit markets provide powerful industrial elites with access to ample credit on subsidized terms. When the domestic banking sector undergoes substantial reforms, local elites no longer have access to cheap credit through political connections. The need to obtain finance outweighs firms' preferences to exclude foreign direct investors. Under such conditions, industrial elites will pressure governments to pursue liberal FDI policy environments. Using a mixture of quantitative and qualitative research methods, I find substantial support for this theory. Banking sector reforms are associated with considerable decreases in foreign equity restrictions, even after controlling for a variety of alternative explanations of FDI policy liberalization. Financial reforms are also positively associated with moving from closed to partially open FDI policy states and with preventing policy backsliding once the investment climate fully liberalizes. Availability of alternative investment sources reduces the propensity to fully liberalize FDI policies. A comparative case study of investment policy maintenance and reform in Indonesia and Malaysia from 1965 to 2013 shows industrial elites in both countries were influential to the policymaking process and that these elites

advocated restrictive policies under financial repression and openness after banking system reforms. These findings suggest elite interests, rather than the ways domestic political institutions mediate the interests of capital and labor, drive FDI policymaking and underscore how financial access influences firms' interests.

To Robarn and Sophia.

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LIST OF ABBREVIATIONS

AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
ATM	Automated Teller Machines
BAFIA	Banking and Financial Institution Act
BI	Bank of Indonesia
BKPM	Badan Koordinasi Peranman Modal
BN	Barisan Nasional
BNI	Bank Negara Indonesia
BNM	Bank Negara Malaysia
DAP	Democratic Action Party
FDI	Foreign Direct Investment
FIC	Foreign Investment Committee
FMM	Federation of Malaysian Manufacturers
FSMP	Financial Sector Master Plan
GSP	Generalized System of Preferences
IBRA	Indonesian Bank Restructuring Agency
KADIN	Indonesian Chamber of Commerce and Industry
KLSE	Kuala Lumpur Stock Exchange
LDC	Least Developed Country
LOI	Letter of Intent
M&A	Mergers and Acquisitions
MFA	Multi Fibre Arrangement
MICCI	Malaysian International Chamber of Commerce and Industry

MIDA	Malaysian Industrial Development Authority
MITI	Ministry of International Trade and Industry
NIE	Newly Industrializing Economy
NEP	National Economic Plan
OECD	Newly Industrializing Economies
PAS	Pan-Malaysian Islamic Party
PEPI	National Team on Export and Investment Promotion
PIA	Promotion of Investment Act
PKR	Parti Keadilan Rakyat
PPP	Public-Private Partnerships
RAL	Regional Autonomy Law
SEACEN	South East Asian Central Banks Research and Training Centre
UNCTAD	United Nations Conference on Trade and Development

CHAPTER 1: INTRODUCTION

This dissertation argues policies toward foreign direct investment (FDI)¹ are best understood as the product of domestic political coalitions that are conditioned on the local financing environment. Local capitalists, as profit-maximizing actors, work to protect their access to operating and investment finance as well as the rents they accrue through protectionist policies. When the domestic credit allocation process is dominated by the state, and when loose global credit markets provide substantial capital readily intermediated through local financial institutions, domestic industrial elites will be able to finance their activities without sacrificing equity and without opening local labor and product markets to foreign competitors. When the domestic banking sector undergoes substantial reforms, local elites no longer have access to subsidized credit through political connections. The need to obtain finance outweighs firms' preferences to exclude foreign direct investors. Under such conditions, industrial elites will support increasingly liberal FDI policy environments.

In many ways, this argument is a return to earlier frameworks for understanding regulation of direct investors. Scholarship on FDI in the 1960s through mid 1980s often placed the development financing needs of states as central to understanding government policies toward foreign investors. Writing on the cusp of the Latin American Debt crisis, Jeff Frieden marveled at less developed countries' (LDCs) swift and unprecedented ability to attract massive foreign portfolio capital inflows (1981). The rapid growth of LDC commercial bank debt to

¹ Foreign Direct Investment (FDI) is generally defined as “an investment involving a long-term

foreigners changed the nature of how development was financed. Rather than rely on multinational corporations to bring industrial development and integration into a global economic system, governments could support the development of indigenous firms owned by locals and financed by international capital channeled through state banks. Under these conditions, many developing countries set about limiting direct investment, often in response to domestic elite pressures for protection and buttressed by popular nationalistic opposition to foreign firms (Frieden 1981; Lipson 1985).² Many scholars subsequently pointed to the ensuing debt crises that swept much of the developing world as the cause of liberalizing policies in the 1980s and 1990s (Feenstra 1999; Lipsey 1999; Lipson 1985, 24).

In comparison, recent research on FDI policy has been strangely ahistoric. Drawing on distributive models of economic conflict, researchers have extended models of trade openness to explain FDI liberalization.³ The central proposition of this research agenda is that democratic institutions lead to more open FDI regulatory environments since investment inflows benefit workers and disadvantage local capital. Yet, such accounts gloss over the broader historical context of policies toward foreign investment. Most countries were largely permissive of direct foreign investment through much of the 19th century until mid 20th century (Lipsey 1999; Scott

² The sense that policies toward FDI had substantially and permanently changed is perhaps best encapsulated by Lipson's stark assessment: "the rules dealing with foreign investment have changed significantly and irreversibly. Regardless of the incentives for new foreign investment or the existing regulations, there are no real long-term guarantees. . . . What has been lost, perhaps irretrievably, is a sense of certainty about the way investments will be treated in the future." (Lipson 1985, 24)

³ Others have emphasized policy diffusion as driving liberalization among countries competing for capital (Simmons, Elkins, and Guzman 2006). While there is evidence that policy innovations do tend to spread regionally, a diffusion theory is incomplete on two accounts. First, it is unclear if governments are responding to the policy innovations of competitors or if governments are simultaneously responding to similar structural changes that shift domestic coalitions' willingness to support restrictiveness or liberalization. Second, if FDI policy innovations occur due to cross-border diffusion, what instigates the decision by leading state to liberalize?

and Rooth 1999; Wilkins 1970). A democracy-driven explanation of FDI liberalization cannot explain why policies toward direct investment were largely permissive until the mid- 20th century. Nor can they explain why many advanced democracies increased FDI regulation in the post-war era..

Extant theories of FDI liberalization also tend to ignore policy developments toward FDI in advanced economies. This is problematic because advanced economies host the most FDI stock. While much of the analytic focus of FDI research has adopted, either explicitly or implicitly, a model of advanced economies as home states exporting FDI to developing host states, the majority of which through establishing new wholly owned subsidiaries, the reality of FDI flows is quite different. Most of the time, most FDI occurs between developed countries and is driven by cross border mergers and acquisitions (M&A) (UNCTAD 2013). Cross border M&A is less prevalent in developing countries because these deals have smaller book values, local governments often block such acquisitions, and multinational firms are often wary of their legal protections regarding such deals. However, the relative importance of greenfield investment to the composition of FDI flows declines as the investment environment becomes more open. As local firms in developing countries amass increasingly large book values and become more desirable M&A targets, cross border deals will become increasingly important components of FDI activity (UNCTAD 2000). Indeed, we see that M&A activity in developing countries is currently larger than new greenfield equity investments (UNCTAD 2013, xx). Much of what is classified as greenfield FDI in developing countries is actually follow-on investment from retained earnings. Moreover, these retained earnings are often reserved in cash rather than put toward productive investment. Additionally, as developing countries increasingly become sources of FDI, the distinction between home and host countries, however tenuous in original

construction, increasingly breaks down. The growing importance of state-owned enterprises and sovereign wealth funds as international direct investors has made developed economies increasingly wary of their own FDI inflows (Marchick and Slaughter 2008; UNCTAD 2006). As the sources and targets of FDI merge, it is important to return to thinking about the ways in which the politics of FDI in developed and developing countries are similar rather than assuming they are distinct.

Another prominent argument for why FDI is more acceptable to localities today than it was in 1970 is that FDI to developing countries in particular has shifted from extractive and market-seeking investments to export-oriented manufacturing. Current characteristics of FDI are not as fundamentally distinct from historical forms of FDI as some analysts suggest. The majority of FDI in both developed and developing localities occurs in the service sector (UNCTAD 2013, 8). Manufacturing FDI certainly increased through the 1960s and 1970s, but it is not the modal form of FDI. Just-in-time multinational production chains have also led to a large increase in subcontracting, which allows local firms in developing countries in particular to partake in international production networks without taking on foreign equity partners. FDI in developing countries before the 1960s was also often characterized by export-oriented enclave production, though often of agricultural products, which generated foreign exchange, (Frieden 1981; Lipson 1985). And, FDI began primarily as investments in service sectors, particularly infrastructure development such as railroads (Lipsey 1999). In other words, the types of activities in which FDI concentrates have changed much less than popular perceptions allow.

A financing-based explanation of FDI policy has several advantages over theories that emphasize the redistributive politics of domestic institutions. But, doing so requires us to assume direct investment is largely substitutable for other kinds of cross-border capital flows. For some,

this may be a herculean assumption. The study of FDI originated in the field of industrial organization, and subsequent research has often focused on the multinational firm's choice between direct investment and some other form of international operation.⁴ Economists largely cleaved to this firm-level insight that direct investment is in some way superior to indirect investment for the technology transfer and organizational insight multinational investments convey as well as the high redeployment costs that make FDI less “footloose” than easily transferred portfolio investment. However, many of the advantages of FDI are not really “intangible” since local firms can and frequently do obtain technology and organizational innovations through licenses and management contracts. In a liberalized policy environment, the fixed nature of FDI is overstated since investors could sell localized assets, withdraw from operations, and repatriate earnings. At the firm level, there may be important distinctions between modes of investment. However, in the aggregate, FDI and other forms of foreign investment exhibit characteristics of substitutes. In studies across developed and developing countries as well as studies across long periods of time, FDI and other forms of foreign investment are consistently negatively correlated. More generally, a focus on what makes FDI special obscures the reality that FDI is fundamentally a flow of investment capital that finances domestic economic activity.

In many ways, this research project is an initial attempt to seriously consider how financial regulation affects the strategies of economic actors in an economically interdependent global system. The global financial crisis led many IPE scholars to call for increased emphasis on the role of financial regulatory systems in explaining patterns of international investment flows and in explaining policy outcomes (Mosley and Singer 2009). This dissertation attempts to

⁴ See Hymer (1960) and Dunning and Rugman (1985) for an orientation.

answer that call by combining insights from earlier work on FDI, mainly thinking about FDI as a source of international investment, and the literature on financial repression and reform to consider how local access to financing influences domestic firm strategies with respect to FDI.

Theory

The central argument of this dissertation is that changes in elites' strategies toward foreign investment, rather than transformations in domestic political institutions, drive FDI policy liberalization. I argue higher levels of FDI liberalization occur when structural conditions at the global and local levels reduce domestic firms' access to alternative sources of investment finance. As the availability of other sources of investment declines and the costs of such capital increases, powerful business elites will be more willing to open the local economy to foreign owners in order to gain greater access to foreign firms' investment financing. If this is true, we should expect alternative financing constraints to be associated with FDI liberalization, while access to other forms of investment will impede reform. In Chapter 2, I develop expectations for how an easy global credit environment, the ability to attract portfolio and direct investment without further policy liberalization, and openness toward short-term capital flows all make local firms better poised to operate and grow without ceded managerial control to foreign firms. Thus, under such conditions, FDI policy liberalization is unlikely.

However, dramatic changes to the way in which capital is intermediated domestically can shift elite's strategies toward favoring more liberal FDI policy environments. In particular, I focus on how banking sector reforms, often pursued in response to external pressures and financial crises, can substantially disrupt elite access to and costs of credit. When governments exhibit high levels of control over the financial sector; through interest rate controls, directed credit requirements, and large state-owned banks; lending decisions are based on political

calculus and therefore provide powerful firms with preferential access to subsidized credit. Under such conditions, business elite most likely to be able to effectively pressure governments for their preferred policies will be happy to restrict FDI. With access to subsidized credit, these firms will not view foreign direct equity necessary to fuel their growth. At the same time, the certain costs of FDI liberalization – mainly higher labor costs and demands for increased productivity – will outstrip the possible benefits of foreign firm entry since gains from linkages are firm specific and difficult to predict *ex ante*. However, when the banking sector undergoes substantial reform, the link between politically powerful firms and subsidized credit diminishes. Under tighter local financing constraints, large and powerful firms will be more willing to bear the costs associated with foreign entry in order to gain access to investment financing through foreign direct equity.

Thus, this dissertation argues transformations in elite policy preferences, caused by disruptions to access to capital rather than changes in political institutions that shift political power toward labor, explain alterations in policies toward FDI. While access to cheap alternative sources of capital make elites less likely to support reform, policy developments that limit short-term investment and debt financing will cause elites to re-evaluate the costs and benefits of openness. In particular, banking sector liberalization reorients powerful societal and state interests from restricting to encouraging foreign entry.

My theory contributes to the literatures of FDI and macroeconomic reform sequencing in the following ways. First, I explain change in policy outcomes as primarily the result of shifting interests rather than changes in domestic political institutions. This contrasts sharply with arguments that regime type explains differences in policies toward FDI and complements arguments that institutions in transition are unable to act as binding constraints on politicians and

are therefore improbable sources of major changes in policy outcomes (Pepinsky 2013b, 6). Second, I re-conceptualize FDI policies as adhering to discrete levels of openness. In doing so, I emphasize the possibility that FDI liberalization is subject to a partial reform equilibrium not unlike other policies of structural adjustment (Hellman 1998). Third, I place FDI liberalization within the context of other liberalizing reforms, particularly those that pertain to reforming other financial policies such as capital account openness and banking. I show how antecedent reforms in these areas reshape domestic interests over FDI openness. FDI openness is not merely a reflection of a general liberalizing trend, but reflects the formation of supporting coalitions as previous reforms shift policy preferences of politically powerful interest groups.

Analysis

To test this theory, I employ a mixed-method approach. Two analytical chapters use large N statistical analysis to establish both the long-term relationship between banking sector reforms and FDI policy liberalization and how changes in the financing environment affect the propensity of switching between discrete categories of openness to FDI. The second two analytic chapters compare the historical development of FDI policy in Indonesia and Malaysia while identifying the political coalitions that supported FDI restriction and liberalization. Below, I briefly outline each chapter.

Establishing Long-Term Relationship

In Chapter 3, I assess the long-term relationship between banking reforms and changes in FDI openness using a dataset of up to 68 countries from 1973 to 2000. Using error correction techniques that isolate short-term and long-term dynamics, I demonstrate that banking sector reform is statistically significantly associated with subsequent increases in liberalization of foreign equity restrictions, that the effect of banking reform on FDI openness takes several years

to develop, and that this relationship is robust to multiple alternative explanations such as regime type, IMF coercion, general trends toward economic liberalization, and international treaty obligations. These results provide macro-evidence consistent with my theory.

Explaining Policy Switching

In Chapter 4, I make use of Markov transition modeling techniques to more fully explore the conditions that make it more likely that governments will transition between three states of FDI policy: closed, intermediate, and liberal. In particular, I consider the conditions under which governments may become “stuck” in a partial reform equilibrium in which they welcome and perhaps even pursue FDI in certain industries but continue to maintain substantial restrictions such industry-specific equity restrictions, employment related performance requirements, technology transfer, and/or project-specific screening requirements. I find substantial support for the premise that openness to FDI depends on the ability of local firms to obtain financing from alternate sources. Global financing constraints, short-term capital account openness, and banking sector reforms that reduce access to state-subsidized loans all affect the propensity to liberalize. At the same time, the effect of these factors is often conditional on starting state. In particular, gaining alternative means of accessing international finance is associated with a reduced chance of fully liberalizing the FDI policy environment. A similar pattern of regulatory retrenchment emerges as well for the level of development and democracy of a host state. These findings are robust to multiple controls including accounting for regional and income peer policies, IMF lending, banking crises, and natural resource wealth. Despite these results, I find only modest support for the proposition that banking sector reforms can puncture partial reform equilibrium. Taken in conjunction with the result of Chapter 3, this may be indicative of a relationship

between banking sector reforms and FDI liberalization that takes a relatively large time to play out.

Tracing Elite Strategies, Lobbying, and Policy Outcomes

In Chapters 5 and 6, I examine the evolution of FDI policy in Indonesia and Malaysia from 1965 to today. I demonstrate how different banking sector policy developments through three distinct periods of these countries' economic histories affected elite interests, and accordingly policy outcomes, over restrictiveness toward FDI. This chapter traces the development of banking and investment policy from 1965-1997 while the following focuses on policy reform in the aftermath of the 1997 Asian Financial Crisis. Over the time period I cover, Malaysia has more consistently pursued banking sector deepening that has supported gradual liberalization of FDI policies with limited backsliding. In contrast, Indonesian governments have more often pursued policies designed to maintain substantial control over domestic credit allocation decisions, and therefore has less elite support for loosening restrictions on FDI. However, while the *level* of FDI openness in Indonesia has consistently shown protectionist bias, a period of rapid banking sector deregulation in the 1980s did lead to a period of limited liberalization. These policy developments, along with documentation of elite lobbying activities toward FDI policy at the time, provide further evidence that banking sector reform affects FDI policy *changes*. Subsequent state consolidation of the banking sector in Indonesia has led to reform stagnation and reversal, illustrating FDI policy can be subject to a partial reform equilibrium as well as increased protectionism even in a global environment of overwhelming economic integration.

In Chapter 5, I trace the process of financial crisis and the relationship between banking reforms and foreign direct investment liberalization in Indonesia and Malaysia from 1965 to

1997 in order to look more closely at stated policy preferences of elite groups in different domestic credit environments. While regime management of inter-ethnic political cleavages initially led the Malaysian government to cautiously embrace high regulated foreign investors as a way of limiting the economic dominance of non-*bumiputera* capitalists, Indonesia's tight alliance between the military, ruling party, and ethnic Chinese financiers provided the political logic for largely excluding foreign capital from direct investments in the local economy. The Indonesian government's policy of banking deregulation in the 1980s in response to tight global credit conditions and elite interest in establishing private banks linked to powerful domestic conglomerates, however, created local elite support for limited FDI reforms such that by 1997 Indonesia's FDI policies were slightly less restrictive than were Malaysia's.

In Chapter 6, I demonstrate how divergent crisis response strategies to the 1997 Asian financial crisis led to substantial liberalization of credit allocation in Malaysia while Indonesia's foreign bank-led financial sector restructuring did little to force fundamental changes in the way banks make debt financing decisions and insulated the state from needing to privatize its extensive state-owned banking system. As a result, Indonesian business interests have successfully blocked attempts to implement large-scale liberalization of FDI beyond the initial IMF-imposed policy changes in 1998-9. In contrast, the Malaysian business community has largely supported, and in many cases driven, more fundamental liberalization of FDI policy. These findings point to micro-level evidence to support the primary claim of this dissertation that financial sector liberalization shifts preferences of politically important business interests toward favoring opening to FDI.

To be clear, this comparative case study is not meant as a definitive test of my theory, which is fundamentally based on a probabilistic conception of causality. Instead, these chapters

provide an opportunity to look more closely at the evolution of banking and investment policies and to probe my argument that the causal link between banking sector reforms and FDI liberalization is both shifting elite preferences and the diminished political power of domestic banking interests.

CHAPTER 2: A FINANCING OPPORTUNITY COST FRAMEWORK OF FDI REGULATION

Introduction

Today, most countries have relatively open policy environments toward FDI that include relaxed equity restrictions, guarantees of national treatment, legal protection through international treaties, and investment incentives (UNCTAD 2012, Elkins et al. 2006). The tenor of these policies stand in stark contrast to dominant opinions of FDI just thirty or forty years ago when most developing countries were largely statutorily closed to FDI and many advanced economies also placed targeted restrictions on domestic activities of multinational firms.⁵ The extent of anti-FDI rhetoric is best illustrated by the push by developing countries in the 1970's to adopt a new international economic order (NIEO) that would establish states' rights to expropriate and regulate transnational investments. While FDI was previously considered exploitative of development countries, today such investment flows are considered vital components of economic development and poverty reduction strategies.⁶

⁵ Restrictions of FDI in the mid 20th century themselves represent a break from a long-standing norm in international law that afforded foreign investors extra protections beyond those available to domestic firms. See Lipson (1985) for a detailed history of foreign investor protection regimes.

⁶ *Dependencias* argued FDI perpetuated underdevelopment by exploiting natural resources in the periphery, preventing the development of local industry, and repatriating profits to the core, which worsened the investment gap in developing countries. See Evans (1979) for a review. With the development of export platform FDI strategies and a growing intellectual focus on agglomeration effects, development economists in the 1990s emphasized the positive externalities associated with FDI inflows. The Asian Financial Crisis solidified this stance, as the experiences of countries in crises underscored the fragilities associated with securing portfolio investment from overseas while FDI remained robust to crisis and even displayed corrective

However, while very few countries still impose outright bans on FDI, the freedom to invest directly in foreign jurisdictions is far from complete. Limitations on foreign equity participation remain common, particularly for investments in natural resources and services that display non-competitive market structures (UNCTAD 2012, 79). Many states maintain screening authority over larger investment proposals, and require such projects to demonstrate their positive economic effects on employment, local business, and the national account in order to gain entry. Most governments have maintained the authority to block incoming FDI for national security concerns, and regulatory trends indicate countries are taking increasingly expansive views on what constitutes a threat to national security (UNCTAD 2012, 79-80). Thus, while most countries are at least nominally open to FDI, the degree of openness remains varied.

In contrast to previous research that emphasizes democratization and the changing nature of FDI to explain patterns of increased FDI openness, I argue higher levels of FDI liberalization occur when structural conditions at the global and local levels reduce domestic firms' access to alternative sources of investment finance. As the availability of other sources of investment declines and the costs of such capital increases, powerful local business elites will be more willing to support policies that open the local economy to foreign owners. They will do so in order to gain greater access to foreign firms' investment financing. If this is true, we should expect alternative financing constraints to be associated with FDI liberalization, while access to other forms of investment will impede reform.

counter-cyclical tendencies (Prasad et al. 2003). Empirical evidence that FDI is associated with growth further bolstered arguments to liberalize FDI (Borensztein, De Gregori, and Lee 1998). However, skeptical interpretations of FDI remain (Görg and Greenaway 2004; Hausmann and Fernández-Arias 2000; Rodrik 2008).

Dramatic changes to the way in which capital is intermediated domestically can shift elite lobbying strategies toward favoring more liberal FDI policy environments. Banking sector reforms, often pursued in response to external pressures and financial crises, can substantially disrupt elite access to and costs of credit. When governments exhibit high levels of control over the financial sector through interest rate controls, directed credit requirements, and large state-owned banks; lending decisions are based on political calculus and therefore provide powerful firms with preferential access to subsidized credit. Under such conditions, business elites most likely to be able to effectively pressure governments for their preferred policies will be happy to restrict FDI. With access to subsidized credit, these firms will not view foreign direct equity necessary to fuel their growth. At the same time, the certain costs of FDI liberalization – mainly higher labor costs and demands for increased productivity – will outstrip the possible benefits of foreign firm entry since gains from affiliation and linkage are firm specific and difficult to predict *ex ante*. However, when the banking sector undergoes substantial reform, the link between politically powerful firms and subsidized credit diminishes. Under tighter local financing constraints, large and powerful firms will be more willing to bear the costs associated with foreign entry in order to gain access to investment financing through foreign direct equity.

Thus, the central argument of this dissertation is that transformations in the way credit is intermediated in local financial markets disrupt elite access to capital and therefore create incentives for local industrial interests to support loosening restrictions on foreign equity ownership. While access to cheap alternative sources of capital make elites less likely to support reform, policy developments that limit short-term investment and debt financing will cause elites to re-evaluate the costs and benefits of openness. In particular, banking sector liberalization reorients powerful societal and state interests from restricting to encouraging foreign entry.

In the sections that follow, I first explain why extant explanations of FDI liberalization are insufficient. Next, I outline my theory and establish why foreign entry represents a threat to local firms. I then explore how global and local financing environments condition industrial elites' willingness to oppose or support foreign entry. The sixth section addresses concerns about the distinctiveness of banking sector reforms from FDI policy liberalization. The next section summarizes the main expectations of the theory and crystalizes them into a series of testable hypotheses. The final section briefly discusses the research design strategies I employ in following chapters to test these hypotheses.

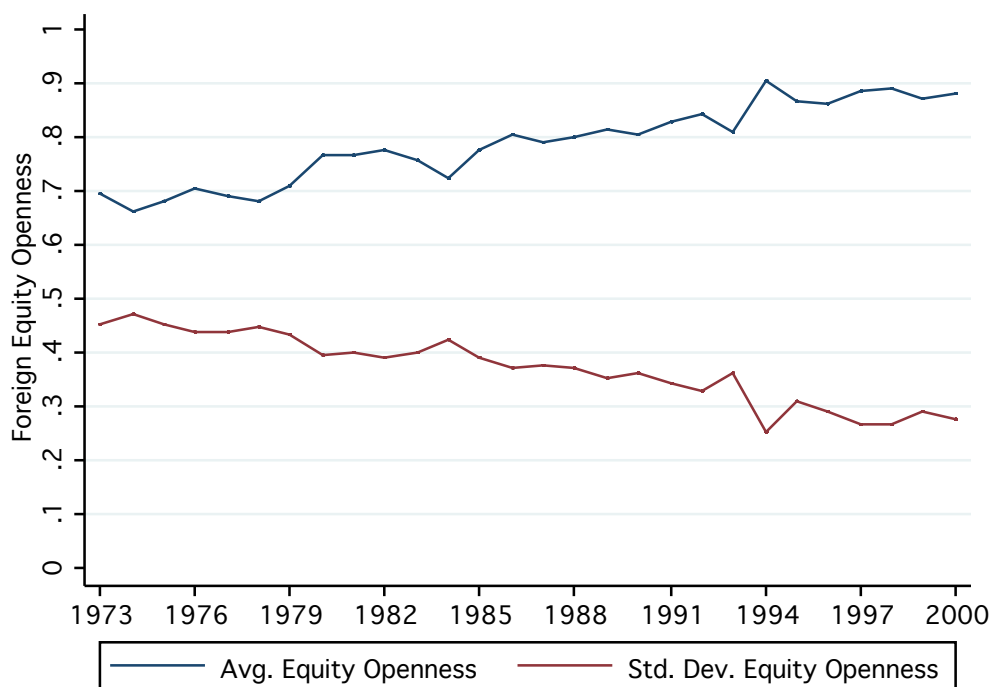
FDI Policies, 1970-2000

The last quarter of the twentieth century saw a distinct trend toward decreased restrictions on foreign equity. Restrictions on FDI inflows have declined worldwide through the 1970s-1990s as countries have largely abandoned central planning and indigenous development models in favor of economic liberalization and structural adjustment. Moves toward openness are not confined to developing countries. Many advanced European economies entered the period with specific restrictions on cross border mergers and acquisitions. For example, Sweden made all foreign acquisitions subject to government review in 1973 and also required foreign investors to source at least 50 percent of capital overseas (Blomström and Kokko 1997, 367). France had similar investment screening provisions that were only relaxed for non-EU originating FDI in 1992 (Michalet 1997, 330). Japan also greatly restricted inward FDI for much of this period. Figure 2.1 illustrates the average level of foreign equity openness, defined as the percentage of industries that restrict FDI to minority ownership, as well as the sample standard deviation for the time period 1973 through 2000.⁷ Over this time, FDI policies across developed and

⁷ These data are from Pandya (2014) and are explained in further detail in Chapter Three.

developing countries experienced convergence toward a policy environment more statutorily open to direct investment by foreigners.

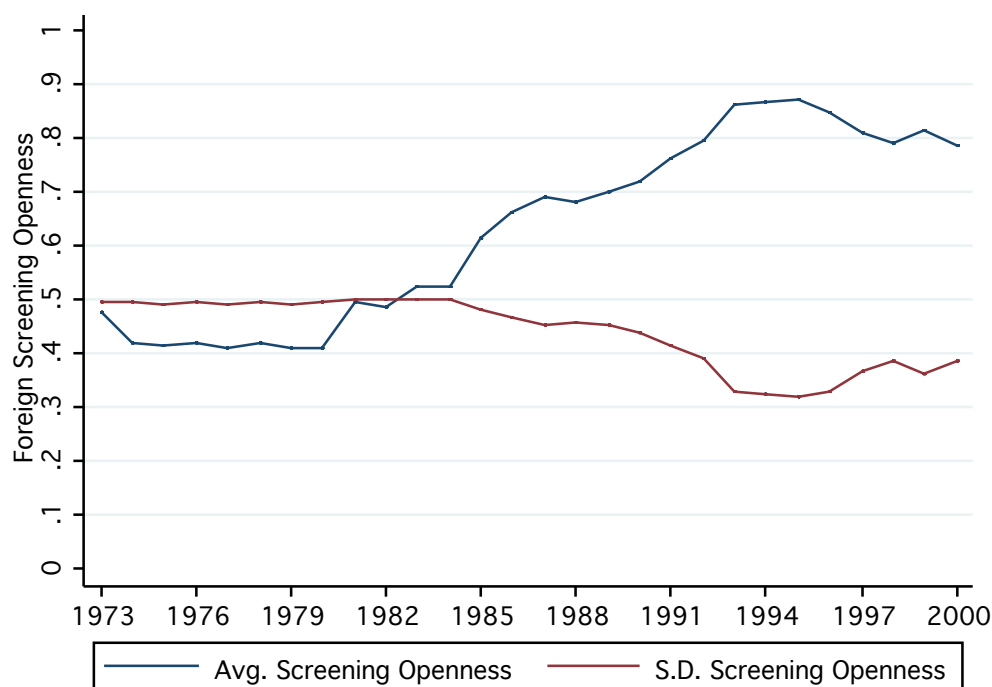
Figure 2.1: FDI Policy Over Time



Despite this macro-level convergence, variation continues to persist. Most countries pursue a complex of investment policies designed to attract certain types of FDI inflows, particularly manufacturing, while repelling foreign investment in other areas of the economy (Golub 2009; UNCTAD 2013). Since 2000, the percentage of yearly changes in national investment policies that are more restricting has steadily risen from 6 percent to 25 percent. Restrictive investment policy changes are not isolated to developing countries. In 2012, the largest share of restrictive policy changes occurred in developed countries (UNCTAD 2013, 93). Countries also vary in the extent to which they use centralized screening mechanisms to approve investment projects with foreign participation; such approval processes tend to have a chilling effect on cross border mergers and acquisitions (Taylor 2000; UNCTAD 2013, 98). Figure 2.2

shows how screening processes had progressively liberalized through the early 1990s, but experienced a reversal in the second half of the decade. Since 2000, many governments have further tightened investment approval requirements.⁸ UNCTAD estimates 30 percent of all cross border M&As withdrawn after announcement in 2010 were due to restrictive investment policies (UNCTAD 2013, 97). The total value of M&As withdrawn for regulatory reasons between 2008 and 2012 approximated \$265 billion, or about 10 percent of cross border deals concluded over the same time period (UNCTAD 2013, 8, 97).

Figure 2.2: Investment Screening Liberalization Over Time



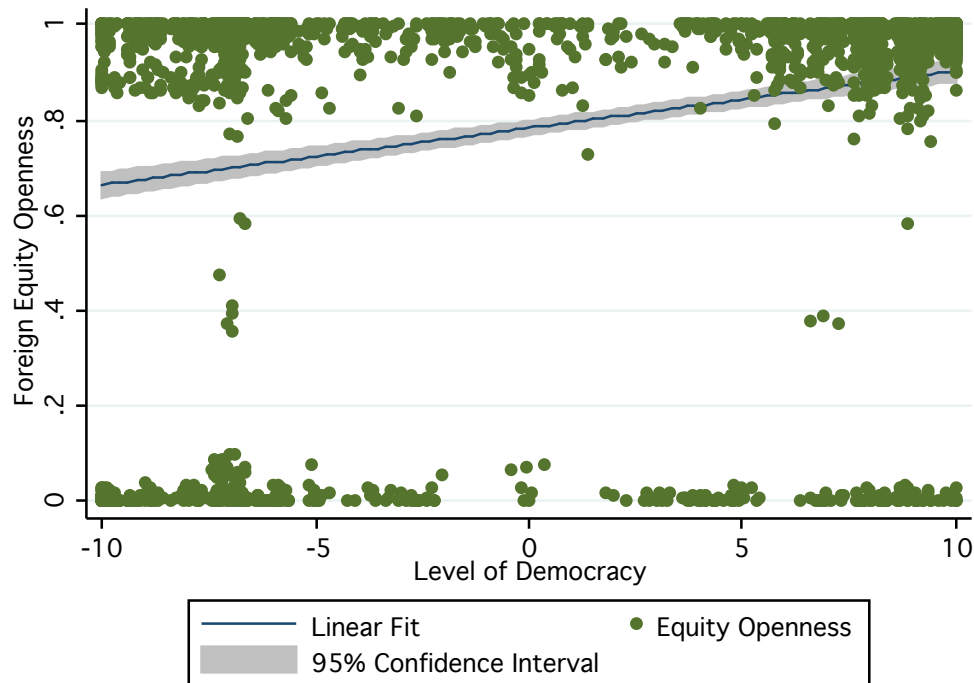
These stylized facts pose at least two questions: what explains a general trend toward increased FDI policy liberalization and what explains the remaining variation in levels of openness across countries? From a policy standpoint, restrictions on FDI are non-trivial since

⁸ The U.S. congress expanded federal authority over proposed cross-border mergers and acquisitions in the 1970s and 80s. See Kang (1997).

policy restrictiveness is statistically significantly and negatively correlated with FDI stocks (Kalinova, Palerm, and Thomsen 2010, 7) and policy liberalization is associated with increases in FDI inflows (Taylor 2000). Moreover, FDI that is established in joint venture with local firms are more likely to generate many of the positive spillovers frequently associated with FDI inflows (Abraham, Konings, and Sootmaekers 2007; Blomström and Sjöholm 1999; Dimelis and Louri 2002; Javorcik 2004; Javorcik and Spatareanu 2008; Smeets 2008). It follows that country that are able to craft FDI policies that restrict foreign firms from establishing wholly owned subsidiaries but are none-the-less able to attract substantial FDI flows will be able to successfully reapportion rents from multinationals to local firms. Therefore, FDI policies affect both the patterns of global FDI inflows and the distribution of gains from the activities of FDI-making enterprises.

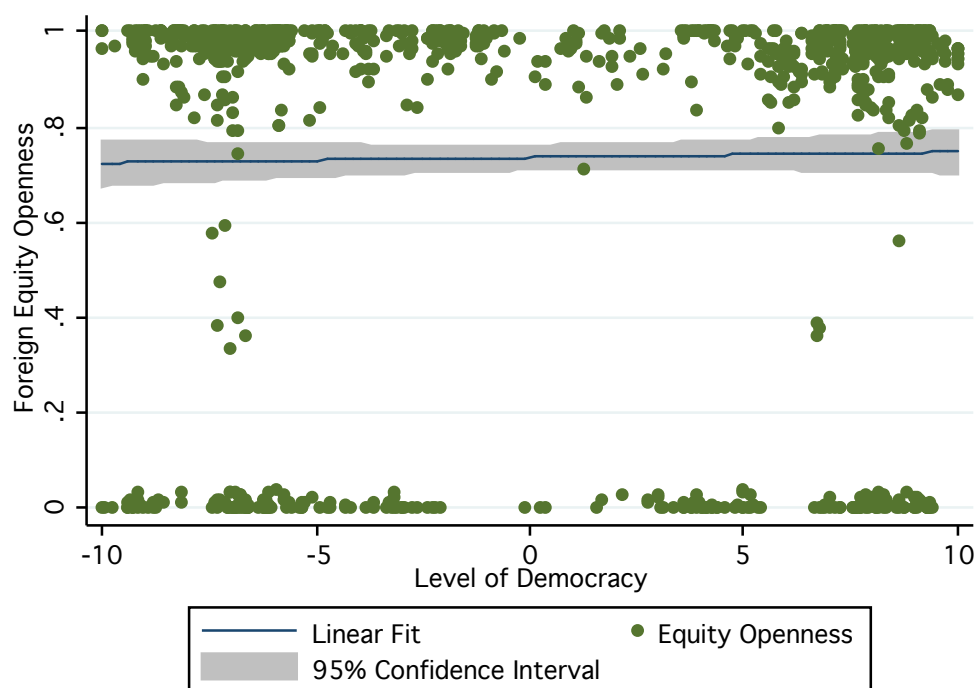
One prominent explanation of both a liberalizing trend and cross-country variation in FDI policy is democracy. Since FDI generates employment, workers should view such capital inflows positively. Survey data from developed and developing countries tends to support this intuition, though attitudes toward foreign investment during times of structural adjustment and privatization are less sanguine (EBRD 2005; Pandya 2010; PAIZ 2006; Rohrscheider and Whitefield 2004). As countries democratize, political institutions provide greater voice to workers who may use their newly acquired policy influence to demand governments relax barriers to entry for foreign firms. Figure 2.3 illustrates why a regime type explanation of FDI liberalization is unsatisfying.

Figure 2.3: FDI Openness and Regime Type



FDI policy and democracy are positively correlated, but with a good deal of noise. Since democratic countries also tend to be advanced industrial economies, we may wonder if regime type and economic development are confounding variables. Figure 2.4 looks at relationship between FDI policy and democracy in developing countries. Note that the causal story that workers will demand increased openness should be most likely in developing countries where labor is abundant relative to capital. Contrary to *a priori* expectations, level of democracy has virtually no effect on level of openness for developing countries. Rather, the positive relationship between democracy and openness to FDI seems to be driven by the fact that advanced economies display more liberal investment policies than do developing and that advanced economies also tend to be democracies.

Figure 2.4: FDI Openness and Regime Type in Developing Countries



Another prominent explanation of FDI liberalization is that countries open their economies to multinationals when balance of payment crises and international financial institutions (IFIs) force them to do so. However, the evidence suggests the relationship between crises, creditor pressures, and FDI policy reform is not so straightforward. Currency, debt, and banking crises exhibit no consistent pattern of association with FDI policies and periods of liberalization.⁹ The International Monetary Fund (IMF) very rarely attaches loan conditions to demands to liberalize foreign equity restriction or undertake any other economic reform directly related to inward FDI policy.¹⁰ IMF lending is basically uncorrelated with FDI openness, either

⁹ All three categories of crises are weakly but negatively associated with liberalizing FDI policies in the following year.

¹⁰ Stone (2008) compiled perhaps the most comprehensive dataset of IMF loan conditions from 1992 – 2002. Foreign equity restrictions were not even included in a separate category. Structural reforms coded as “others” were present in seven percent of all IMF loan programs during this

in terms of level of openness or in the timing of liberalizing changes.¹¹ Other, more widely applied, conditions such as privatization and macroeconomic reforms may make foreign investors more interested in local economies (Pop-Eleches 2009). However, increased attractiveness from the perspective of multinationals is distinct from governments implementing more welcoming investment policies.

Theory

If levels of and changes in regime type, as well as economic crisis and IMF conditionality, provide a poor explanation of FDI policy variation and change, then how might we improve our understanding of these developments? I argue FDI policy is primarily driven by political coalitions dominated by business elites. These elites prefer to restrict foreign ownership in order to protect their own rents, but their ability to do so depends on the capacity to finance investment and operational activities through other sources. When the domestic financial system is characterized by state control and direction of credit, the most politically influential firms will benefit from subsidized lending, either directly from state owned banks or due regulations that require private banks to direct credit toward favored industries and firms at below-market rates. Under these conditions, local firms can grow without substantial foreign equity participation and will therefore support restrictive policies toward FDI. When the domestic financial system is liberalized, powerful local firms will no longer have access to subsidized credit. In this context,

time. Even if all of the conditions included in the “other” category related to FDI reform, it is clear that the IMF did not regularly tie lending to liberalizing inward FDI during this period.

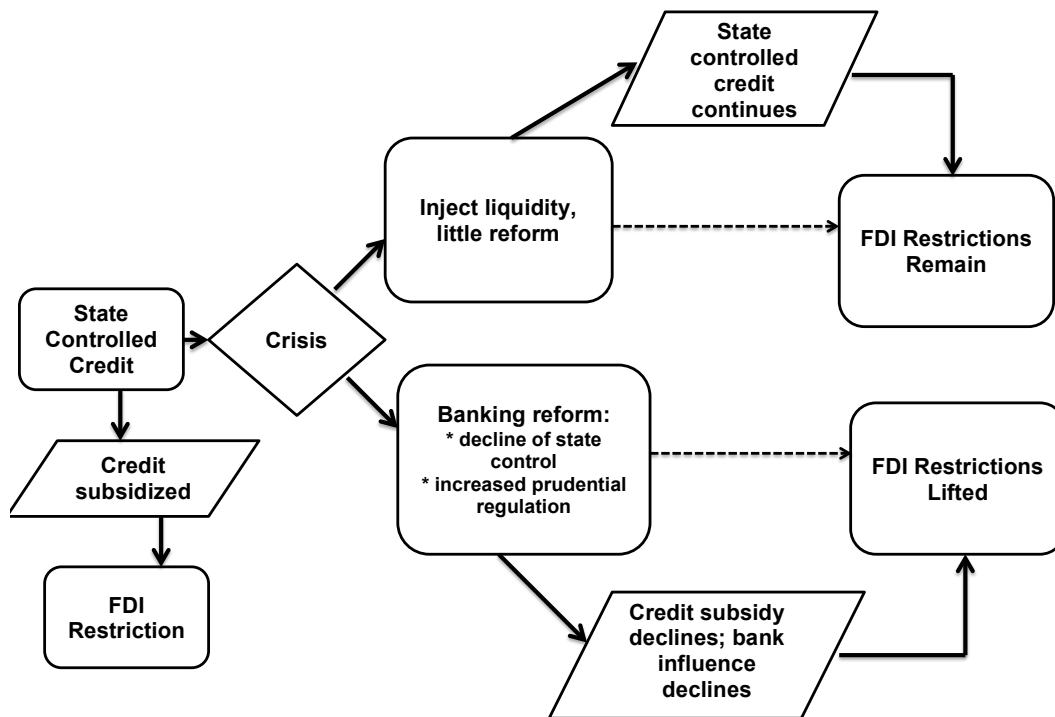
¹¹ FDI Equity Openness and IMF programs have a correlation of 0.0281 while FDI Screening Openness and IMF program exhibit a correlation of 0.0323. Correlations between IMF programs and liberalizing changes are even lower.

business elite will support FDI policy liberalization in order to benefit from the capital injections and technology transfer that accompanies cross-border mergers and acquisitions.

Figure 2.5 illustrates the causal logic of my theory. State directed credit regimes suppress the need of local capital to finance economic expansion through foreign direct equity. A cheap credit environment encourages firms to support policies that allow them to retain majority control. Incumbents' preference for the status quo locks in restrictive policy environments toward FDI. When governments pursue banking sector reforms, most often in response to balance of payment crises that make state-driven banking sector insolvent, this equilibrium is substantially disrupted. Reforms that remove state control and direction of the financial sector through privatizing state owned banks and eliminating state guidance of interest rates and directed credit requirements make domestic credit more expensive to those who had previously benefited from subsidies.¹² As banking reforms also strengthen prudential regulations that emphasize risk-based lending portfolios, industries that had formerly profited from easy credit obtained from affiliated financial firms experience a further decline in access to below-market rates of credit. Under these new financing constraints, large firms will be more willing to support loosening restrictions over FDI in order to gain new and less expensive sources of capital.

¹² Financial reforms make borrowing less expensive for those previously shut out of credit markets. However, these firms are small and medium enterprises that have less policy influence.

Figure 2.5: Banking Sector Reform and FDI Policy Change



Importantly, while banking reforms might be induced by balance of payment crises, they are not the inevitable conclusion of such shocks. As such, crises do not necessarily lead to FDI liberalization; this relationship is mediated by governments' crisis response strategies. This dissertation largely brackets the question of the conditions under which crisis leads to banking sector reforms and instead focuses on the implementation of banking sector reform as contributing toward a reorientation of business elites' interests toward foreign equity investment. However, the extent to which governments respond to crisis through meaningful banking reforms is most likely related to the degree to which governments have the political support and economic capacity to weather temporary balance of payment crises. Governments in weaker economic and political positions will face greater pressures to reform. I generally treat the

decision to reform given crisis as more or less randomly generated, though of course this is a simplification.¹³ It may be that non-reformers are just better positioned to maintain the status quo. However, given my argument is one of change through punctuated equilibrium, the fact that incumbent interests in some states are more robust to shocks than are others does not fundamentally challenge a financing opportunity cost theory of FDI liberalization.

Below, I further develop the component parts of this theory. First, I establish industrial capital faces identifiable and universal costs but uncertain and firm-specific benefits to multinational entry. Next, I explore how the domestic financial system conditions large industrial firms' policy preferences over FDI. I also provide historical context for the turn to financial repression in the mid 20th century and the formation of the political coalitions that supported these policies.

To be clear, this is a theory that emphasizes the central role of business elite in determining FDI policy outcomes. I assume the politics over FDI liberalization are primarily elite driven and that industrial elites¹⁴ have a strong influence over government policies regarding foreign entry into their respective industrial sectors. Other actors may have some influence, such as financial capitalists and labor groups, but I focus on industrial elites because their strategies toward foreign investment are the most likely to directly relate to statutory limits

¹³ In chapters five and six I relax this assumption by considering the divergent crisis response strategies of the Malaysian and Indonesian governments during the 1997 Asian Financial Crisis and the political and economic foundations of these differences.

¹⁴ By industrial elites I mean business interests engaged in the real economy rather than the financial sector. Industrial elites include manufacturing interests but are not confined to that particular sector of the economy.

on foreign equity and screening requirements.¹⁵ However, I also discuss below how other societal groups will support or oppose the coalitions built by business elites.

Incumbent Firms and the Threat of Multinational Entry

FDI inflows entail certain, economy-wide costs to indigenous firms by placing upward pressure on wages. There is robust evidence that foreign-owned firms pay higher wages than their domestic-owned counterparts.¹⁶ This is true in both developed and developing countries, and studies typically find a wage premium of around 10 to 30 percent.¹⁷ There is also ample evidence that these wage effects permeate the broader economy. Several studies have found evidence of positive wage spillovers from FDI in the United States. Feliciano and Lipsey (1999) find foreign ownership has a positive effect on wages in domestically owned firms in non-manufacturing sectors. Figlio and Blonigen (2000) uncover evidence of positive wage spillovers in South Carolina. There seem to be similar spillover effects in other developed economies;

¹⁵ Labor groups will support policies that create jobs and protect wages. Financial capital will support policies that allow them to obtain the largest spread between deposit and lending rates. Each of these groups has reason to view FDI favorably. So long as FDI creates employment and encourages wage bid up, labor will benefit from FDI. If foreign firms generate any increased demand for local financing, domestic financial firms will also benefit from new clientele. However, these groups will also face potential threats from FDI. Foreign firms have a more credible exit option that may reduce labor's wage bargaining strength. Since multinationals have a greater capacity for self-finance and have access to multiple financial markets, foreign firm entry may reduce domestic banks' rents associated with intermediating between global and local capital markets. These countervailing benefits and costs of FDI to labor and finance suggest such groups will have a difficult time generating overarching preferences over foreign entry and instead will focus on regulating FDI post-establishment.

¹⁶ See Lipsey (2004) for a comprehensive review.

¹⁷ Some of this differential can be attributed to characteristics of the types of firms that engage in FDI. Direct investment is often concentrated in high-wage industries and tend to be employed by large firms that are comparatively more capital-intensive and therefore require more highly skilled labor. However, even after controlling for these characteristics, foreign firms' wage premium persists.

evidence of wage “bid up” exists though the extent of these spillovers depends on skill levels and is often regionally contained.¹⁸ Empirical studies of wage spillovers in developing countries also find consistent evidence that FDI inflows lead to increased wages across the local economy. Aitken, Harrison, and Lipsey (1996) demonstrate foreign-owned plant establishment in Mexico and Venezuela leads to industry-wide wage increases. Feenstra and Hanson (1997) show maquiladora activity in Mexico increases wages of skilled labor. Lipsey and Sjöholm (2003) calculated wage spillovers with consideration for industry-specific and location-wide effects in Indonesia. They find significant spillovers to wages in domestic-owned firms and that these spillovers increase with skill level. In sum, the empirical record shows foreign firms pay wage premiums in local labor markets and contribute to broad-based wage increases.

Foreign entry also creates wide-scale productivity pressures that erode incumbent firms’ rents. Firms that choose to engage in FDI are more highly productive than other firms in their home and host country (Helpman 2006). This productivity gap is more pronounced when multinationals locate in previously protected industries since rents accrued from protection reduce the propensity to invest in productivity-enhancing technology (Schwab and Werker 2014). Multinational entry, by increasing competition in host country product and labor markets, also forces less efficient domestic firms to exit (Alfaro and Chen 2013). For these reasons, inefficient domestic firms will view FDI as a threat to their survival.

Indigenous firms are less certain about the potential benefits they may realize from foreign entry. A local firm is most likely to profit from FDI inflows when it joins a multinational

¹⁸ See Driffield and Girma (2003) for U.K., Girma, Greenaway, and Wakelin (2001) find limited evidence of wage spillovers that depend on the productivity gap and import penetration.

in a joint venture.¹⁹ Local participants benefit from capital injections, risk-sharing, procurement contracts with parents, and technology and knowledge spillovers (Blomström and Sjöholm 1999; Javorcik and Spatareanu 2005; UNCTAD 2003). Research on the effect of FDI on local firms consistently finds vertical integration through foreign-domestic equity partnerships that develop backward linkages with multinational parents are most likely to increase local firms' productivity and profits of local firms (Blalock and Gertler 2009; Havranek and Irsova 2011; Javorcik and Spatareanu 2005).²⁰ Conversely, competition effects disadvantage domestic enterprises when foreign investors establish wholly owned subsidiaries (Aitken and Harrison 1999; Djankov and Hoekman 2000; Javorcik and Spatareanu 2008; Konings 2001).²¹ Local firms may want to restrict FDI to minority shares in order to ensure FDI inflows will benefit them. However, such restrictions often reduce foreign firm willingness to engage in joint venture activity and impede technology transfer and industrial upgrading in the joint ventures foreign firms do establish

¹⁹ Entry through mergers and acquisitions dominate FDI flows. While the composition of flows to developing countries tends to tilt toward greenfield investment, it is erroneous to conclude that most FDI in developing countries occurs through the establishment of wholly owned subsidiaries of foreign firms. A large percentage of these flows counted as greenfield investment actually come from retained earnings of already established enterprises. In 2010, for example, 40 percent of FDI income was retained and reinvested in host countries (UNCTAD 2011, 11). While the propensity to establish joint ventures varies across subsector and home country, the prevalence of shared ownership structures increased in the 1960s and 1970s (Lipson 1985, 128-129).

²⁰ Another potential vertical spillover could occur from forward linkages, where domestic upstream firms purchase inputs from foreign affiliates. However, there is much greater evidence that productivity spillovers from FDI are more likely to occur through backward linkage than any other. See Havranek and Irsova (2011).

²¹ The benefits of multinational entry through joint venture may also accrue to potential suppliers. Joint ventures tend to engage in more local sourcing than do wholly owned subsidiaries of foreign parents, mostly because local partners have existing networks of suppliers and therefore encourage foreign partners to integrate into local production networks rather than source from abroad (Belderbos, Capannelli, and Fukao. 2001; Desai, Foley, Hines 2004; FIAS 2003; Kiyota, Matsuura, Urata, and Wei 2004; Toth and Semjen 1999; UNCTAD 2001).

(Moran 2005, Qui and Wang 2011). Therefore, reducing equity restrictions on foreign participation can lead to more extensive partnership agreements with domestic firms. Since FDI inflows benefit local firms that become partners with foreign firms but disadvantage domestic enterprises that do not, local firms will only want to liberalize FDI policy if they believe doing so will result in foreign firms creating local partnerships with them.

The known costs and uncertain benefits of FDI liberalization create opposition to reform since industrial capital faces identifiable and universal costs but uncertain and firm-specific benefits to multinational entry.²² Foreign entry projects known costs through upward pressure on wages and increased competition in product markets that decrease producer surplus. The potential benefits to individual firms from foreign entry, however, are difficult to identify because firms do not know if they will secure lucrative partnerships with foreign firms. Therefore, industrial incumbents will view unrestricted FDI with caution, and instead prefer foreign entry be restricted entirely or limited to minority joint venture partnerships. This will be especially true of small and medium size firms who typically have higher labor costs, lower capital investments, lower productivity, and lower access to investment financing (Rajan and Zingales 2003). Such firms are most in danger of failing to remain competitive in a sector with foreign firms and also, due to their size, capacity constraints, and low productivity, are least likely to benefit from affiliation and lucrative procurement contracts (Brown 2002; Crespo and Fontoura 2006; Damijan, Rojec, Majcen, and Knell 2013; Helpman 2006).

Strategies, Coalitions, and the Financing Environment

As established above, foreign entry is a threat to incumbents' rents. At the same time, foreign firms hold resources incumbents often want including large pools of working capital,

²² See Roland (2002; 2000) for the role of aggregate and individual uncertainty in raising ex ante political constraints to economic reforms more generally.

greater access to capital markets, advanced technology, and inroads to international procurement and sales markets. As profit-maximizing actors, incumbents must balance the threats and opportunities foreign entry represents when formulating policy positions. The calculus of threats and opportunities rests on access to and costs of finance from other sources.²³ When powerful local firms have access to cheap investment finance, the benefits to foreign entry are offset by the costs. Without a substantial financing constraint, firms do not need to sacrifice controlling equity and associated rents for survival. With sufficient capital, firms can overcome technology gaps through licensing and other non-equity forms of multinational participation. When borrowing costs increase, the cost of excluding foreign equity participation also increases. As the cost of financing investment and operational costs through debt increases, local firms will be increasingly willing to relax restrictions on FDI inflows. Since government control and direction over the financial sector strongly influences the cost of domestic credit, it follows that domestic firms will establish influential anti-FDI coalitions when the state represses the financial system and will assemble equally powerful pro-FDI coalitions when the financial sector is not directed by the state.

Financial Repression in Historical Context

It is important to remember that strict regulation of foreign investment is a relatively novel phenomenon. International law has long protected foreign investors' property rights, particularly with respect to expropriation and compensation (Lipson 1985). Right of

²³ One potential objection to a financing opportunity cost theory of FDI policy is that direct investment is distinct from more liquid forms of investment and therefore is not a substitute for debt or portfolio investment. Empirically, FDI is negatively correlated with other types of international investment flows and this relationship is consistent through time and both in samples of developed and developing countries (Humanicki, Kelm, and Olszewski 2013; Lipsey 1999; Smith and Valerrama 2009). While FDI might provide technological and managerial expertise, these benefits can also be acquired through non-equity participation deals including licensing and management contracting arrangements (UNCTAD 2011).

establishment was hardly controversial through the 19th century when much of the world was under colonial rule and when patterns of cross border investment typically sent capital from developed Western Europe to the cash-poor periphery. Most of this investment was used for large-scale infrastructure projects such as railroads and to government bonds (Lipsey 1999).²⁴ Direct investment, though always the preferred method of cross border capital flows for the United States, did not become an important source of international investment until the end of the 19th century and did not dominant portfolio flows until the first World War (Dunning 1970; Lipsey et al. 1999).

By the 1920s, the general permissive stance toward inward FDI began to erode. As governments embraced varying degrees of statist intervention in domestic economic development, foreign firms were viewed as impediments to domestic capital accumulation (Frieden 1981, Lipson 1985, Moran 1978). The rise of state-led industrialization, which entailed national planning, state owned enterprise development, and state-driven finance created conditions conducive to powerful anti-FDI coalitions. State owned banks created the capacity for local economies to marshal development finance without direct participation of foreign firms. These banks quickly took over foreign owned companies. Governments increasingly declared that foreign investment could only be undertaken if firms could demonstrate how such projects would contribute to national development. In this new period of anti-FDI policy Mexico and Turkey led the way (Lipson 1985). Most starkly, Turkey's first president, Mustafa Kemal Atatürk, declared, "we are always prepared to provide the necessary security to foreign capital *on the condition that its profits be regulated by law* [emphasis added]" (quoted in Lipson 1985, 72). The era of FDI regulation had arrived.

²⁴ Though see Lewis (1938) and Svedberg (1978) for arguments that direct investment figures for this time were much higher.

The political coalitions fostered by state-led development strategies ossified resistance to foreign control of locally operating firms. Local firms profited from high tariffs, and did not want market-oriented foreign entrants to eat away at their market share. Where labor was well organized, workers benefited from the high wages earned in protected industries. Managers at state-owned enterprises gained advantage from soft budget constraints that weakened competitive pressures and ensured the continued existence even of highly inefficient enterprises. State politico-bureaucrats who guided development policy benefited from their gatekeeper status. The 1960s saw an erosion of international investment norms that protected foreign firms. Expropriation of foreign investment peaked in the early 1970s when governments began to target specific industries and firms. During this time, 75 percent of all takeovers were of enterprises that were wholly owned by foreigners. Only 4 percent of nationalizations during this time were of firms in which foreign investors held only a minority stake (Lipson 1985).

What allowed governments to continue their anti-FDI stance, and what maintained powerful political coalitions in support of such restrictive policies were policies directed at the banking sector that gave governments control over credit allocation either directly through state-owned banks or indirectly through guiding the lending portfolios and terms of private banks. Financial repression in the mid 20th century was far reaching. Many states had large state development banking systems. Those that did not often retained great control over the financial sector by maintaining licensing restrictions that led to highly concentrated, wholly domestically owned banking sectors and high reserve requirements that channeled credit to favorite domestic industries, financed government spending, and generated seigniorage that was particularly

helpful at raising government revenue when tax collection systems were dysfunctional (Brooks and Kurtz 2012).²⁵

Importantly, financial repression during this time was not limited to developing countries. Though banking sector policies were more liberal among advanced economies during this time, they were not entirely open. In 1973, the average level of banking sector liberalization in advanced economies was about what the average level of banking sector reform among developing countries is today (Abiad, Detragiache, and Tressel 2008). Only the U.S., the U.K. and Germany had already completely reformed their financial sectors by 1973. Other advanced economies enthusiastically embraced state-led capitalism and pursued policies designed to restrict multinational entry. Many European countries promulgated investment screening mechanisms mid century in order to minimize foreign acquisitions (Blomström and Kokko 1997; Michalet 1997; Safarian 1999). While most accounts of domestic and international politics surrounding FDI place the bulk of analysis on developing host states and developed home economies, the majority of FDI occurs among developed countries and that these countries also have a history of regulating foreign direct entry.²⁶ A theory that emphasizes the financing opportunity costs to FDI regulation has the distinct advantage of providing a united explanation for liberalization of entry restrictions in both developed and developing countries.

Anti-FDI Coalitions under Financial Repression

In a previous section I outlined the reasons why industrial capital prefers to limit foreign firms' ability to invest directly in local markets. Foreign entry pushes up wage costs, forces local firms to sacrifice rents for increasing in productivity, and is generally disruptive to existing

²⁵ McKinnon (1973) first developed the concept of financial repression.

²⁶ Seminal analyses of FDI policy regimes include Vernon (1971), Evans (1979), and Lipson (1985).

market structures. Therefore, domestic firms will support restrictive policies toward FDI so long as their access to operations and investment financing is sufficient.²⁷ Under the terms of financial repression, large and politically important firms can easily finance operation and expansion through subsidized debt. They will support policies that restrict foreign entry outright or to minority joint ventures. This allows them to maintain ownership and control as well as protects rents. While repressed financial systems ration credit, the losers of financial repression – small, weakly organized firms – are poorly situated to pressure governments to reform (Rajan and Zingales 2003). Moreover, such firms are the least likely to benefit from FDI liberalization since foreign entry typically increases drop out rates among small and inefficient firms (Alfaro and Chen 2013). Because financial repression channels cheap credit to politically powerful firms, such systems also tend to consolidate industries into large and closely held industrial-financial conglomerates. Conglomeration intensifies market-distortions in credit markets as the financial arm of these groups loan to connected corporations at below market rates (Akerlof and Romer 1993; La Porta et al 2000). The rise of powerful conglomerates thus further entrenches local firms' capacity to use domestically intermediated sources of finance.

²⁷ The main theoretical contribution of this dissertation is in looking at the overall level of country openness to FDI. However, a theory of preferences over FDI that emphasizes financing constraints can also explain variation in openness across sectors and firms. First, we may expect firms that employ more capital-intensive production strategies to face larger financing constraints and less concern over labor costs. Thus, such firms are likely to be more amenable to liberal FDI policy. Second, conglomerates will be less likely to support FDI liberalization since they are able to use their financing arm to obtain cheap credit. The ability to do this will diminish greatly as local governments enact prudential regulatory reforms, which means such firms will be more apt to shift from a restrictive to open policy stance post banking sector reforms. Third, firms who have previous experience as suppliers to foreign firms will be likely to reap the benefits of openness and therefore more willing to pursue liberalization of entry restrictions. Finally, the extent to which industry-specific restrictions on FDI are enacted should be a function of how concentrated and how much political power these industries wield. Future work could directly test these sectorally-specific expectations, though data limitations may render large N statistical inference particularly challenging.

Local capital can build large anti-FDI coalitions under conditions of financial repression. Where labor is well organized, capitalists can buy off union support for restrictions on FDI through sharing rents (Teichman 1995; 2001). Directed credit to labor-intensive industries creates an alliance between firms and the state since these investments create jobs and economic growth that help maintain popular support for the ruling government. Politico-bureaucrats benefit from expanded jurisdiction, power, and control over investment project proposals. This allows them to use their influence over credit allocation to develop patronage networks to construct ruling coalitions, reward supporters, and punish detractors (Bueno de Mesquita et al. 2003; Haggard, Lee and Maxfield 1993; Hutchcroft 1998; Pepinsky 2013b). Public and private banking interests benefit from restricting foreign firm entry since multinationals impinge on local banks' privileged position of mediating between international capital and local borrowers. In sum, FDI openness threatens the material and political profits of many influential domestic actors while the benefits of openness to other groups are too small to encourage mobilization efforts for reform.

Pro-FDI Coalitions under Financial Reform

As explained above, under conditions of financial repression, governments will place onerous restrictions on FDI by either banning foreign equity outright or by limiting FDI to joint ventures with local firms, usually as minority partners, and by maintaining screening requirements. When governments pursuing banking sector reforms, often in response to financial crisis, the coalitions supporting such policies can weaken significantly.

Banking sector reforms, by eliminating subsidized credit schemes, encourage incumbent firms to consolidate and increase productivity. Successful firms, therefore, are better poised to have increasingly international orientations. These firms are likely to develop their own ability to invest abroad and therefore will support further openness to FDI to encourage reciprocity. They

also are most poised to benefit from FDI inflows as they have the capacity and productivity that make them attractive partners, acquisition targets, and sources of inputs. The high cost of credit encourages them to seek FDI as a less costly financing option. Because they are highly productive, these firms are also less likely to become uncompetitive in markets that include foreign investors.

Banking sector reforms also erode the power of other societal groups that might continue to support FDI restrictions. First, banking reform decreases the political power of domestic financial interests who may prefer to continue to restrict FDI as a means of maintaining their privileged position intermediating between foreign investors and local firms. Banking sector reforms entail privatizing state owned banks and severing the close connections between government bureaucrats and bankers. This makes the financial sector a weaker political actor less capable of successfully lobbying for protective policies. Second, such reforms soften governments' antipathy for FDI as financial repression is no longer a viable strategy for industrial expansion. When the government liberalizes banking, it no longer retains the ability to control credit allocation for political purposes. Therefore, it cannot rely on cheaply obtained credit to finance development projects and needs to cultivate new sources of investment to drive economic growth. Thus, banking sector reforms erode the power of societal groups that are most opposed to FDI openness and creates new capital interests that are more internationally focuses. As the banking sector liberalizes, therefore, states will be more likely to pursue greater openness to FDI to accommodate these new interests.

System Dynamics – The Role of the Global Credit Environment

Since the strength of an anti-FDI coalition will be strongest when alternative sources of finance are relatively abundant and inexpensive, the amount of funds available for intermediation

through the domestic financial system should also affect the propensity to liberalize FDI policy. When the domestic banking sector is so small that it cannot generate enough low-cost credit for the state, governments may decide the benefits of regulated FDI outweigh complete restriction. African experiences with FDI follow this pattern, with many governments pursuing partial openness to foreign investment early in their post-colonial histories (UNCTAD 2005). When domestic banks can easily access international sources of credit, they can channel large volumes of investment debt finance to local firms. Loosening of capital controls on portfolio flows, therefore, may mute pressures for FDI openness since local firms will have increased access to debt finance as domestic banks use foreign investment flows to expand loan portfolios. Furthermore, when global credit conditions are loose, local elite will be better able to generate investment financing through international debt markets and therefore will be less likely to press for FDI openness.

The dynamics above point to the possibility that some success at attracting foreign investment may function reduce elites' financing constraints and therefore prevent further FDI liberalization. These expectations run counter to claims that liberalization of capital flows are complementary (Haggard and Maxfield 1996) and claims that FDI inflows give foreign firms a foothold in which they can pressure the government to enact further liberalization (Desbordes and Vauday 2007; Hewko 2003; Lewis 2005; Malesky 2009). To be able to attract any substantial amounts of foreign capital, however, the investment policy environment must be at least partially open. In other words, we should expect the capacity to attract substantial capital flows to be associated with partial reform.

Is Banking Sector Reform Distinct from FDI Liberalization?

The theory sketched above attributes major changes in FDI policies as the consequence of antecedent banking sector reforms. To establish that correlation between banking sector and FDI reforms are causal, we must eliminate several alternative explanations for why these particular reforms co-vary. First, such reforms may be caused by broader reorientations toward open markets. Because neoliberal adjustments toward the market often occur through clusters of policy reforms, casual observers have often claimed FDI liberalization is merely a reflection of a general ideological shift from structuralism to free-markets. It is important, therefore, to establish that banking sector reforms and FDI liberalization are not just part of larger reform packages. From the perspective of policy elites, technocratic reports on reform sequencing tend to associate FDI liberalization with real sector reforms such as tariff reductions and banking sector reforms with policies toward portfolio investment (Johnston, Darbar and Echeverria 1997). In other words, technocrats themselves tended not to see policies toward FDI and banking as complementary in any particular way. Another potential problem with the theory has to do with the causes of banking sector reform. If banking sector reform precedes FDI liberalization, why would forward-looking financial interests consent to reforms in the banking sector, knowing that such reforms would most likely create more support for additional reforms that would further weaken them? In short, the timing of banking sector reforms is well explained as crisis response.²⁸ Abiad and Mody (2005) find balance of payment crises significantly raise the probability of such reforms, though banking crises make financial sector reform more difficult. Rajan and Zingales (2003) offer an alternative mechanism, suggesting financial and industrial

²⁸ This dynamic is similar to explanations that emphasize short-term capital account liberalization as responses to balance of payment weaknesses. See Haggard and Maxfield (1996).

interests are more likely to support financial reform under conditions of high global liquidity and low tariffs. Such an argument has a more difficult time isolating banking reforms from FDI liberalization, but the empirical support for this theory is relatively weak.²⁹ Pepinsky (2013b) finds the primary drivers of banking sector reform in both Indonesia and Mexico were external, respectively the Asian financial crisis and NAFTA negotiations.

Thus, the explanation for banking sector reform that is most clearly supported by empirical analysis is that such reforms are often policy responses to external pressures. These findings lend support for the claim that banking sector and FDI liberalization are separate reforms. Nevertheless, the research designs employed in both my large N statistical analysis and qualitative case comparison use a variety of techniques to ensure I clearly identify investment policy reforms separately from banking sector reforms.

Summarizing Hypotheses

To summarize, the theory I present in this dissertation is that FDI policy changes as transformations in domestic credit conditions shift elite incentives for attracting or restricting foreign equity investment. Elites' policy preferences depend on access to and cost of alternative sources of investment. When domestic capital allocation processes, particularly related to financial repression, provide politically powerful industrial firms access to subsidized credit, elites will align in an anti-FDI coalition. These preferences for continued restrictions will be further entrenched when short-term capital account openness increases the domestic stock of available capital while also placing financial capital in a privileged position of intermediary

²⁹ Rajan and Zingales' (2003) theory suggests the effect of openness on financial sector development is conditional on industrialization. Statistically significant results disappear in models that correctly model this interaction, mainly those that include a coefficient estimate for each component of the interaction variable plus an interaction term.

between international and local capital markets. These anti-FDI coalitions, however, can break down when banking sector reform, often pursued in the wake of financial crisis, change the way that domestic capital is allocated and break down channels through which politically connected firms can obtain subsidized access to capital. This will lead business elites to advocate for more open policies toward FDI.

This broad theory leads to a number of implications:

Hypothesis 1 *Industrial elites will support greater openness to FDI when domestic credit allocation is market-driven.*

Hypothesis 2 *Industrial elites will support restrictions over FDI when domestic credit allocation is dominated by the state.*

Hypothesis 3 *Industrial elites will be more willing to support restrictive FDI policy when the global credit environment is loose.*

Hypothesis 4 *Industrial elites will support partial reform of FDI restrictions when they have access to other forms of international capital such as portfolio capital.*

Testing

My theory hypothesizes business elite support for FDI openness and restriction will depend on domestic credit allocation environment. However, data availability and measurement issues render it difficult to quantify elite support for policies in a large N context. Therefore, to test my theory I assume elites are generally successful in their lobbying efforts and therefore policy outcomes can be used as a proxy for elite support. The strength of this approach is that I can broadly test my theory using data on FDI policy across a large set of countries from the early 1970s through 2000. The weakness of this approach is that it is an indirect test of my central hypotheses. To strengthen the link between elite support and policy outcomes, I complement large N statistical analysis in chapters 3 and 4 with comparative case studies of Malaysia and Indonesia in chapters 5 and 6. In these chapters, I am able to more carefully consider the

relationship between the lobbying efforts and stated policy preferences of business elites and actual policy outcomes.

The analytic chapters proceed as follows. In Chapter 3, I use error correction statistical models to infer the long-term relationship between banking sector reforms and the level of openness toward FDI. In doing so, I establish a dynamic, long-term relationship between these two sets of reforms. In Chapter 4, I shift analytical focus from a continuous conception of FDI policy openness and use Markov transition models to explore how antecedent financial reforms affect the probability of switching between closed, intermediate, and fully open FDI policy environments. This approach emphasizes the substantive importance of discrete categories of investment regulations, and investigates the conditions under which FDI regulations may become stuck in partial reform. In chapters 5 and 6, I trace the process of investment and financial sector regulation and reform in Indonesia and Malaysia from 1965 to 2013. These chapters allow me to use archival resources to uncover the lobbying activities over FDI of elite groups as domestic credit environments underwent dramatic changes. These chapters, therefore, move beyond testing policy outcomes to also exploring elite strategies toward FDI regulation. Especially since the 1997 Asian Financial Crisis, I find evidence that elites in repressed financial systems are likely to oppose further liberalizing FDI reforms while elites in reformed financial systems are more likely to advocate for investment regulatory reform.

Taken together, these chapters provide evidence that banking sector reforms are statistically associated with FDI liberalization and that elites' strategies toward FDI policy become increasingly liberal as domestic credit allocation becomes more market-driven. There is also substantial evidence that investment regulations are subject to partial reform equilibria.

Chapter 4 finds even banking sector reform may not always be powerful enough to disrupt coalitions favoring dualism.

Such findings also suggest, contrary to typical treatments of the topic, states continue to place substantial limitations on FDI inflows. While the policy environment toward direct investment has become more open since policies of substantial closure in the 1970s, claims that most countries have entirely eliminated restrictions on investment are erroneous. Governments continue to use regulatory bodies to encourage politically desirable investment while preventing other types of investment. The findings in chapter four in particular suggest scholars and policy makers may want to revise the way they talk about patterns of FDI regulation and incentives. While governments may compete over tax incentives for certain kinds of investment projects,³⁰ they clearly are not reaching for any available investment dollar.

This project contributes to our understanding of FDI policy reform primarily by emphasizing how financial sector reforms alter the costs and benefits of FDI to domestic firms. This is important because doing so demonstrates how particular sequences of liberalization shift domestic firms' strategies about how to operate in an increasingly financially integrated global economy. My findings have broad implications for how we can explain changes in policies toward economic openness over time. In particular, the findings I present here challenge explanations of financial openness that place causal significance on the role of democratic institutions in giving political power to labor groups. I find instead that investment policy follows the preferred policies of economic and political elites, and that the preferences of these groups change as global and domestic conditions change the way that capital is allocated

³⁰ See Thomas (2007) for an assessment of the global scope of investment incentives.

domestically. In other words, investment policy changes when elites want it to, not when mass groups force policy change through institutional mechanisms.

CHAPTER 3: THE LONG-TERM EFFECT OF BANKING SECTOR REFORM ON FDI POLICY

Introduction

In the previous chapter, I outline a theory of FDI liberalization that emphasizes the importance of access to and costs of alternative sources of investment. Most centrally, banking sector reforms that disrupt subsidized and directed credit schemes while also strengthening prudential regulations that limit concentrated lending substantially change the nature of domestic credit allocation and therefore will shift economic elites' policy preferences toward increased openness to FDI. In this chapter, I test the relationship between banking reforms and changes in FDI openness using a dataset of up to 68 countries from 1973 to 2000. Using error correction techniques that isolate short-term and long-term dynamics, I demonstrate that banking sector reform is statistically significantly associated with subsequent increases in liberalization of foreign equity restrictions, that the effect of banking reform on FDI openness takes several years to develop, and that this relationship is robust to multiple alternative explanations such as regime type, IMF coercion, general trends toward economic liberalization, and international treaty obligations. These results provide macro level evidence consistent with my theory.

The remainder of this chapter proceeds as follows. The second section briefly revisits the theoretical predictions generated in Chapter 2, paying particular attention to expectations regarding banking sector reform. The third section details the error correction modeling strategy and outlines measurement of outcome and explanatory variables. The fourth section presents and interprets results of the statistical analysis, and the fifth section concludes.

Theory

Throughout this dissertation, I argue FDI liberalization is driven by changes in elite preferences over openness to foreign direct equity ownership in the local economy. As the availability of other sources of investment declines and the costs of such capital increase, powerful business elites will be more willing to open the local economy to foreign owners. They will do so in order to spur capital formation and therefore economic growth generally, which will provide a macro-environment more conducive to firm growth. Additionally, they will support increased openness to gain greater access to foreign firms' investment financing. Thus, decreased state control over the banking sector as well as declining availability of cheap credit from abroad will increase elites' appetite for FDI while access to foreign capital through portfolio investment, inexpensive global credit environments, and subsidized loans from state-owned banks will encourage elites to pressure governments to limit FDI.

My argument stands in sharp contrast to the most prominent explanations of FDI liberalization in recent years, which emphasize the role of political institutions that privilege labor groups (Pandya 2014, Pinto 2013). While FDI liberalization and democratization have followed broadly similar trajectories in the last quarter of the 20th century, FDI liberalization has often *preceded* rather than followed shifts to free and fair elections. Additionally, democratic institutions are often poor constraints on political agents' power during times of transition (Pepinsky 2013a), which suggests newly democratized countries will not have strong enough institutions to force elites to enact policies that benefit labor at the peril of capitalists. Moreover, since popular opinion toward FDI is often negative during the depths of structural adjustment (Bauerle Danzman and Stoyan 2014, Doronbantu 2010, Rohrscheider and Whitefield 2004, Sinn 1997), we might expect democratization to make FDI reform *less* likely.

FDI is a type of investment flow, and therefore changes to policies regulating these flows should be understood within the context of other features of the investment environment. In this chapter, I focus specifically on how changes to the domestic banking sector shift the costs of and patterns of access to investment in local economies. When governments exhibit high levels of control over the financial sector through interest rate controls, directed credit requirements, and large state-owned banks; lending decisions are based on political calculus and therefore provide powerful firms with preferential access to subsidized credit. Under such conditions, business elite most likely to be able to effectively pressure governments for their preferred policies will be happy to restrict FDI. With access to subsidized credit, these firms will not view foreign direct equity necessary to fuel growth. At the same time, the certain costs of FDI liberalization – mainly higher labor costs and demands for increased productivity – will outstrip the possible benefits of foreign firm entry since gains from linkages are firm specific and difficult to predict *ex ante*. However, when the banking sector undergoes substantial reform, the link between politically powerful firms and subsidized credit diminishes. Under tighter local financing constraints, large and powerful firms will be more willing to bear the costs associated with foreign entry in order to gain access to investment financing through foreign direct equity. Thus, banking sector reforms will be positively associated with FDI liberalization. Since elites' strategic realignment toward pressuring governments to liberalize should take time, banking sector reforms should affect long-term levels of FDI regulation, but should be less associated with short-term changes in FDI openness.

Data, Methods, and Empirical Strategy

To test the above theory, I employ a dataset of up to 68 countries from 1973-2000. This time period includes most of the movements toward FDI openness in the developing world. I describe the methodology below.

FDI Openness

Policies toward FDI are multifaceted and encompass a diverse set of rules regarding equity restrictions, screening requirements, licensing laws, and legal provisions regarding profit repatriation, export balancing requirements, nationalization, and legal recourse for aggrieved firms. The complexity of FDI policy has been a contributing factor to the under study of this topic, as measurement remains a challenge to researchers. I focus specifically on two measures of FDI openness: equity restrictions and screening requirements. This choice is partially one of practicality; data for these FDI rules are more widely available than more comprehensive indices of FDI openness, which are available for limited time frames or cover single regions.³¹

However, there are several theoretical reasons why it may be most appropriate to test this particular theory on variables that measure government control directly over foreign equity entry. First, equity restrictions are part of the long-term capital account position. Because I place FDI liberalization within the analytical context of capital account openness more generally, it is appropriate to focus on entry restrictions because these policies are most analogous to measures

³¹ There exist at least six indices of FDI openness. The Heritage Foundation Index of investment freedom begins in 1995, which is after much of the movement toward FDI liberalization. The Frazer Institute has some measures extending back to 1970 on a five year basis, but in early years concentrates mainly on advanced industrial economies. Furthermore, its coding scheme conflates FDI policy with locational attractiveness. Hardin and Holmes (2002, 1997) develop a methodology for a comprehensive index of investment policy in APEC countries. Golub (2003) and Dorobantu (2010) use variations of these coding decisions to measure investment policy in OECD and transition economies respectively. UNCTAD (2012) counts the number of FDI regulatory changes since 1992, but does not measure the relative importance of these changes.

on restrictions on flows of short-term investment. Second, equity restrictions are the cornerstone of a government's policy stance toward FDI. Even if a government has an expansive network of international treaties designed to provide legal protections to foreign investors, equity restrictions can prevent MNEs from entering specific industries either at all or as fully owned foreign subsidiaries. Thus, the importance of any other FDI policy depends on whether foreign firms are allowed to enter a given industry and, if so, to what extent. Finally, when governments retain screening authority over FDI entrance, they are able to discriminate against projects that may potentially harm domestic industrial constituents. Screening can create investment environments in which economies are statutorily open to FDI but foreign firms remain largely excluded from participation.

I use Pandya's measure of equity restrictions and screening requirements, which covers 94 countries between 1970 and 2000 (2014). The equity restriction index was constructed by first identifying the number of all manufacturing and service industries that limit foreign firms to a minority share or ban foreign ownership outright in each country year. Then, the number of limiting industries were summed and divided by the number of industries at the ISIC two digit level for which there was any domestic employment in the given country year. The screening index follows the same methodology by counting the number of industries for which FDI requires government approval. This weighting system corrects for the possibility that some industries simply do not exist in particular countries. Because this measure likely over counts service sector industries and does not include the primary sector, it potentially understates restrictions on foreign entry (Pandya 2014, 17). Furthermore, it does not weight for importance of individual sectors in terms of economic output or share of domestic employment. However, these coding decisions compress the distribution of equity restrictions, making it more difficult to

obtain statistically significant results, and thereby create a conservative test of my theory. To aid in interpretation and discussion, I recode both of these variables so that higher values indicate greater liberalization and lower scores indicate more restrictions.

Banking Sector Liberalization

My primary hypothesis is that banking sector liberalization will induce loosening of foreign equity restrictions. To measure *Banking Sector Reform*, I use modified version of Abiad et al.'s index (2008). This measure has broad temporal and cross-sectional coverage, including 103 countries from 1973-2005. This index compiles qualitative judgments over liberalization in five aspects of banking sector policy: credit controls and excessively high reserve requirements, interest rate controls, state ownership in the banking sector, prudential regulations and supervision of the banking sector, and securities market policies.³²

Controls

I include a variety of other variables to account for alternative explanations of FDI liberalization. First, I control for a variety of factors that influence the cost and benefit of opening. Countries with fixed exchange rates (*Fixed XR*) may find liberalization costly as increased capital flows may require costly interventions into foreign exchange markets to maintain a peg.³³ Conversely, a fixed exchange rate may make a country a more attractive target for MNEs by decreasing uncertainty over the future value of any fixed investment. Additionally,

³² The original index also includes judgments over restrictions on the short-term capital account and foreign equity participation in the banking sector. I remove these measures from the index because 1) I prefer to use a more widely accepted measure for capital account openness (discussed further below) and 2) foreign equity restrictions in the banking sector are also included in Equity Liberalization. All results are robust to the full index, available upon request.

³³ This measure is from Levy-Yeyati and Sturzenegger (2005).

fixed exchange rates may induce balance of payment crises and therefore lead to structural reforms. Therefore, the relationship between fixed exchange rates and FDI policy is most likely complex and consequently I have no expectation about the direction of any effect. Countries with high levels of domestic liquidity ($M2/GDP$) may find FDI less necessary for development, and therefore less beneficial.³⁴ Short-term capital account openness (*KA Open*) may signal a generally economically liberal stance, making FDI liberalization more likely.³⁵ However, I argue access to international portfolio investment decreases domestic firms' demand for access to finance through FDI while strengthening the political position of the most ardent anti-FDI actors. Therefore, I expect *KA Open* to be negatively associated with FDI liberalization. Access to domestic lending (*Domestic Credit*) may operate similarly as the availability of domestic finance will decrease the benefits of FDI openness.³⁶ The level and trajectory of development (*GDP Per Capita*) may influence the extent to which liberalizing FDI policy will actual result in MNE activity.³⁷ Because I employ an error correction modeling strategy, I also include a differenced *GDP Per Capita*, which measures economic growth.

The extant literature on FDI policy formation emphasizes the causal role of regime type. Following convention, I measure regime type using *Polity2* from the *Polity IV* measure of

³⁴ To correct for skew, this variable is log transformed. Source: World Development Indicators.

³⁵ Source: Brune and Guisinger (forthcoming). This measure is an additive index of the presence of controls in twelve components of the capital account, as identified by the IMF's AREAER Report. I modify this measure by subtracting two subcomponents related to restrictions on FDI inflows and outflows and removing a measure for controls over operations of banking and financial institutions. The resulting index can vary from 0 to 9 and is an improvement over more widely used measures such as Karcher and Steinberg (2013) and Chinn and Ito (2006), which combine short-term and long-term restrictions on the capital account.

³⁶ To correct for skew, this variable is log transformed. Source: WDI.

³⁷ To correct for skew, this variable is log transformed. Source: WDI.

democracy and autocracy.³⁸ Polity2 combines two ten point scales of democracy and autocracy, resulting in a measure that ranges from negative ten to positive ten, with higher scores indicating a higher degree of democracy. In the reform sequencing literature, FDI policy is often assumed to follow real sector reforms (Johnston, Darbar and Echeverria 1997). Therefore, I include a measure of de facto trade openness $((Imports+Exports)/GDP)$ to control for FDI openness following trade liberalization.

Another common explanation of the timing of economic liberalization is that financial crises provide a “window of opportunity” for reform either by providing political space for technocratic decision-making, by making political leaders realize their current growth models are no longer viable, or by pressure from international financial institutions that have increased power over states during economic crisis. Therefore, I include indicators for *Banking Crisis*, *Currency Crisis*, and *Debt Crisis*.³⁹ Each measure indicates whether a particular crisis began in a particular country year. Currency and debt crises may induce liberalization, but since banking sector reforms are less likely in the aftermath of banking crises, I anticipate banking crises to either be unrelated to or negatively correlated with FDI liberalization. The literature on capital account openness more generally has emphasized the coercive role of the IMF in the implementation of neoliberal economic reforms. Therefore, I include an indicator variable *Under IMF* to account for countries subject to an IMF loan program.⁴⁰

Finally, because many policy liberalizations exhibit wave-like patterns of implementation, it may be the case that decisions to liberalize FDI follow mechanisms of policy

³⁸ Source: Marshall, Gurr, and Jagger (2012).

³⁹ Source: World Bank Dataset on Financial Crisis.

⁴⁰ Source: Pandya (2014), originally from Dreher (2006).

diffusion across peer groups (Simmons and Elkins 2004). Accordingly, I control for the FDI policies for both regional and income peers by constructing variables that measure the average equity liberalization and screening liberalization score in each country year for a country's regional⁴¹ (*Regional Restrictions*) and income peers⁴² (*Income Restrictions*).

Case Selection and Data Coverage

Conceptually, I expect my theory to apply broadly. However, my statistical analysis covers a limited number of countries due to issues of data availability. The most inclusive empirical models cover sixty-eight developing and advanced economies, while models with additional controls often restrict the sample further. I run a variety of robustness checks to be sure results are not driven by a particular sample. Table 3.1 provides a list of countries included in each of the main estimations. Table 3.2 provides descriptive statistics. To aid in the interpretation of relative effects, I standardize all non-indicator variables in the models I estimate below.

Table 3.1 Country Coverage, Main Models

Algeria	Denmark	Indonesia	New Zealand	Sri Lanka
Argentina	Dominican Republic	Israel	Nicaragua	Sweden
Australia	Ecuador	Italy	Nigeria	Switzerland
Austria	Egypt	Japan	Norway	Tanzania
Belgium	El Salvador	Jordan	Pakistan	Thailand
Bolivia	Ethiopia	Kazakhstan	Paraguay	Tunisia
Brazil	Finland	Kenya	Peru	Turkey
Cameroon	France	Madagascar	Philippines	Uganda
Canada	Germany	Malaysia	Portugal	UK
Chile	Ghana	Mexico	Singapore	Uruguay
China	Greece	Morocco	South Africa	Uzbekistan
Colombia	Guatemala	Mozambique	South Korea	Venezuela
Cote d'Ivoire	India	Netherlands	Spain	Zimbabwe

⁴¹ I use UN subregional categories.

⁴² I use World Bank income categories.

Table 3.2 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max	Source
FDI Equity Openness	2255	0.8044	0.3673	0	1	Pandya (2014)
FDI Screening Openness	1461	0.6662	0.4607	0	1	Pandya (2014)
Banking Reform	1564	6.6148	4.3917	0	15	Abiad <i>et al.</i> (2008)
Fixed Exchange Rate	2340	0.4047	0.4909	0	1	Levy-Yeyati and Sturzenegger (2005)
Capital Account Openness	2303	3.01433	3.0578	0	9	Brune and Guisinger (n.d.)
Ln GDP/PC (\$US)	2177	8.1539	1.6239	4.823	11.3138	World Development Indicators
Ln Trade/GDP	1644	2.2398	1.4179	-4.3283	4.5762	World Development Indicators
Ln M2/GDP	2014	3.06017	0.6417	1.4035	6.428	World Development Indicators
Currency Crisis	2340	0.0474	0.2126	0	1	Claeseens and Kose (2013)
Banking Crisis	2340	0.0274	0.1631	0	1	Claeseens and Kose (2013)
Debt Crisis	2340	0.015	0.1214	0	1	Claeseens and Kose (2013)
Polity	2258	1.2759	7.8212	-10	10	Marshall, Gurr, and Jaggers (2012)
IMF Program	2279	0.3054	0.4667	0	1	Pandya (2014)
BITs	1595	2.9085	3.4462	0	15	Büthe and Milner (2008)
Region Equity Openness	2340	0.082	0.176	0.3316	0.9972	Author Calculation
Income FDI Openness	2340	0.802	0.1057	0.5364	0.9381	Author Calculation
Region Screening Openness	2335	0.7119	0.1767	0.3192	1	Author Calculation
Income Screening Openness	2340	0.6761	0.0788	0.5838	0.806	Author Calculation

Modeling Technique

My theory argues banking sector reform creates a policy environment more conducive to FDI liberalization. Because interest realignment takes time to transfer into policy change, the causal process should display temporal lags rather than instantaneous change. Moreover, modeling the precise timing of reform is particularly important in this case because doing so helps attenuate concerns that reforms of FDI and financial sector policies may be linked through common reform packages rather than through a truly causal process. I choose to employ a single equation error correction model to estimate these dynamics. Such models are useful for several reasons. First, SECMs are particularly suited for integrated time series; diagnostics confirm both measures of FDI openness as well as banking sector reform conform to a first order integration. Second, unlike estimation models that include each explanatory variable lagged by a predetermined amount, SECMs remain agnostic to the length of time it takes for the effect of explanatory variables to fully transfer into outcomes of interest. SECMs estimate three qualitatively important quantities of interest - the average instantaneous change in Y as a result of x , the average long-term effect of x on Y , and the rate at which the long term effects of x change Y . Third, SECMs are accommodating of many problems typical with running dynamic models. These models can handle both integrated and stationary explanatory variables within the same equation (Engle and Granger 1987; Keele and DeBoef 2008), and they also are robust to weak endogeneity (DeBoef 2001).

Results and Interpretation

Table 3.3 reports the main results for *Equity Restrictions*. Recall that all non-indicator variables are standardized to aid in interpreting relative effects. The primary finding of these empirical models is measures of financial sector reform are consistently statistically significantly

related to FDI liberalization, and these results are robust to both fixed and random effects modeling, multicollinearity concerns, and measurement choice.⁴³ Because measures of trade, M2, and domestic credit are often unavailable for many country years in my dataset, I exclude these variables in models that include measures of diffusion. Inclusion of trade and money supply variables reduce my country year observations by almost half and also disproportionately drop developing countries from the sample. Post-estimation diagnostic assessment indicates a fixed effects model is the appropriate modeling choice.⁴⁴

Table 3.4 reports results of a similar set of models that substitute *Screening Requirements* for *Equity Restrictions*. Interestingly, banking sector reforms do not have consistently statistically significant effects on the liberalization of screening requirements. Moreover, the sign of the coefficient estimate for banking reforms in these models is negative. While data availability restrict the *Screening* models, these findings do suggest the political processes that lead to removal of screening requirements is different from the mechanisms that lead to decreased equity restrictions on direct foreign investors. This interpretation is further supported by fact that the screening policies of geographic and income peers seems to have a divergent rather than convergent effect on local regulatory changes. I discuss these findings further below.

⁴³ Results of random effects models are substantively similar to fixed effects models. Results are also robust to other common measures of short-term capital account openness. Results of these robustness checks are available upon request.

⁴⁴ A Hausman specification test rejects the null hypothesis that the coefficient estimates of the random effects model do not systematically differ from the parameter estimates of the fixed effects model at $p=0.000$ (Hausman, 1976).

Table 3.3 Main Models – Equity Restrictions

	Equity Restrictions FE Model 1		Equity Restrictions FE Model 2		Equity Restrictions FE Model 3	
	Coef	SE	Coef	SE	Coef	SE
LDV	-0.4110	0.0298***	-0.4146	0.0218***	-0.4186	0.0220***
Banking Sector Reform						
Lag	0.1595	0.0576***	0.0730	0.0324**	0.0575	0.0351*
Change	0.0354	0.1047	-0.0109	0.0683	-0.0337	0.0710
Capital Account Openness						
Lag	-0.1283	0.0484***	-0.0524	0.0307*	-0.0607	0.0316*
Change	-0.0779	0.0871	-0.0213	0.0574	-0.0286	0.0593
Fixed Exchange Rate						
Lag	-0.0837	0.0833	-0.0527	0.0469	-0.0607	0.0484
Change	-0.0120	0.0673	0.0010	0.0409	-0.0108	0.0422
ln GDP/PC (\$US)						
Lag	-0.0260	0.3009	-0.0386	0.1611	0.1085	0.1656
Change	-1.5198	1.0318	-0.8225	0.6947	-0.8055	0.7177
ln Trade/GDP						
Lag	0.3220	0.1503**				
Change	0.5905	0.4195				
ln M2						
Lag	-0.0277	0.0767				
Change	0.1056	0.1162				
Currency Crisis						
Lag	-0.3850	0.1532**	-0.1056	0.0984	-0.1088	0.1018
Change	-0.2124	0.1004**	-0.0904	0.0667	-0.0945	0.0690
Banking Crisis						
Lag	-0.1475	0.1812	-0.0827	0.1096	-0.0380	0.1132
Change	-0.0423	0.1235	-0.0048	0.0724	0.0093	0.0748
Debt Crisis						
Lag	-0.3719	0.2328	-0.2125	0.1593	-0.1573	0.1645
Change	-0.2575	0.1562*	-0.2428	0.1101**	-0.1947	0.1137*
Under IMF						
Lag	-0.0379	0.0733	-0.0122	0.0454	-0.0081	0.0470
Change	0.0350	0.0799	0.0012	0.0495	-0.0012	0.0511
Polity						
Lag	-0.0247	0.0550	-0.0626	0.0354	-0.0370	0.0358
Change	0.0359	0.1054	-0.0283	0.0641	-0.0357	0.0662
ln Domestic Credit/GDP						
Lag	-0.0613	0.0861				
Change	-0.0537	0.1352				
Regional Mean Policy						
Lag			0.2293	0.0332***		
Change			0.5094	0.0412***		
Income Peers Policy						
Lag					0.1497	0.0291***
Change					0.2727	0.0351***
Constant	-0.0094	0.0740	0.0616	0.0383	0.0771	0.0410*
R ²	0.1442		0.1789		0.1593	
N	57		66		66	
n	746		1386		1386	

* p<0.1, ** p<0.05; *** p<0.01; two-tailed tests. Analysis covers 1973-2000, subject to data availability

Table 3.4 Main Models – Screening Requirement

	Screening FE Model 4		Screening FE Model 5		Screening FE Model 6	
	Coef	SE	Coef	SE	Coef	SE
LDV	-0.2783	0.0313***	-0.2661	0.0217***	-0.2689	0.0218***
Banking Sector Reform						
Lag	-0.1016	0.0693	-0.0594	0.0348*	-0.0511	0.0375
Change	-0.0733	0.1173	0.0237	0.0725	0.0142	0.0762
Capital Account Openness						
Lag	0.0091	0.0502	0.0217	0.0324	0.0119	0.0332
Change	-0.0656	0.0971	-0.1115	0.0589*	-0.1225	0.0611
Fixed Exchange Rate						
Lag	0.1163	0.0910	0.0243	0.0469	0.0546	0.0486
Change	0.0990	0.0730	0.0268	0.0413	0.0460	0.0428
ln GDP/PC (\$US)						
Lag	-0.3495	0.3371	-0.0365	0.1730	-0.0150	0.1796
Change	-0.0910	1.1589	-0.1132	0.7318	-0.1735	0.7591
ln Trade/GDP						
Lag	-0.985	0.1735				
Change	0.3870	0.4948				
ln M2						
Lag	-0.1113	0.1101				
Change	0.0102	0.1416				
Currency Crisis						
Lag	-0.0966	0.1763	0.0354	0.1065	0.0645	0.1106
Change	-0.0372	0.1142	-0.0108	0.0725	0.0071	0.0753
Banking Crisis						
Lag	-0.3506	0.1935*	-0.1279	0.1135	-0.1359	0.1178
Change	-0.2037	0.1313	-0.0735	0.0753	-0.0752	0.0782
Debt Crisis						
Lag	-0.1016	0.2802	-0.1924	0.1749	-0.1535	0.1817
Change	-0.1029	0.1925	-0.1182	0.1193	-0.1138	0.1239
Under IMF						
Lag	-0.0251	0.0798	0.0005	0.0472	-0.0179	0.0490
Change	0.0405	0.0832	0.0449	0.0504	0.0265	0.0523
Polity						
Lag	0.0029	0.0651	0.0022	0.0361	0.0124	0.0376
Change	-0.1985	0.1090*	-0.0137	0.0643	-0.0061	0.0667
ln Domestic Credit/GDP						
Lag	0.1574	0.1182				
Change	-0.0775	0.1675				
Regional Mean Policy						
Lag			-0.1423	0.0288***		
Change			-0.5470	0.0416***		
Income Peers Policy						
Lag					-0.1411	0.0275***
Change					-0.4399	0.0524***
Constant	0.1329	0.0970	0.0076	0.0508	0.0075	0.0523
R2	0.0477		0.1992		0.1516	
N	48		55		55	
n	612		1147		1147	

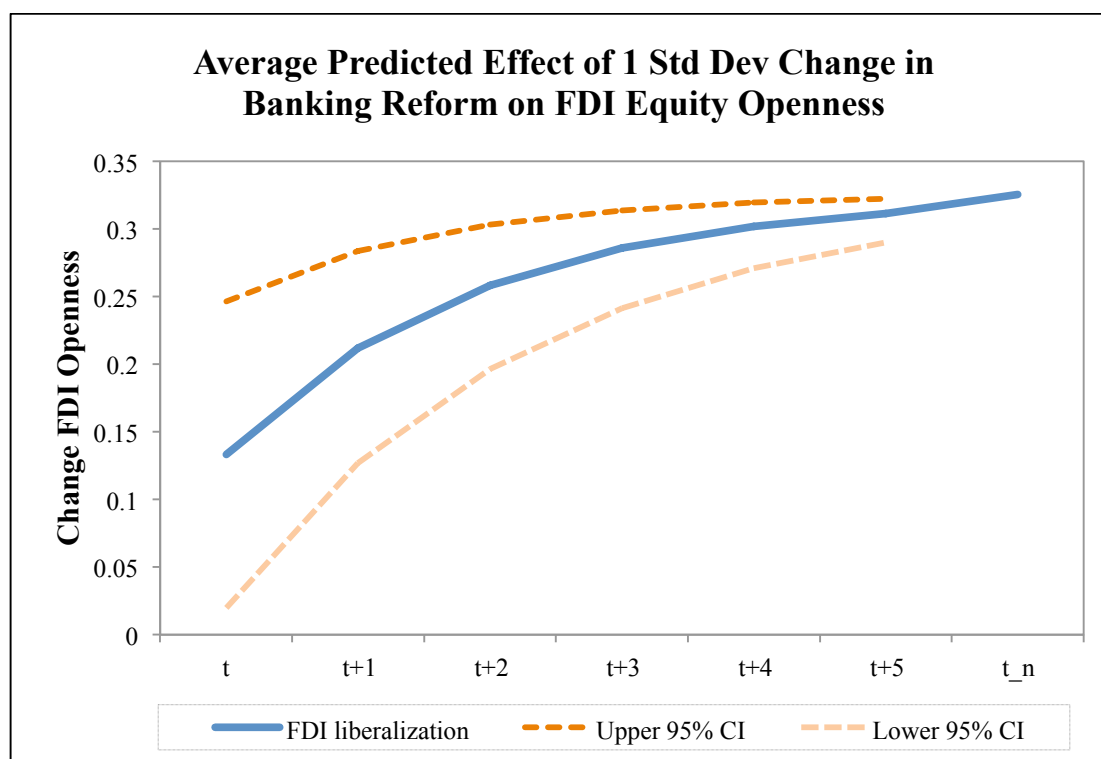
* p<0.1, ** p<0.05; *** p<0.01; two-tailed tests. Analysis covers 1973-2000, subject to data availability

Interpreting SECMs requires separating the short-term effects of explanatory variables from the long-term effects, which transfer into the data through an equilibrating process. The intuition behind error correction models is if two or more time series are cointegrated, they should share a stochastic trend that moderates toward an equilibrium relationship. First, note that for all models, the coefficient estimate for the lagged dependent variable is negative and statistically significant. This finding provides evidence that an error correction model is indeed appropriate for the data; the differenced level of FDI openness is stationary and trends back toward an equilibrium value. Interpreting the short-term effects of the explanatory variables is straightforward; the coefficient estimate of the differenced value of an explanatory variable represents the average instantaneous change in FDI openness. Interpretation of long-term effects requires dividing the coefficient estimate for the lagged explanatory variable by the coefficient estimate for the lagged dependent variable. Since all variables have been standardized, the resulting coefficient estimate represents the average total effect of a standard deviation change in the explanatory variable; the coefficient estimate for the lagged dependent variable provides an indication for how quickly the total long term effect transfers into the data.

What becomes immediately clear is financial reform has no immediate effect on FDI liberalization, but instead influences openness to foreign investment through a longer temporal process. This finding establishes that the correlation between FDI and financial sector liberalization is not driven by contemporaneous reforms in both policy areas. The substantive long-term effect of financial sector reform on liberalization of equity restrictions is quite large. Figure 3.1 illustrates the average predicted long-term effect of banking reforms on FDI liberalization for Model 2. Overall, Model 2 predicts a standard deviation change in banking sector liberalization leads to an average increase in FDI openness equal to 36.68 per cent of its

standard deviation. Model 3 predicts an effect of similar magnitude. Model 1 predicts a larger effect, but is also estimated on a smaller sample. Figure 3.1 illustrates the temporal dimension of this predicted change in FDI openness; most of the effects of banking reform transfer into the data within five years.

Figure 3.1 Long-Term Effects of Banking Reform on FDI Policy



A few other explanatory variables are consistently significantly associated with liberalization of equity restrictions. In Model 1, trade openness is positive and statistically significant association with decreases in equity restrictions, but not with liberalization of screening requirements. It bears mention that trade openness has the largest substantive effect on changes in equity restrictions, which corroborates Kobrin (2005) who argues FDI liberalization follows the logic of economic opportunity costs of closure. However, other economic variables such as level of development and economic growth are not statistically significant.

Perhaps most interestingly, short-term capital account openness is consistently statistically significantly negatively associated with equity restriction liberalization and displays predicted substantive effects around the same magnitude as banking sector liberalization. This finding quite clearly shows that the decision to pursue short-term capital account liberalization is quite distinct from decisions to liberalize long term flows and is also consistent with the above theory that emphasizes different interest coalitions with respect to each policy area. The above theory emphasizes the importance of access to and costs of alternative investment in explaining patterns of FDI liberalization, and specifically argues FDI reform is more likely when access to domestic credit sources is limited. Domestic credit as a percentage of GDP is not a statistically significant predictor of FDI openness, but this variable suffers from a large amount of missingness, which may be driving that result.

There is also evidence that economic crises have long-term negative effects on FDI liberalization. Debt crisis, and to a lesser extent, currency crisis is statistically significantly related to decreased FDI openness for measures of equity restrictions but not for screening requirements. These variables exhibit statistically significant short-term effects, though these predicted effects are not as large as those for financial reform. Banking crisis is not consistently associated with changes in FDI policy This finding is unsurprising within the theoretical framework sketched above because banking sector reform, which significantly drives movements toward FDI liberalization, is less likely in the wake of banking crises (Abiad and Mody 2005). Contrary to arguments that loan conditionality forced FDI liberalization, there is no evidence that being under an IMF program drives FDI policy reform.

These models also provide an important correction to two most prominent theories of liberalization. First, democracy is not consistently statistically significantly associated with

reform. In most models, the coefficient estimate is *negative* and even reaches significance in Model 4. The sign for democracy is particularly interesting because it contradicts previous findings that democracy drives FDI openness (Pandya 2014; Dorobantu 2010). In a large cross-sectional analysis, it is not clear if this negative association is due to democracies blocking reform or because countries typically open to FDI before they transition to democracy. Regardless, the results do call in to question theories of FDI reform that emphasize democratic transition.

Another typical theory of liberalization is that FDI policies diffuse across countries in competition for capital. The models presented here provide a partial confirmation of this expectation. For equity restrictions, FDI liberalization among geographically proximate and economically similar states has a large and statistically significant positive effect on a country's subsequent propensity to liberalize. However, the coefficient estimates for models of screening requirements are statistically significant and negative. This finding is rather puzzling and further suggests the politics surrounding screening requirements are different from those that drive policies toward foreign equity ceilings. The negative relationship between screening liberalization and regime type in Model 4 indicates that screening requirements may be more associated with the way political power is organized domestically. Another possibility is that the politics surrounding the liberalization of screening requirements might play out at the bureaucratic level since rescinding screening authorization amounts to a dramatic decrease in power of whichever ministry administers investment project requests.

Sensitivity Analysis and Alternative Explanations

To provide further statistical support for my theory, I run a series of robustness checks. Table 3.4 reports results for models that use *Equity Restrictions* as the outcome variable and

include a regional diffusion measure. Similar robustness run on *Screening Requirements*, and models that include an income-based diffusion measure also do not change the central results of those models.

First, one of the more surprising results of Models 1-6 is that level of democracy is either not associated or negatively associated with FDI liberalization. To ensure this finding does not rest on measurement choice, I use an indicator for democracy. Model 7 shows that an indicator of democracy further undermines claims that democratization leads to FDI liberalization – in this model, democracy has a statistically significant and negative effect on lifting equity restrictions. Second, it may be that countries are more likely to pursue FDI liberalization when they have a highly skilled labor force. Another alternative explanation for FDI liberalization is the proliferation of bilateral investment treaties (BITs) compelled developing countries to open their borders to FDI (Elkins, Guzman and Simmons 2006). Model 8 includes a count of *BITs*, and again my results are robust to this alternative explanation.⁴⁵ Figure 3.2 illustrates the average predicted change in FDI openness over time for Model 8. The curve is similar to Figure 3.1 indicating the temporal dynamics of reform follow a similar trajectory.

⁴⁵ Because BITs are typically considered to constrain developing countries rather than advanced industrial countries, the easiest test of the hypothesis that BITs increase FDI openness would only apply to developing countries. Therefore, Model 7 is restricted to the developing world.

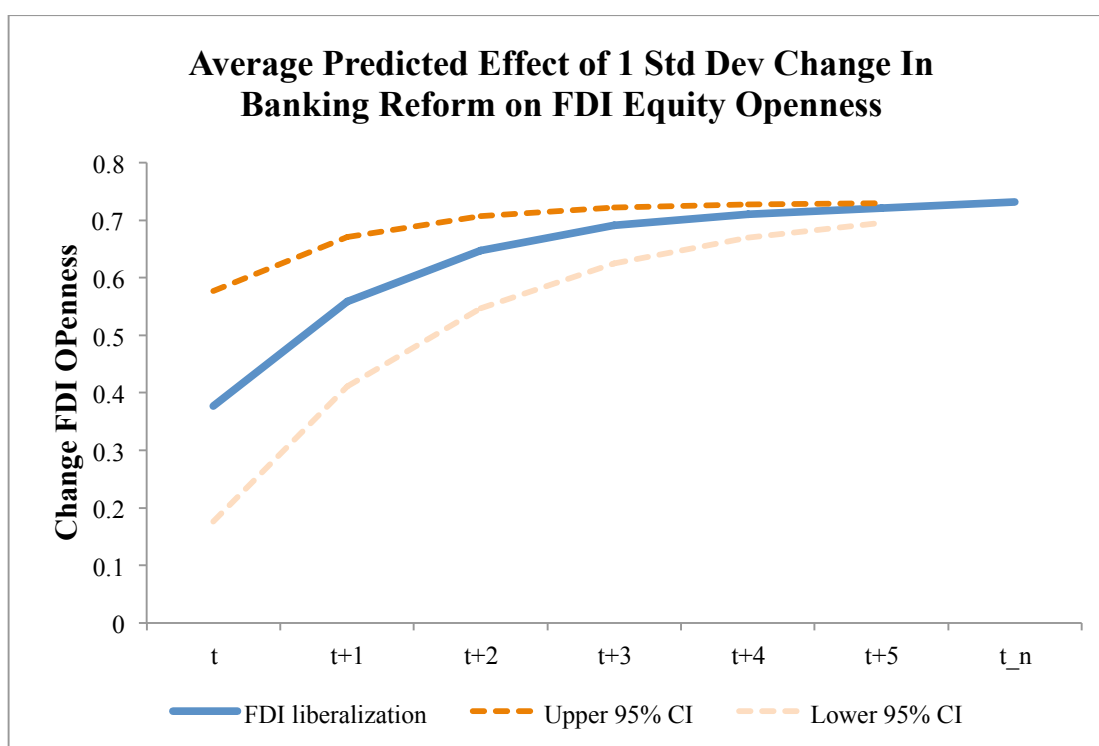
Table 3.5 Results of Robustness Models

	Democracy Model 7		BITs Model 8		TSCS Model 9	
	Coef	SE	Coef	SE	Coef	SE
LDV	-0.4182	0.0217***	-0.4464	0.0282	0.5834	0.0229***
Banking Sector Reform						
Lag	0.0684	0.0320**	0.1395	0.0488	0.1158	0.0322***
Change	-0.0141	0.0681	-0.0790	0.0953		
Capital Account Openness						
Lag	-0.0536	0.0306*	-0.1102	0.0568*	-0.0681	0.0308**
Change	-0.0240	0.0573	-0.0368	0.0997		
Fixed Exchange Rate						
Lag	-0.0580	0.0469	-0.0737	0.0683	-0.0664	0.0405
Change	-0.0014	0.0408	-0.0170	0.0581		
ln GDP/PC (\$US)						
Lag	-0.0230	0.1609	0.0899	0.2186	0.2237	0.1638
Change	-0.8067	0.6935	-1.0285	0.8867		
Currency Crisis						
Lag	-0.1027	0.0983	-0.1414	0.1266	0.0108	0.0659
Change	-0.0880	0.0667	-0.1105	0.0858		
Banking Crisis						
Lag	-0.0815	0.1093	-0.2315	0.1387*	-0.0400	0.0769
Change	-0.0039	0.0722	-0.1109	0.0907		
Debt Crisis						
Lag	-0.2427	0.1598	-0.2032	0.1889	0.0292	0.1103
Change	-0.2568	0.1100**	-0.2434	0.1301*		
Under IMF						
Lag	-0.0217	0.0454	-0.0262	0.0569	0.0094	0.0417
Change	-0.0055	0.0494	-0.0076	0.0622		
Democracy						
Lag	0.1796	0.0614***	-0.1046	0.0442**	0.0073	0.0350
Change	-0.0396	0.0998	-0.0364	0.0768		
BITs						
Lag			-0.0922	0.1116		
Change			0.0470	0.1086		
Regional Mean Policy						
Lag	0.2428	0.0332***	0.2911	0.0456***	0.0598	0.0314*
Change	0.5154	0.0411***	-0.540.60897	0.0575***		
Constant	0.1466	0.0514***	0.1005	0.1097	0.0117	0.0353
R2	0.1737		0.1859		0.6399	
N	66		46		66	
n	1386		874		1386	

* p<0.1, ** p<0.05; *** p<0.01; two-tailed tests. Analysis covers 1973-2000, subject to data availability

Additionally, it is worth noting that the substantive effects are larger in the restricted sample; a one standard deviation change in banking reform is associated with a increase in FDI openness equal to about 75% of a standard deviation change in the outcome variable. Finally, to ensure that my results are robust to alternative estimation techniques, Model 9 uses a standard time series cross sectional estimation with all explanatory variables lagged one period and with fixed effects. Again, my main results remain robust.⁴⁶

Figure 3.2 Effect of Banking Reform on FDI Policy, Developing Countries



It may be that liberalizing reforms may generate additional liberalizing forms more generally. If this is true, the causal mechanism linking banking reforms with FDI liberalization may be growing ideational propensities toward economic liberalism rather than anything particular to how changes in credit allocation processes may shift elite preferences. Therefore, I

⁴⁶ All results are also robust to random effects.

run a series of error correction, pooled time series, and granger causality models to probe the statistical relationship between trade liberalization, measured by applied tariff rates, and banking sector reforms. Across model outputs, there is no consistent statistical relationship between reforms in the banking sector and trade liberalization. In particular, error correction specifications reveal little evidence that banking sector reforms are systematically linked to tariff reforms in either direction. Jointly, these tests provide additional evidence that the statistical relationship between banking reforms and FDI liberalization are more than just an artifact of a virtuous circle of liberalizing reforms.

Conclusion

Over the past thirty years, states have generally opened their long-term capital account by loosening the restrictions on foreign equity ownership in a number of industries. Instead of converging on a particular level of openness, however, states retain a non-trivial degree of variation in their statutory position toward FDI. Previous research on the determinants of FDI liberalization has focused largely on variations in domestic political institutions to explain disparate levels of openness. Such analyses largely ignore the broader macroeconomic context in which governments make decisions about FDI policy, place great confidence in the constraining function of institutions within the context of institutional instability, leave little room for autonomous state preferences, and do not consider how domestic firms may face changing preferences over time. In contrast, I develop a theory that considers how banking sector reform over time induces changes in the political economy of FDI in developing countries. As governments liberalize the domestic financial sector, often in response to balance of payment crises, they lose their ability to use tools of financial repression to maintain regime support. When governments are no longer able to channel investments toward politically important

development projects, they must look to alternate sources of investment to fuel economic growth. At the same time, banking sector reform breaks down traditional coalitions that previously lobbied to maintain high restrictions on FDI while fostering new coalitions of industrial and financial interests that benefit from FDI inflows.

As the results reported above show, there is robust support for the proposition that banking sector reform leads to FDI liberalization, at least in terms of equity restrictions. However, changes screening requirements are not consistently associated with banking sector reforms, nor measures of short-term capital account openness, IMF coercion, or political institutions. Several important implications emerge from these findings. First, they provide a useful corrective to theories of FDI policy orientation that emphasize democratic institutions. Once controlling for banking sector reform, level of democracy is not statistically significantly associated with FDI liberalization. Second, these findings reiterate the importance of considering ways in which global factors influence government policymaking while still retaining explanatory space for domestic level political struggles. Banking sector reform, often induced by external pressures, consequently changed preferences over FDI policy both at the societal level and within the state apparatus itself. Third, the theory these findings support places great emphasis on disentangling the causal logic that underlies decisions to liberalize different “types” of financial flows. In particular, the policy preferences of domestic actors over short-term and long-term capital account openness are not always united and sometimes countervail each other.

These findings open up multiple directions for future research. First, while the statistical analysis here provides evidence of the temporal sequencing of banking sector reform and FDI liberalization, it cannot directly uncover the precise causal mechanisms that lead from banking sector liberalization to decrease domestic ownership requirements. Comparative case study can

further augment support for this theory by tracing the processes through which FDI policy is created, maintained, and amended. Second, my theory of reform suggests access to external short-term investment may create a partial FDI reform equilibrium. Therefore, analysis techniques such as Markov transitions modeling may be useful in more closely examining reform pathways and stumbling blocks as well as the ways in which other financial reforms interact with FDI policy. Third, the results of the models presented here suggest liberalization of equity restrictions and screening requirements follow different pathways and that the mechanisms commonly thought to induce greater openness to FDI do not apply to the lifting of screening requirements. Future research should explore this finding more fully.

Similarly, while this chapter focused on equity restrictions and screening requirements, which are central to governments' long-term capital account position, policies toward FDI are multifaceted. It would be helpful to think about how a theory that takes the temporal sequencing of reform seriously may augment understanding of the political determinants of other facets of FDI policy. For example, when do governments enact new FDI incentive policies? To what extent do the creation of special economic zones speed up or stall FDI liberalization? Finally, these findings place great emphasis on how domestic firms' strategies with respect to foreign investment changed as global conditions changed. Future research might consider more fully the conditions under which the distinction between domestic and multinational firms breaks down. As foreign firms enter host markets and develop both arms-length and intra-firm relationships with domestic incumbents, how do the policy preference orientations of incumbents change and how do firms adapt their lobbying strategies in the context of a breakdown in distinction between domestic and foreign firms?

CHAPTER 4: POLICY, FLOWS, AND PARTIAL REFORM – A MARKOV MODEL

Introduction

In the previous chapter, I demonstrate that banking sector reform is statistically significantly associated with subsequent increases in FDI liberalization, that the effect of banking reform on FDI openness takes several years to develop, and that this relationship is robust to multiple alternative explanations such as regime type, IMF coercion, general trends toward economic liberalization, and international treaty obligations. However, the modeling techniques used in Chapter 3 assume FDI openness is a continuous and linear concept. In other words, moving from complete closure to five percent openness represents the same qualitative change as moving from 45 percent openness to 50 percent openness or 95 percent openness to a completely liberalized FDI policy environment. However, it may be the case that FDI openness is best understood as conforming to a finite set of qualitative distinct policy environments. In particular, it may be useful to distinguish among governments that largely prevent foreign firms access to direct investment from those that welcome FDI, subject to certain conditions, and from governments that allow FDI without meaningful restrictions.

In this chapter, I make use of Markov transition modeling techniques to more fully explore the conditions that make governments more likely to transition between three states of FDI policy: closure, partial openness, and liberalism. In particular, I consider the conditions under which governments may become “stuck” in a partial reform equilibrium in which they welcome and perhaps even pursue FDI in certain industries but continue to maintain substantial restrictions such industry-specific equity restrictions, employment related performance

requirements, technology transfer, and/or project-specific screening requirements. For example, China's 1986 Law on Wholly Owned Foreign Enterprises for the first time allowed some foreign firms to establish wholly owned subsidiaries in China. However, the government retained vast authority to place equity restrictions on specific sectors and individual projects and continues to subject all proposed FDI projects to centralized review (U.S. State Department 2013).

Restrictions on FDI are not limited to countries with state-dominated economies. Mexico, despite NAFTA, continues to restrict FDI in several important sectors either in part or in whole. For example, FDI continues to be limited to a minority share (49 percent) in fixed telecommunications (U.S. Bureau of Economic, Energy, and Business Affairs 2009).

The remainder of this chapter proceeds as follows. The second section briefly revisits the theoretical predictions generated in Chapter 2, paying particular attention to expectations regarding partial reform. The third section introduces the theoretical justification for and mechanics of developing a three category measure of FDI regulation as well as provides a descriptive analysis of this measure over time. The fourth section details the Markov modeling strategy and outlines measurement of explanatory variables. The fifth section presents and interprets results of the statistical analysis, and the sixth section concludes.

Theory

To review my theory, FDI liberalization is driven by changes in elites' policy preferences over openness to foreign direct equity ownership in the local economy. As the availability of other sources of investment decline and the costs of such capital increases, powerful business elites will be more willing to open the local economy to foreign owners. They will do so in order to spur capital formation and therefore economic growth generally, and also to gain greater access to foreign firms' investment financing. Thus, decreased state control over the banking

sector as well as declining availability of cheap credit from abroad will increase elites' appetite for FDI while access to foreign capital through portfolio investment, inexpensive global credit environments, and subsidized loans from state owned banks will encourage elites to pressure governments to limit FDI.

This argument stands in contrast with the most prominent explanations of FDI liberalization in recent years, which emphasize the role of political institutions that privilege labor groups (Pandya 2014, Pinto 2013). Since FDI liberalization often precedes or co-occurs with democratization, it is difficult to show robust causal sequencing between democracy and liberalization. Additionally, since democracy institutions are often poor constraints on political agents power during times of transition (Pepinsky 2013a) and since popular opinion toward FDI is often negative during the depths structural adjustment (Bauerle Danzman and Stoyan 2014, Doronbantu 2010, Rohrscheider and Whitefield 2004, Sinn 1997), we may expect the relationship between democracy and FDI regulation to be complex.

My theory also differs in important ways from arguments that emphasize the role of the IMF as either a coercive agent of change or a convenient source of political cover for local governments who otherwise could not withstand popular dissent against neoliberal reforms. IMF programs themselves cannot explain FDI liberalization, especially since structural adjustment programs only rarely explicitly include the lifting of foreign equity restrictions as conditions for future loan disbursements (Stone 2008, 601). Neither can financial crisis directly cause relaxation of FDI restrictions since dismantling legal restrictions against FDI do not solve immediate balance of payment problems.⁴⁷ Instead, I argue specific policy responses to financial

⁴⁷ Crises can lead to “firesale” FDI in which foreign firms acquire local firms, taking advantage of rapid local currency depreciations, which lower the relative price of acquisitions (Krugman 2000). However, these sales are usually not large enough to sufficiently ameliorate balance of

crisis, such as banking sector reforms, can overtime lead to FDI liberalization because such policies change the availability and cost of alternative sources of investment capital and therefore shift elites' attitudes toward openness.

The primary argument is that FDI liberalization will be more likely to occur when access to and the costs of alternative means of financing investment are constraining to local business elites. The most fundamental domestic structural condition that affects the local financing environment is the financial regulatory environment. When governments exhibit high levels of control over the financial sector; through interest rate controls, directed credit requirements, and large state-owned banks; lending decisions are based on political calculus and therefore provide powerful firms with preferential access to subsidized credit. Under such conditions, the business elite most likely to be able to effectively pressure governments for their preferred policies will be happy to restrict FDI. With access to subsidized credit, these firms will not view foreign direct equity necessary to fuel growth. At the same time, the certain costs of FDI liberalization – mainly higher labor costs and demands for increased productivity – will outstrip the possible benefits of foreign firm entry since gains from linkages are firm specific and difficult to predict *ex ante*. However, when the banking sector undergoes substantial reform, the link between politically powerful firms and subsidized credit diminishes. Under tighter local financing constraints, large and powerful firms will be more willing to bear the costs associated with foreign entry in order to gain access to investment financing through foreign direct equity. This lead to the first hypothesis:

payment difficulties and such rapid sales usually occur without changing investment laws. My interest is not understanding the conditions under which governments might *temporarily* allow foreign firms to acquire substantial equity in distressed companies; but when governments will undergo substantial policy changes that reduce their own ability to manage the conditions under which foreign firms are able to enter.

Hypothesis 1 *Banking sector reforms will be positively associated with FDI liberalization.*

If economic elites drive FDI regulation, and their access to alternative sources of finance conditions their willingness to pursue openness, we may also expect measures that capture the overall supply of alternative sources of capital to affect the propensity to liberalize FDI policy. First, the global credit environment may affect elites' strategies toward FDI. When global credit conditions are loose, local elite will be better able to generate investment financing through international debt markets and therefore will be less likely to press for FDI openness. Conversely, when global credit is tight, domestic firms will be more likely to look toward foreign investors. Since a tight global credit environment constrains investment finance regardless of the level of FDI policy openness, we would not expect the global credit environment to be subject to a partial equilibrium:

Hypothesis 2 *Tight global credit markets will be positively associated with FDI liberalization.*

In addition to global credit conditions, the local economy's ability to attract investment may reduce elites' financing constraints and therefore prevent FDI liberalization. Two primary sources of foreign capital include portfolio and direct investment; note this expectation is that countries that already attract a good deal of investment – direct or otherwise – are unlikely to pursue further reform. This expectation runs counter to claims that liberalization of capital flows are complementary (Haggard and Maxfield 1996) and claims that FDI inflows give foreign firms a foothold in which they can pressure the government to enact further liberalization (Desbordes and Vauday 2007)). To be able to attract any substantial amounts of foreign capital, however, the investment policy environment must be at least partially open. In other words, we should expect the capacity to attract substantial capital flows to be associated with partial reform:

Hypothesis 3 *Portfolio Investment inflows will be positively associated with partial FDI liberalization.*

Hypothesis 4 *FDI inflows will be positively associated with partial FDI liberalization.*

Along with actual inflows of foreign investment, a policy environment that welcomes short-term capital inflows should also mute pressures for FDI policy reform since portfolio investment opportunities can substitute for direct investment. With open policies toward portfolio flows, local banks can use access to international capital markets to intermediate the lender-borrower relationship. Again, we might expect this effect to be non-linear. Short-term capital account openness can provide the financial infrastructure necessary to complement an intermediate FDI policy environment in which foreign firms are selectively provided local entry, often in joint ventures with domestic firms. Therefore, we may expect short-term capital account openness to be positively associated with moves from closed to partial openness and negatively associated with policy changes from partial to full openness:

Hypothesis 5 *Short-term capital account openness will be positively associated with partial FDI liberalization and negatively associated with full FDI liberalization.*

Measuring FDI Policy

In this section, I explain my motivation for using a trichotomous measure of FDI policy, my method for doing so, and present descriptive information about my outcome variable.

Most measures of FDI policy employ an index strategy in which laws regarding foreign entry and establishment, operations and repatriation, dispute settlement, and investment promotion are coded generally at the industry level and then are averaged into one observation for each country year that is typically scaled [0,1]. These measures implicitly assume FDI policy environments are best conceptualized as continuous – changes along the scale represent uniform

movements toward liberalization or restriction. In some cases, it may be useful to distinguish between policy environments in such fine grained detail, particularly if researchers expect FDI policy innovations to be implemented gradually or if the primary area of interest is long term effects of variables of interest on levels of openness to FDI.⁴⁸

If, however, researchers wish to explain direct changes in FDI policy that constitute *meaningful change* in the underlying policy environment such that foreign investors are likely to base locational decisions in part on innovations in the local policy environment, it is less likely that continuous measures of FDI restrictions are particularly useful. Moreover, FDI policy change is “lumpy.” FDI regulatory policy is most frequently set by company or investment laws that cover the majority of economic activity.⁴⁹ And while industry-specific investment policy changes on the margins may reflect lobbying victories of narrow privileged groups, these small changes do little to alter more fundamental features of the legal environment toward foreign investors. For example, Kobrin finds close to one third of all changes to FDI policy in developing countries from 1992-2001 were related to specific investment incentives (2005, 83). However, among the policy categories least likely to undergo liberalization during the same time period were industry-wide ownership limits and approval screening processes (Kobrin 2005, 83). Accordingly, theoretically meaningful changes in FDI policy may display threshold effects that distinguish between a closed, open, or “managed” investment environment. Small changes in an

⁴⁸ These detailed measures may also be helpful in a disaggregated context to consider the determinants of industry-level differences in FDI restrictions. I refrain from such analysis due to the difficulty of obtaining these data in disaggregated form and the lack of available data on industry-level political leverage in a time series cross-sectional context.

⁴⁹ Sometimes natural resources, banking, and/or infrastructure is subject to additional laws, but most agricultural, secondary, and tertiary sector activities are covered by a single law.

index of FDI regulations, therefore, may provide less information about substantive changes in the overall orientation of investment policy.

Measuring FDI policy on a more compressed ordinal scale involves making choices about what these categories should be. Early discussions of FDI policy tended to treat regulatory environments as dichotomous – either governments prohibited foreign entry or allowed foreign firms to invest locally to some degree. However, this simple distinction between nominal openness or full closure obscured the fact that many countries that began to incorporate FDI into their development strategies did so by carefully managing access. The emergence of partially open policy environments that encouraged FDI into specific industries and individual projects while maintaining high levels of investment restrictions generally became evident as economic development entities such as UNCTAD, ASEAN, and the investment bureau of OECD began to produce periodic investment policy reports (ASEAN 1999). Distinguishing between “closed,” “intermediate,” and “open” legal environments not only reflects emergent qualitative differences among countries’ investment policies but also is theoretically relevant. An intermediate category allows us to consider the conditions under which governments will mediate between the availability of a particular source of investment in a globalized financial system and domestic political concerns that might render full liberalization infeasible or undesirable. And unlike portfolio flows, restrictions on FDI remain viable since firm licensing requirements are difficult to thwart.

Partial FDI openness entails relaxation of restrictions on foreign entry while maintaining the state’s legal authority to set limits on entry, thereby requiring foreign firms to enter joint ventures with local entities, and/or submit individual investment proposals to a centralized screening procedure through which governments can reject FDI deemed to not advance the

economic development goals of the state. Retention of these legal limitations on FDI entry also makes subsequent changes, both liberalizing and restricting, to investment policy easier. For example, maintenance of positive or negative lists that detail the industries that (dis)allow specific levels of foreign equity can be changed frequently by executive or ministerial order. Investors have routinely identified such lists as contributing to policy uncertainty since frequent changes to foreign equity allowances can force divestitures and make medium and long-term planning difficult for foreign firms.⁵⁰

To distinguish between these three states of FDI policy, I modify Sonal Pandya's measures of equity restrictions and screening requirements on foreign firms (2014). This dataset is the most comprehensive measure of laws regarding entry treatment of direct foreign investors currently available, covering up to 91 countries from 1970 to 2000. Other available measures either have more limited temporal or cross-sectional coverage. For instance, the dataset with the next best coverage is the OECD's FDI Restrictiveness Index covers 43 to 58 countries in 1997, 2003, 2006, 2010-2013.⁵¹ Moreover, by focusing on the legal barriers to entry, this measure provides a more direct assessment of the policy environment that is specific to foreign firms who wish to invest directly. Other indices also include measures for policies regarding land ownership by foreigners, access to dispute settlement mechanisms, limitations on hiring non-native managers, and the ability to repatriate profits. While such laws affect foreign firms' operational

⁵⁰ Indonesia's expansive and unstable negative list through the 2000s is indicative of the risks foreign investors face in dualist policy environments. A series of increasingly complex negative lists, particularly the 2007 negative list that increased coverage from 83 to 338 sectors, created concerns that foreign investors could face divestiture requirements in the future if changes to the negative list lowered the legal equity limit on foreign ownership in relevant industries. See Teo, Laurel. "Indonesia's New Investment Rules Add to Confusion," *The Business Times Singapore*. 13 July 2007.

⁵¹ Available at <http://www.oecd.org/investment/fdiindex.htm> (last visited 25 March 2014).

considerations; they do not address the fundamental right of establishment, represent barriers that are more easily circumvented,⁵² and also are often protected through extra-territorial instruments such as bilateral investment treaties (BITs). At the same time, since the vast majority of BITs only provide national treatment post-establishment (UNCTAD 1999), regulating entry remains at the purview of the state.

Pandya's *Entry Restrictions* measures the percentage of all non-extractive sector industries that limit foreign ownership to a minority share or ban foreign participation outright in a given country.⁵³ Limiting foreign ownership to a minority position is important because doing so requires foreign firms to form partnerships with local firms in which the domestic participant holds all decision-making authority. Such restrictions are substantially burdensome to foreign entities, which relinquish managerial control and therefore must provide significant technology transfer for the privilege of local establishment. Based on this measure, I create three categories: *Closed Equity*, *Intermediate Equity*, and *Open Equity*. For a given year, a country is coded as *Closed Equity* if more than fifty percent of industries limit foreign ownership to a minority share or less. I code countries as *Open Equity* if no industries limit foreign ownership to a minority share. *Intermediate Equity* countries occupy the intermediate category. It is important to note that this coding scheme allows states coded as fully open to retain equity restrictions, so long as foreign investors are allowed a majority share of a joint venture.⁵⁴ Figure 4.1 depicts the

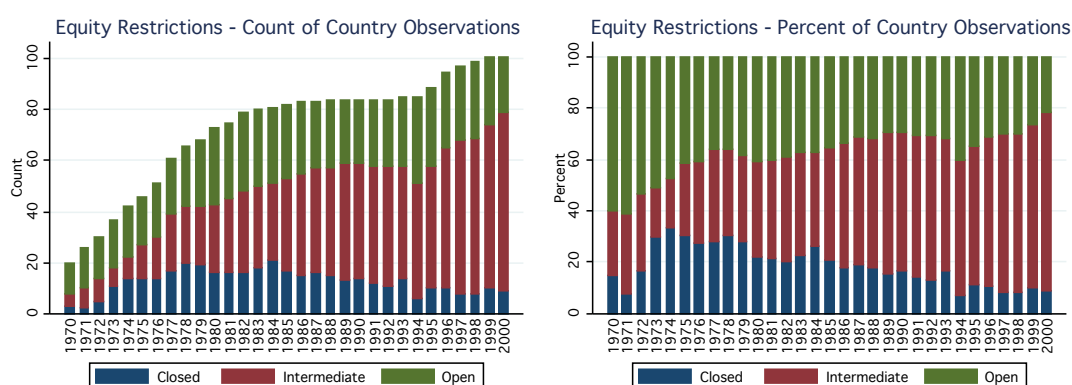
⁵² For example, capital controls that may be designed to limit repatriation may be easily evaded through transfer pricing manipulation (Pandya 2014)

⁵³ Excluding equity limitations on extractive activities is appropriate since all most all countries have some amount of restriction on extraction, either through a royalty system or through requirements to establish joint ventures with state-owned enterprises.

⁵⁴ As with any discrete coding scheme, establishing cut-offs for policy environments involves making several choices. I also considered varying the cut-off between "intermediate" and

distribution of these categories in my sample by year. I report both the count of each country and the percentage of the sample in each category since the sample increases in size in later years. Descriptively, while the sample shows an increase in openness overtime, much of this change has been due to an expansion of the intermediate category. Table 4.2 is a transition matrix that shows the distribution of transitions to and from each policy category.

Figure 4.1 Distribution of Equity Restriction Environment Type, 1970-2000



source: Pandya 2010; author's own calculations

“open,” but ultimately decided the distinction between policy environments in which FDI is allowed majority ownership share across all industries versus policy environments in which some industries restrict FDI to less than a majority share is more meaningful than establishing a coding rule in which a policy environment could be coded as fully open so long as it met a minimum threshold of industry restrictions to minority share. This coding rule also ensures that a sufficient number of observations exist in each policy category and that the dataset has a sufficient number of transitions between each policy category to make statistical inference possible. However, there are many other justifiable ways to establish distinct policy groupings. An ideal solution would be to code countries as “closed” if they limit FDI to minority shares, “intermediate” if they allow FDI to take majority shares but restrict full ownerships, and “open” if they allow foreign firms to establish wholly owned subsidiaries throughout all or most industries. Unfortunately, the underlying data necessary to create such a coding rule are not available at this time.

Table 4.1 Equity Policy Category Transitions – One Year Lag

Previous Year	Current Year		
	Closed	Partial Openness	Open
<i>Closed</i>	334	43	16
<i>Partial Openness</i>	43	972	49
<i>Open</i>	14	52	718
<i>Total</i>	391	1067	783

Pandya's *Screening Requirements* similarly measure the percentage of all non-extractive sector industries that require centralized government screening prior to foreign equity entry. This measure captures the extent to which governments retain informal restrictions on entry. Screening allows governments the authority to pick and choose among investment proposals they view as beneficial economically and politically while barring entry to projects that are unpopular among domestic constituents and, in particular, powerful local business interests. Governments may view equity restrictions and screening requirements as complementary or as substitutable; for instance, China notoriously has little explicit equity restrictions since 1987 but uses its intentionally vague screening requirements to allow maximum flexibility of the government in approving and rejecting investment projects (EIU 2010, 22; U.S. Bureau of Economic and Business Affairs 2013, 1). In Pandya's dataset, *Entry Restrictions* and *Screen Requirements* exhibit little correlation with a coefficient of 0.13. To create three distinct categories of screening environment, I employ an identical coding rule as explained above to generate *Full Screen*, *Intermediate Screen*, and *No Screen*. It may also be possible that an intermediate category is less useful conceptually for screening than in is for equity restrictions. As I will show below, my estimation strategy directly tests whether these categories should be collapsed.

Figure 4.2 depicts the distribution of these categories in my sample by year. I report both the count of each country and the percentage of the sample in each category since the sample

increases in size in later years. Descriptively, while the sample shows an increase in openness overtime, the most striking temporal trend is the emergence of an intermediate category. Because the sample is unbalanced, it is unclear the extent to which this trend is due to sample size increase. However, sample size stabilizes substantially in the mid to late 1980s and shows a marked increase in countries falling into the intermediate category in the mid 1990s, which corresponds with a string of emerging market financial crises, particularly in Asia. The timing of the expanded intermediate category also is associated with increased FDI sourced from developing countries. Table 4.3 provides the instance of switching between the three policy categories.

Figure 4.2 Distribution of Screening Requirement Environment Type, 1970-2000

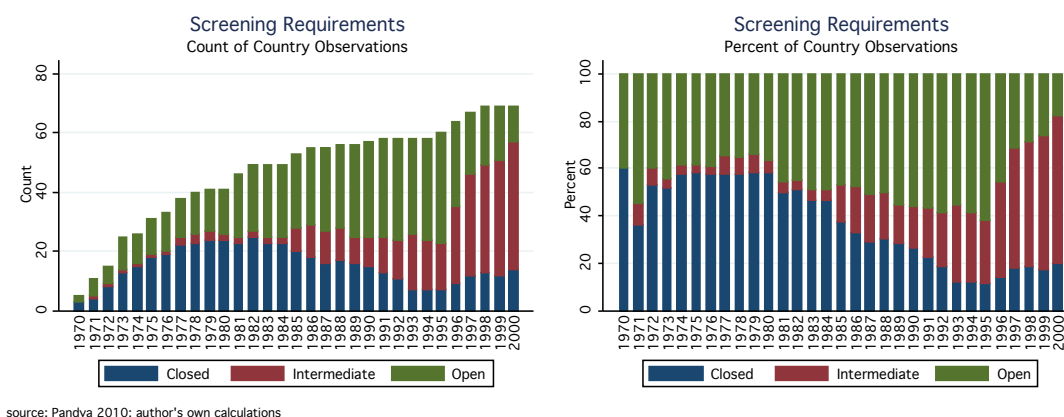


Table 4.2 Screening Policy Category Transitions - One Year Lag

Previous Year	Current Year		
	Closed	Partial Openness	Open
<i>Closed</i>	418	22	25
<i>Partial Openness</i>	20	270	24
<i>Open</i>	24	39	577
<i>Total</i>	462	331	626

Method

By measuring FDI restrictions as three distinct categories, I can design an empirical strategy to infer how changes in multiple explanatory variables affect the propensity of countries to switch among categories. In doing so, I can more fully explore the extent to which FDI policies may be subject to a partial reform equilibrium in which government loosen restrictions but do not relinquish substantial control over access. This possibility could be an important correction to popular conceptions that governments have liberalized FDI full stop and that the majority of contemporary policy innovations regarding foreign investment are aimed at creating more competitive tax environments for potential investors. Moreover, looking at policy switching allows me to consider how access to alternative sources of investment finance may limit the extent to which governments will fully liberalize FDI restrictions.

Rather than employ a standard ordinal logit, I use a Markov model specification. The main innovation of these class of models is they allow the probability of $a \rightarrow b$ differ from the probability of $b \rightarrow a$. The three-state model I employ estimates distinct transitions probabilities for closed to intermediate, intermediate to open, closed to open, and the reverse of each of these transitions. Markov transition models have been used extensively in health science, but are not widely used in political science contexts. One notable exception is within the literature on democratic transitions. I follow Epstein, Bates, Goldstone, Kristensen, and O'Halloran (2006) to adapt a Markov model to a three-category outcome variable.

The essence of a Markov model is the conditions present in period t affect the probabilities of each possible type of transition in the subsequent time period. In this way, Markov models are at once analytically focused on *change*, while also flexible to the possibility

that variables of interest matter differently depending on what the starting state is. The general form of a Markov equation is:

$$F [Pr(Y_{it} = b \mid Y_{it-1} = a)] = \theta_{ab} + X_{it} \beta_a,$$

where a and b are possible states (in this case FDI policy types) and $F(\bullet)$ is a function on support $[0,1]$, such as logit or probit link functions. Rather than estimating separate equations for each category, I can modify the equation above to accommodate a dependent variable with C ordered categories in which $C=3$ and are labeled $0, 1, \dots, C-1$ and then use cumulative transition probabilities to interpret model output. The equations can be expressed in terms of Y^* variables, where $Y_a^* = 1$ if $Y \leq a$. Concretely, $Y_{it} = 0$ indicates country i has a closed FDI environment at time t ; $Y_{it} = 1$ indicates an intermediate policy environment, and $Y_{it} = 2$ indicates full FDI liberalism. This expression allows us to recover individual transition probabilities from the estimated cumulative probabilities by estimating the following equation:

$$F [Pr (Y_{it} = b \mid Y_{it-1} \leq a)] = \theta_{ab} + X_{it} \beta_a,$$

where $b = 0, 1, 2$ and $a = 0, 1$. By substituting values of Y^* for values of Y at $t-1$ and interacting each of the independent variables with lagged values of Y^* , this yields

$$F [Pr(Y_{it} = b \mid Y_{it-1}^* \leq y_{it-1}^*)] = \theta_b + \sum_{\ell=0}^1 \alpha_{\ell b} y_{it-1\ell}^* + x_{it}(\beta + \sum_{\ell=0}^1 \gamma_{\ell} y_{it-1\ell}^*),$$

for $b = 0, 1, 2$.

The first two expressions on the right-hand side (θ_b and α_{ab}) represent, respectively, the coefficient estimates for the effect of each potential previous state on the probability of switching to or remaining in the current state ($\theta_b = \theta_{C-1}$; $\alpha_{ab} = \theta_{ab} - \theta_{(a+1)b}$). Thus, a statistically significant α indicates categories are distinct. Likewise, $\beta = \beta_{C-1}$ and $\gamma_a = \beta_a - \beta_{a+1}$, so a statistically significant value of γ indicates the related explanatory variable's effect on FDI

policy depends on the starting state and an insignificant value of γ suggests an explanatory variable's affect on FDI policy is not conditioned on starting state. Thus, the model tests whether the categories of the dependent variable really are distinct, and it allows explanatory variables flexibility in that simultaneously some can be conditionally dependent on starting state and others can uniformly affect outcomes.

One draw back of this model is that explanatory variables quickly consume degrees of freedom since the specification requires each variable on the right hand side to be interacted with indicators for *Closed* and *Intermediate* policies. Due to the profusion of interaction terms, I am limited in the number of right hand side variables I can include simultaneously. Accordingly, I run and report multiple models to fully explore the affect of a number of explanatory variables and controls. Table 4.1 reports descriptive data.

Main Explanatory Variables

Recall from the above the primary argument is that FDI policy reform is more likely when domestic business elites face increasing financing constraints. Therefore, easy access to credit and inward investment flows should be negatively associated with liberalization. I operationalize this argument as follows.

First, banking sector policies are fundamental to domestic capital allocation decisions. Governments have historically used heavy state control and regulation to influence decisions about which industries and specific firms obtain debt financing. Whether through direct management control over state-owned banks or using directed credit requirements, regulations in the banking sector have typically distorted credit markets to provide subsidized financing to politically important industry groups and firm. Therefore, hypothesis 1 anticipates banking sector reform will be positively associated with FDI liberalization because such reforms will limit

politically powerful firms' access to subsidized financing options. I measure banking sector reform using a modified version of Abiad, Detragiache, and Tressel's (2008) Financial Reform Dataset. This measure codes a panel of 91 countries from 1973-2005 on seven dimensions of reform: credit controls and excessive reserve requirements (defined as over 20 percent), interest rate controls, banking entry barriers, state ownership, capital account restrictions, prudential regulations, and securities market policy. To isolate *Banking Sector Reform* (0,15) from financial reforms that overlap with short and long term capital account liberalization, I eliminate banking entry barriers and capital account restrictions from the modified index. Higher values indicate reform while low values signify countries with highly repressed banking systems. It is also important to note the prudential regulation dimension is coded such that more substantial and effective risk-based regulations are coded as positive; while many regulations on banking activities serve to influence *specific* lending decisions and are therefore distorting, prudential regulations shift credit allocation decisions from those based on political and relational considerations to those based on market risk-based assessments of creditworthiness.

Access to alternative financing also depends on the supply of international capital. The global financial cycle, which closely follows U.S. monetary policy, drives global liquidity (Rey 2013). To test hypothesis 2, which expects tight global lending conditions will lead to movements toward FDI liberalization, I measure global availability of credit with *US Fed Funds*. Since higher interest rates restrict credit, I expect *US Fed Funds* to be positively associated with FDI liberalization. Another way to measure global availability of investment funds is through patterns of balance of payments. Global imbalances matter for the supply of global investment because trade deficits require net capital inflows. When a few large countries⁵⁵ have persistently

⁵⁵ For the time period in this analysis, the U.S.

large current account deficits, this requires these same countries to absorb the majority of net investment flows, which reduces the ability of international capital flows to other economies, at least on a net basis. I measure the structure of global balance of payment inequality through *Current Account Gini*, which uses a gini index to measure the degree to which current account deficits are concentrated in a few economies.⁵⁶ I expect high current account inequality will increase pressures for FDI reform by reducing the pool of investment flows available to countries without these large current account deficits.⁵⁷ Inward investment flows should also mute pressure to liberalize by lessening the financing constraint. Therefore, I expect *Portfolio Inflows* and *FDI Inflows* in the previous period to both be negatively associated with switching to a fully open regulatory environment (hypotheses 3 and 4).

Government policies that affect financing availability should also be related to the propensity to liberalize FDI policy. Short-term capital account openness allows domestic firms to access foreign sources of investment either through debt or short-term equity instruments. Therefore, contrary to conventional arguments that short and long-term capital account liberalization are complementary, my theory expects that short-term capital account openness will reduce the propensity to fully liberalize FDI policy (hypothesis 5). In particular, I expect short-term capital account openness to reduce transitions from intermediate to fully liberal FDI policy environments since portfolio inflows allow domestic firms to access foreign sources of capital investment without requiring them to cede control over their own firms or forcing domestic capital to compete in labor and product markets with comparatively more productive

⁵⁶ This measure is from Oatley (2014).

⁵⁷ By “large,” I mean relative to global imbalances. Small countries can have current account deficits that are large relative to their own economies, but insignificant to global patterns of trade and investment flows because their economies are dwarfed by the activities in the largest countries.

multinationals. I measure short-term capital account openness (*SKA Open*) by modifying Brune and Guisinger's (forthcoming) index that sums policy openness across twelve dimensions of current and capital account transactions as reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). To ensure this measure does not conflate openness to portfolio and direct investment, I subtract out measures of controls on inward and outward FDI. To isolate capital account openness from banking sector reform, I also extract the subcomponent of the index that measures credit controls.

Table 4.3 summarizes my expectations:

Table 4.3 Expected Relationships

Hypothesis	Variable	Closed -> Partial	Partial -> Open	Open -> Open
1	Banking Reform	+	+	+
2	US Fed Funds	+	+	+
2	Current Account Gini	+	+	+
3	Portfolio Inflows	+	-	~
4	FDI Inflows	+	-	~
5	SKA Open	+	-	~

Alternative Explanations and Controls

In addition to my main explanatory variables described above, I also control for a variety of factors that have either been well established to affect FDI policymaking or are frequently forwarded as alternative explanations. First, I control for *Democracy* using the widely used Polity scale;⁵⁸ this is the same measure Pandya (2014) uses to argue democratization brings FDI liberalization. I also control for *IMF Coercion* by included a dummy variable for IMF program participation.⁵⁹ In some models I include indicators for *Banking* crises.⁶⁰ A growing literature on

⁵⁸ Source: Marshall et al. (2012)

⁵⁹ Source: World Development Indicators

policy diffusion suggests governments are more likely to pursue liberalization in a variety of policy areas when their peers do as well. Accordingly, I include measures for the average level of FDI policy for each countries' *Regional* and *Income* peers.⁶¹

Several economic factors may also matter for FDI policy. We know that countries with large internal markets and higher levels of development are less likely to pursue liberalization. Accordingly, I control for *Level of Development* as proxied by GDP per capita⁶². Other possible national account measures may be related to FDI policy changes such as *GDP* and *GDP Growth*, however, GDP and GDP per capita are highly correlated (.83) and therefore inclusion of both measures would be distorting. Additionally, the temporal dimension of my modeling technique makes inclusion of growth redundant since this information is already included in the analysis through lagged variables. Countries which have substantial natural resource wealth may have reduced external financing needs and therefore be less likely to pursue an open FDI policy environment. Because broad measures of natural resource wealth typically display substantial missingness, I ran several models using an indicator of *OPEC* membership. However, it is

⁶⁰ Abiad and Mody (2005) argue capital flows liberalization is strongly predicated on financial crisis. They find evidence that currency and debt crises spur liberalization while banking crises are associated with periods of retrenchment. I run a series of diagnostic tests that indicate only banking crisis and not debt or currency crisis is statistically associated with FDI policy environment transitions, and therefore omit indicators for debt and currency crises. These finding are different from the relationship I uncover in the previous chapter, and therefore suggest other types of financial crisis may have a long-term relationship with FDI policy, but do not seem to drive transitions in the short-term.

⁶¹ Regional and income groups come from U.N.

⁶² To provide as much coverage as possible, I use GDP in current local currency and then control for inflation with the GDP deflator. I then divide by population and take a log transformation to correct for skew. While this method does not correct for exchange rate changes, it provides substantially more observations than does GDP in constant US dollars. Source: World Development Indicators

important to note that resource extraction is often capital and technologically intensive. Resource wealth may increase openness in service sectors related to extraction. Especially since my measure of FDI openness does not include data on the extractive sector, the link between resources and FDI policy may be rather tenuous. Due to the fact that the OPEC measure is largely subsumed by the regional diffusion measure, I omit the OPEC measure from models reported here. Inclusion does not fundamentally change the substantive interpretation of the main variables of interest, but does create some separation problems in the data that inflate coefficient estimates.

Ideally, I would also like to control for two other economic variables that may impact FDI policy: trade flows and human capital. Unfortunately, broadly used measures of these concepts display a great deal of missingness through the earlier part of my time series, especially for poorer countries.⁶³ Therefore, I cannot include these data in this analysis. Table 4.4 provides descriptive information about my variables.

⁶³ Constraining the sample to countries with observations of exports as a percent of GDP and tertiary enrollment as reported in the World Development Indicators constrain my sample to roughly 300 observations.

Table 4.4 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max	Source
Equity Policy	2255	1.18	0.70	0	2	Pandya (2014)
Screening Policy	1461	1.12	0.87	0	2	Pandya (2014)
Banking Reform	1564	6.62	4.39	0	15	Abiad <i>et al.</i> (2008)
Capital Account Openness	2303	2.07	2.63	0	7	Brune and Guisinger (forthcoming)
US Federal Funds	2340	7.35	3.02	3.02	16.39	U.S. Federal Reserve
Current Account Inequality	1841	0.55	0.18	0.19	0.79	Oatley (2014)
Ln(Net Portfolio Flows/GDP)	1610	20.64	1.63	17.60	26.97	World Development Indicators
Ln(FDI Inflows/GDP)	1610	21.76	1.21	17.28	27.63	World Development Indicators
Ln(GDP Per Capita)	2228	10.35	2.29	5.97	16.51	World Development Indicators, LCU, deflated
Banking Crisis	2340	0.03	0.16	0	1	Claeseens and Kose (2013)
Polity	2278	1.35	7.83	-10	10	Marshall <i>et al.</i> (2012)
IMF Program	2279	0.31	0.46	0	1	Pandya (2014)
Region Equity Policy	2322	1.17	0.32	0	2	Author Calculation based on U.N. Region
Region Screen Policy	2312	1.20	0.53	0	2	Author Calculation based on U.N. Income
Income Equity Policy	2340	1.18	0.20	0.68	2	Author Calculation based on U.N. Region
Income Screen Policy	2320	1.17	0.43	0.4	2	Author Calculation based on U.N. Income

Results

As mentioned above, the profusion of interaction terms in Markov analyses limit the number of variables I can estimate simultaneously. Therefore, I estimate and interpret multiple models, paying attention not just to marginal effects but also overall model fit. In all models I lag all explanatory variables by one year to introduce temporal dynamics. Following Epstein *et al.* (2006), I begin by interacting all lagged explanatory variables with lagged indicators for *Closed FDI Policy* and *Intermediate FDI Policy*, which allow the substantive effect of each variable to be conditioned on starting state. For example, if the interaction between *Banking Reform* and *Closed FDI Policy* is statistically significant, banking reform has a statistically distinct effect on the level of FDI openness if a state had a closed FDI policy environment in the previous period than if the state had a dualist or liberal policy environment. If *Banking Reform * Intermediate* is statistically significant, Banking Reform has a different effect when FDI policy was fully liberal at $t-1$ then when FDI policy was either closed or intermediate. Accordingly, if both *Banking Reform * Closed* and *Banking Reform * Intermediate* are significant, banking reform has a different effect for all starting points of FDI policy. From the fully saturated models, I eliminate statistically insignificant interactions and report the results of each constrained model.

Table 4.5 reports the results of models in which FDI policy states are measured through *Equity Restrictions* and Table 4.6 reports the results of models in which FDI policy states are measured with *Screening Requirements*. To more easily interpret estimated effects, Tables 4.7 and 4.8 provide the estimated effects and statistical significance of relevant variables for each model. For each interacted term that reached statistical significance, I summed the interaction's coefficient estimate with the coefficient estimate for the un-interacted variable. Statistically significant terms for both the Y_0 and Y_1 interactions mean that the effect of a given variable is

statistically different for each starting state. A non-significant term for an interaction signifies the effect of a given variable at that starting state is the same as the effect in the intermediate starting state.

The results of these models indicate mixed support for my hypotheses. Hypothesis 1 predicts banking reforms fundamentally alter the process through which domestic credit is allocated and therefore will result in FDI liberalization because elites will view foreign firm entry as necessary to increase access to operations and investment financing. I find qualified support for this central argument. With respect to *Equity Restrictions*, Banking Reform is positively associated with liberal FDI policy when starting from a closed or open investment policy environment. However, there is no effect on FDI policy when starting from an intermediate environment. With respect to *Screening Requirements*, governments with intermediate policies are less likely to liberalize in the wake of banking reform. These findings are contrary to the robust findings in the previous chapter that banking reform has a long-term positive effect on FDI policy liberalization. One potential reason for this discrepancy is that the Markov model, by focusing on the propensity to switch over a short time period, is unable to capture the effect of processes that have long temporal lags.

Table 4.5 Results for Equity Restriction

	Model 1 Bank Reform	Model 2 Fed Funds	Model 3 CA Gini	Model 4 Port Flows	Model 5 FDI Inflows	Model 6 KO Open	Model 7 Combined
Y_0	-10.462*** (0.527)	-7.710*** (0.839)	-12.684*** (0.830)	-16.628*** (3.138)	-8.566*** (0.932)	-8.653*** (0.755)	-20.883 (13.444)
Y_1	-4.364*** (0.849)	-5.704*** (0.232)	-6.072*** (0.291)	-5.798*** (0.295)	-5.940*** (0.297)	-6.075*** (0.275)	-6.394*** (0.850)
Bank Reform	-0.027 (0.039)						-0.021 (0.073)
Bank Reform * Y_0	0.120* (0.066)						1.026*** (0.283)
Bank Reform * Y_1	0.138*** (0.050)						0.135 (0.088)
Fed Funds		0.010 (0.030)					
Fed Funds * Y_0		-0.091 (0.063)					
Global Imbalances			-1.123* (0.591)				-1.278 (0.936)
Global Imbalances * Y_0			2.959** (1.205)				10.177**
Portfolio Inflows				0.016 (0.075)			(4.131) 0.161 (0.124)
Portfolio Inflows * Y_0				0.430*** (0.149)			0.784* (0.471)
FDI Inflows					-0.015		-0.202

(0.766) (0.187)

<i>(cont.)</i>	Model 1 Bank Reform	Model 2 Fed Funds	Model 3 CA Gini	Model 4 Port Flows	Model 5 FDI Inflows	Model 6 KO Open	Model 7 Combined
Portfolio Flow Openness						-0.178*** (0.053)	0.051 (0.092)
Portfolio Flow Open * Y_0						0.221** (0.104)	-1.046** (0.453)
Portfolio Flow Open * Y_1						0.261*** (0.067)	
GDP per capita	0.057 (0.053)	-0.029 (0.034)	0.003 (0.041)	-0.023 (0.044)	-0.086** (0.044)	-0.015 (0.035)	
GDP per capita * Y_1	-0.185** (0.078)						
Democracy	0.013 (0.014)	-0.035* (0.019)	-0.071*** (0.023)	-0.040 (0.025)	-0.049** (0.024)	0.010 (0.013)	0.004 (0.029)
Democracy * Y_0		0.081*** (0.029)	0.139*** (0.036)	0.126*** (0.040)	0.108*** (0.036)	0.040 (0.028)	
Democracy * Y_1		0.064*** (0.024)	0.117*** (0.030)	0.089*** (0.031)	0.110*** (0.030)		
IMF Program	0.158 (0.197)	0.161 (0.171)	0.130 (0.203)	0.083 (0.209)	0.102 (0.219)	0.176 (0.175)	-0.074 (0.388)
Bank Crisis	-1.010** (0.449)	-1.011** (0.425)	-1.283*** (0.451)	-1.326*** (0.461)	-0.254 (0.631)	-1.016** (0.425)	-0.489 (0.741)
Bank Crisis * Y_0	1.244 (0.937)	1.528* (0.929)	1.937** (0.963)	2.395** (0.999)		1.419 (0.920)	9.542*** (2.304)

<i>(cont.)</i>	Model 1 Bank Reform	Model 2 Fed Funds	Model 3 CA Gini	Model 4 Port Flows	Model 5 FDI Inflows	Model 6 KO Open	Model 7 Combined
Regional Diffusion	0.278 (0.340)	1.009*** (0.319)	0.629* (0.370)	0.965** (0.402)	0.851** (0.386)	1.116*** (0.325)	1.423* (0.774)
Regional Diffusion * Y ₀		-1.899*** (0.644)		2.969*** (1.057)	-1.790** (0.911)	-1.941*** (0.676)	-17.530** (7.007)
Economic Peer Diffusion	-0.410 (0.593)	-0.071 (0.462)	-0.330 (0.643)	-0.219 (0.600)	0.184 (0.609)	0.006 (0.475)	-1.053 (1.341)
Observations	1390	2001	1581	1384	1386	2087	569
AIC	1074.2	1394.1	1000.7	933.4	950.5	1373.5	370.9

Note: All explanatory variables lagged one year. Standard errors in parentheses. * p<.1; ** p<.05; *** p<.01; two-tailed tests

Table 4.6 Results for Screening Requirements

	Model 8	Model 9	Model 10	Model 11	Model 12	Model 13	Model 14
	Bank Reform	Fed Funds	CA Gini	Port Flows	FDI Inflows	KO Open	Combined
Y_0	-15.304*** (1.601)	-13.175*** (1.773)	-17.709*** (1.974)	-13.482*** (1.612)	-17.643*** (2.246)	-15.653*** (1.539)	-17.731*** (2.055)
Y_1	-6.754*** (1.080)	-4.750*** (1.129)	-8.690*** (1.395)	-4.082** (0.290)	-6.931*** (1.265)	-6.705*** (1.030)	-8.923*** (1.463)
Bank Reform	-0.087*** (0.041)						-0.128** (0.049)
Bank Reform * Y_0	0.185*** (0.056)						0.184*** (0.060)
Bank Reform * Y_1	0.098* (0.056)						0.157*** (0.059)
Fed Funds		0.162** (0.065)					
Fed Funds * Y_0		-0.194** (0.090)					
Fed Funds * Y_1		-0.193** (0.086)					
Global Imbalances			-2.712*** (1.008)				-2.356** (1.028)
Global Imbalances * Y_0			3.008*** (1.406)				2.612* (1.441)
Global Imbalances * Y_1			2.702**				2.462*

<i>(cont.)</i>	(1.325)					(1.347)	
	Model 8 Bank Reform	Model 9 Fed Funds	Model 10 CA Gini	Model 11 Port Flows	Model 12 FDI Inflows	Model 13 KO Open	Model 14 Combined
Portfolio Inflows				0.072 (0.115)			
FDI Inflows					0.018 (0.073)		
Portfolio Flow Openness						-0.130** (0.062) 0.189** (0.087) 0.189** (0.078)	-0.015 (0.045)
Portfolio Flow Open * Y_0							
Portfolio Flow Open * Y_1							
GDP Per Capita	-0.030 (0.022)	-0.166** (0.068)	-0.247*** (0.074)	-0.041 (0.045)	-0.150* (0.081)	-0.177** (0.068)	-0.251*** (0.076)
GDP Per Capita * Y_0	0.287*** (0.108)	0.294*** (0.102)	0.404*** (0.113)	0.163 (0.102)	0.413*** (0.152)	0.321*** (0.104)	0.390*** (0.116)
GDP Per Capita * Y_1	0.212** (0.089)	0.170** (0.086)	0.265*** (0.093)		0.228** (0.108)	0.187** (0.087)	0.264*** (0.095)
Democracy	-0.030 (0.022)	-0.094*** (0.025)	-0.140*** (0.029)	-0.041** (0.019)	-0.106*** (0.029)	-0.090*** (0.025)	-0.016 (0.018)
Democracy * Y_0		0.115*** (0.038)	0.150*** (0.046)		0.113** (0.049)	0.105*** (0.039)	
Democracy * Y_1	0.047 (0.030)	0.110*** (0.032)	0.148*** (0.036)	0.058* (0.030)	0.103*** (0.038)	0.102*** (0.032)	
IMF Program	0.048	-0.040	-0.140	-0.105	0.078	-0.055	-0.052

<i>(cont.)</i>	(0.201)	(0.190)	(0.206)	(0.215)	(0.270)	(0.194)	(0.214)
	Model 8	Model 9	Model 10	Model 11	Model 12	Model 13	Model 14
	Bank Reform	Fed Funds	CA Gini	Port Flows	FDI Inflows	KO Open	Combined
Bank Crisis	0.384 (0.431)	0.427 (0.432)	0.246 (0.444)	0.491 (0.489)	0.614 (0.613)	0.441 (0.437)	0.206 (0.442)
Regional Diffusion	0.391 (0.358)	0.338 (0.380)	-0.375 (0.333)	0.323 (0.348)	-0.316 (0.356)	-0.051 (0.303)	0.112 (0.407)
Regional Diffusion * Y ₀	-1.707** (0.730)	-1.082 (0.705)					-1.492* (0.794)
Economic Peer Diffusion	-0.376 (0.400)	-0.334 (0.405)	0.032 (0.404)	-0.312 (0.340)	-0.494 (0.415)	-0.311 (0.372)	-0.126 (0.451)
Econ. Peer Diffusion * Y ₀	4.983*** (0.964)	4.202*** (0.927)	3.426*** (0.817)	3.800*** (0.849)	4.602*** (0.941)	3.564*** (0.729)	4.692*** (1.089)
Observations	1147	1305	1061	913	932	1305	980
AIC	1110.4	1182.0	1047.6	862.0	802.1	1183.2	1002.8

Note: All explanatory variables lagged one year. Standard errors in parentheses. * p<.1; ** p<.05; *** p<.01; two-tailed tests

The global financial environment does seem to matter for FDI policy reform. High interest rates in the U.S., which indicate global financing constraints, are not statistically associated with Equity Restrictions. However, they are associated with decreased chance of liberalizing screening requirements when starting from closed policy environments. High U.S. interest rates are also associated with an increased chance of policy backsliding with respect to investment screening, while intermediate policy environments are more likely to liberalize their screening policies when U.S. interest rates are high. Global imbalances are also statistically significantly associated with patterns of policy reform. Governments are more likely to liberalize from a closed policy environment when the global balance of payments is characterized by large, concentrated current account deficits. Conversely, large global imbalances are negatively associated with liberalization from an intermediate starting state and are associated with policy backsliding from an open policy environment. This pattern holds for both equity restrictions and screening requirements.

As a whole, these findings provide some support for hypothesis 2, which predicts periods of global financing constraints are associated with liberalization. Importantly, however, there are differences in propensity to liberalize (or remain liberal), which vary by starting policy state. Global financing constraints display consistent association with liberalization from closed policy environments. However, when the previous period was characterized by an intermediate policy, global financing constraints seem to be negatively associated with liberalization. Given that intermediate policy frameworks give governments the ability to pursue export-oriented industrial strategies, one interpretation of this finding is that when global imbalances are high, countries with intermediate FDI policies are likely experiencing economic buoyancy and therefore have less of a financing constraint.

Table 4.7 Summary of Equity Restrictions Results

		Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
		Bank Reform	Fed Funds	CA Gini	Port Flows	FDI Inflows	KO Open	Combined
Bank Reform	C	0.093*						1.005***
	I	-0.027						
	O	0.111***						-0.021
Fed Funds	C							
	I		0.010					
	O							
Global Imbalances	C			1.836***				8.899**
	I			-1.123*				-1.278
	O							
Portfolio Inflows	C				0.446***			0.945*
	I				0.016			0.161
	O							
FDI Inflows	C							
	I					-0.015		-0.202
	O							
Portfolio Flow Openness	C						0.043**	-0.995**
	I						-0.178***	
	O						0.083***	0.051
Development	C							
	I	0.013	-0.029	0.003	-0.023	-0.086**	-0.015	
	O							
Democracy	C		0.046***	0.068***	0.086***	0.059***		
	I	0.013	-0.035*	-0.071***	-0.040	-0.049**	0.010	0.004
	O		0.029***	0.046***	0.049***	0.061***		
Bank Crisis	C		0.517*	0.0654**	1.069**			9.053***
	I	-1.010**	-1.011**	-1.283***	-1.326***	-0.254	-1.016**	-0.489
	O							
Regional Diffusion	C		-0.89***		-2.149***	-0.939**	-0.825***	-16.107**
	I	0.278	1.009***	0.629*	1.013**	-1.790**	1.116***	1.423*
	O							

Note: Coefficient estimates computed from relevant direct and interactive effects. C=Closed; D=Intermediate; O=Open.

* p<.1; ** p<.05; *** p<.01; two-tailed tests

Hypothesis 3 and 4 predict a history of attracting capital inflows will reduce pressures to liberalize FDI policy. In general, the models reported show previous portfolio and FDI flows are not associated with changes in FDI policy environment. The one exception is that portfolio flows are positively associated with liberalization of equity restrictions in countries starting from a closed policy environment. The overall lack of statistically significant findings, either positive or negative, is rather surprising given the often assumed role of global markets in pressuring governments to enact neoliberal policy reforms.

Table 4.8 Summary of Screening Requirements Results

		Model 8 Bank Reform	Model 9 Fed Funds	Model 10 CA Gini	Model 11 Port Flows	Model 12 FDI Inflows	Model 13 KO Open	Model 14 Combined
Bank Reform	C	0.098**						0.056***
	I	-0.087**						-0.128**
	O	0.011*						0.029***
Fed Funds	C		-0.032**					
	I		0.162**					
	O		-0.031**					
Global Imbalances	C			0.296***				0.256*
	I			-2.712***				-2.356**
	O			-0.010**				0.106*
Portfolio Inflows	C				0.072			
	I							
	O							
FDI Inflows	C					0.018		
	I							
	O							
Portfolio Flow Openness	C						0.059**	
	I						-0.130**	-0.015
	O						0.059**	
Development	C	0.257***	0.128***	0.157***		0.263***	0.144***	0.139***
	I	-0.030	-0.166**	-0.247***	-0.041	-0.150*	-0.177**	-0.251***
	O	0.182**	0.004**	0.018***		0.078**	0.010**	0.013***
Democracy	C		0.021***	0.010***		0.007**	0.015***	
	I	-0.030	-0.094***	-0.140***	-0.041**	-0.106***	-0.090***	-0.016
	O		0.016***	.008***		-0.003***	0.012***	
Regional Diffusion	C	-1.316**						-1.380*
	I		-1.082	-0.375	0.323	-0.316	-0.051	0.112
	O	0.391						
Economic Peer Diffusion	C	4.607***	3.868***	3.458***	3.488***	4.108***	3.253***	4.566***
	I							
	O	-0.376	-0.334	0.032	-0.312	-0.494	-0.311	-0.126

Note: Coefficient estimates computed from relevant direct and interactive effects. C=Closed; I=Intermediate; O=Open.

* p<.1; ** p<.05; *** p<.01; two-tailed tests

Hypothesis 5 predicts short-term capital account openness will reduce pressures for liberalization. Model results support this hypothesis. For both *Equity Restriction* and *Screening Requirements*, short-term capital account openness is positively associated with liberalization at closed and liberal starting states. However, when governments had intermediate FDI policies in the previous period, short-term capital account openness decreased the probability of liberalizing. These findings, consistent across measures of FDI policy openness, support the contention that access to alternate investment sources reduces politically influential business elites' willingness to liberalize foreign firm access to local labor and product markets.

To attempt to consider the relative importance of the many variables of interest I include throughout the Markov Models, I also report models that combine all main explanatory

variables. The results of these models emphasize the continued significance of banking sector reform, which remains most robust to the inclusion of other measures of the global and local financing environment.

Some evaluation of estimated effects of alternative explanations for reform are also warranted. IMF programs never reach statistical significance in any model, providing robust support for the premise that the IMF is not an agent of change with respect to FDI policy. Regime type reaches significance in most models that do not include a measure for banking sector reform. The pattern of significance is mostly consistent, with democracy positively associated with liberal FDI policy when starting from closed and open environments and negatively associated with liberal FDI policy when starting from an intermediate state. However, the significance of democracy is not robust to banking sector reform. Especially given the consistent importance of a variety of measures of global and domestic financing constraints, it may be appropriate to interpret the relationship between democracy and FDI as either correlation without causation or as an indication that causal process that links democracy with FDI policy is more related to increased ability of capitalists to pressure governments rather than increased accountability to labor groups.

A substantial and growing literature points to the role of spatial and/or peer-group diffusion in explaining the patterns and timing of economic and political liberalization (Simmons *et al.* 2008). Recent analysis of FDI liberalization has also pointed to the role of regional and economic peers' regulatory environments in propelling policy change (Vadlamannati and Cooray 2012). Accordingly, I control for diffusion effects in all models. Across almost all models of *Equity Restrictions*, regional diffusion obtains statistical significance. Having liberal regional peers increases the likelihood of having an open FDI policy environment for countries starting

from a state of policy intermediacy or openness. However, countries that have closed policies toward FDI are less likely to liberalize in response to regional liberalization. Liberalizing equity restrictions is not related to policy innovations of income peers, however screening requirement elimination is. Unlike with regional peers, countries that were previously closed are more likely to liberalize in response to reform by economic peers. Economic peer policies show no evidence of diffusing when a country's starting state is either intermediate or open.

Overall, the results of these models provide evidence that mostly supports the main thrust of my theory – FDI policy reform occurs when elites' access to alternative financing sources is constrained. Additionally, these results show that intermediate policy environments are quite difficult to disrupt. Intermediate policies characterized by regulation, once in force, tend to persist. Especially given my findings in Chapter 3, I expected to find more robust evidence that Banking Sector reform pushes countries beyond a partial FDI reform equilibrium that access to substantial and subsidized credit supports. At best, the results from Markov analysis display mixed support for this premise. However, the results do provide stronger evidence that high values of variables designed to measure access to alternative sources of finance create barriers to full FDI liberalization.

Conclusion

In this chapter, I explored the drivers of substantively meaningful shifts in policies toward FDI. While chapter three conceptualized the FDI policy environment as a continuous measure, here I consider the possibility that FDI policy might display important threshold effects. Rather than focusing on incremental changes in regulation of foreign firms, I consider the conditions under which governments may pursue large changes in the policy environment foreign firms face. To do so, I make use of Markov transition modeling techniques to more fully

explore the conditions make it more likely that governments will transition between three states of FDI policy: closure, intermediacy, and liberalism. This technique emphasizes the possibility that the regulatory environment toward FDI may be subject to an equilibrium of partial reform. Indeed, descriptively, the majority of observations in my dataset fall into an intermediate category in which governments use regulatory power actively pursue “beneficial” FDI while restricting entry into protected sectors and using screening processes to prevent politically unpopular foreign investment projects. I find substantial support for the premise that openness to FDI depends on the ability of local firms to obtain financing from alternate sources. Global financing constraints, short-term capital account openness, and banking sector reforms that reduce access to state-subsidized loans all affect the propensity to liberalize. At the same time, the effect of these factors is often conditional on starting state. In particular, gaining alternative means of accessing international finance is associated with a reduced chance of fully liberalizing the FDI policy environment. A similar pattern of regulatory retrenchment emerges as well for the level of development and democracy of a host state. These findings are robust to multiple controls including accounting for regional and income peer policies, IMF lending, banking crises, and natural resource wealth. Despite these results, I find only modest support for the proposition that banking sector reforms can puncture partial reform equilibrium. Taken in conjunction with the result of chapter three, this may be indicative of a relationship between banking sector reforms and FDI liberalization that takes a relatively large time to play out.

More broadly, this chapter provides evidence that policies toward FDI often are only partially liberal, at least over the period covered in this dataset. This is an important corrective to a broad proposition that unfettered FDI is nearly universally embraced in a financial integrated world. Governments may be willing to open their economies to certain types of foreign investors,

but they generally do so while retaining some capacity to prevent less desirable investment. Moreover, the states that are most able to maintain policies of partial openness and regulation are those that have been broadly able to attract foreign capital; in other words, there may be limits to the extent that increased financial flows pressure governments to liberalize policies. This finding opens the door to many more questions regarding variation in the regulatory restrictions over FDI that persist. More precise data on FDI policy could allow researchers to explore the correlates of policy switching at the industrial-level. Additionally, similar methods could be used to explore how different types of FDI policy reforms related to each other – do policy innovations that are FDI promoting reinforce each other, or do some policy reforms reduce the propensity to liberalize other aspects of FDI policy.

CHAPTER 5: PARTIAL FDI POLICY OPENNESS - MALAYSIA & INDONESIA 1965-1997

“FOREIGN INVESTMENT SHOULD BE A SUPPLEMENT TO LOCAL INVESTMENT. THE INVESTMENT POLICY OF INDONESIA IS TO DECREASE THE NUMBER OF FOREIGN DIRECT INVESTMENTS [MADE ANNUALLY] IN INDONESIA.”

Mohammad Zuhdi, chairman of the East
Java Investment Coordinating Board (Indonesia)
July 13, 1981

“[WE IMPOSE CONDITIONS] WHEN YOU ARE COMPETING WITH LOCAL PRODUCERS OR LOCAL PRODUCTS. WE WANT TO MAKE SURE THAT WHILE WELCOMING FOREIGN INVESTORS, WE SET A TARGET ON WHERE EXACTLY THEY CAN COME IN.”

Datuk Seri Rafidah Aziz, Minister of
International Trade and Industry (Malaysia)
March 11, 1997

Introduction

In chapters 3 and 4, I use large N statistical analyses to provide macro-level evidence that is broadly consistent with the proposition that FDI policy liberalization occurs when access to alternative financing is constrained. In particular, I identify banking sector reforms as a key mechanism that alters elite preferences toward FDI.

In this and the following chapter, I trace the process of financial crisis and the relationship between banking reforms and foreign direct investment liberalization in Indonesia and Malaysia from 1965 to today in order to look more closely at stated policy preferences of elite groups in different domestic credit environments. I demonstrate how different banking

sector policy developments through three distinct periods of these countries' economic histories affected elite strategies, and accordingly policy outcomes, over restrictiveness toward FDI. This chapter traces the development of banking and investment policy from 1965-1997 while the following focuses on policy reform in the aftermath of the 1997 Asian Financial Crisis.

Documentation of stated policy preferences of elite groups is more robust post 1997, and therefore my ability to specifically point to public statements and lobbying activities of relevant interest groups is greater in Chapter 6. Nevertheless, this chapter helps provide important context for the substantial divergence in investment policy in Malaysia and Indonesia following the 1997 crisis.

Over the time period I cover, Malaysia has more consistently pursued banking sector deepening that has supported gradual liberalization of FDI policies with limited backsliding. In contrast, Indonesian governments have more often pursued policies designed to maintain substantial control over domestic credit allocation decisions, and therefore has less elite support for loosening restrictions on FDI. However, while the *level* of FDI openness in Indonesia has consistently shown protectionist bias, a period of rapid banking sector deregulation in the 1980s did lead to a period of limited liberalization. These policy developments, along with documentation of elite policy preferences toward FDI policy at the time, provide further evidence that banking sector reform affects FDI policy *changes*. Subsequent state consolidation of the banking sector in Indonesia has led to reform stagnation and reversal, illustrating FDI policy can be subject to a partial reform equilibrium as well as increased protectionism even in a global environment of overwhelming economic integration.

The remaining of this chapter is organized as follows. First, I return briefly to my central theory to generate predictions about elite policy preferences and policy outcomes. Next, I discuss

the justification for my selection of cases. I then briefly outline the trajectory over banking and investment policy in both countries from 1965-2013. The bulk of the chapter traces the development of these policies in two time periods: 1965 to 1985 and 1985 to 1997. The chapter ends with a summary of the development of banking and investment policies in both countries through 1997. To be clear, this chapter and the chapter that follows are not meant to be definitive tests of my theory, which is fundamentally based on a probabilistic conception of causality. Instead, these chapters provide an opportunity to look more closely at the evolution of banking and investment policies and to probe my argument that the causal link between banking sector reforms and FDI liberalization is both shifting elite policy preferences and the diminished political power of domestic banking interests.

Theory and Expectations

FDI policy is more likely to be liberalized when the cost of and access to alternative investment sources sufficiently constrain domestic firms' access to needed capital through debt financing. I argue banking sector reforms constitute a major structural shift in the way credit is allocated domestically, and that such reforms simultaneously encourage industrial capital to prefer more liberal policies toward inward FDI and diminish the political power of financial capital that prefers to maintain its privileged position of mediating between international and domestic capital markets. The general trend toward increased openness to FDI, I argue, is due to reforms in the banking sector that have eliminated credit and interest rate controls, reduced state ownership of the financial sector, and increased prudential regulations and supervision of banks such that credit allocation decisions must be made with respect to risk assessments rather than political and personal connections. These reforms in the banking sector, largely enacted in the wake of financial crises (Abiad and Mody 2005), have made it more difficult for politically

important firms to obtain subsidized credit, have imposed important development financing constraints on governments, and have diminished strong ties between a concentrated and often state-owned financial sector and politico-bureaucrats.

The large N analyses in previous chapters have established a relationship between banking sector reform and FDI liberalization that is consistent with my theory. These analyses, however, cannot speak to a causal mechanism. By tracing the development of policies toward banking and FDI in Indonesia and Malaysia, I seek to uncover elite strategies and lobbying activities related to investment policy as banking sector regulations change. In particular, if my theory is correct, we may expect to find the following. First, we should expect that countries with more liberal banking sectors, meaning banking sectors that operate through market mechanisms rather than government guidance, will also be more open to FDI. We should also find that periods of banking sector reforms within a country lead to increased regulatory openness to FDI. When looking at stated preferences and lobbying activities of domestic business groups, we should observe business groups in more repressed financial environments supporting protectionist policies toward foreign firms and see business groups operating in reformed financial systems embracing policies of FDI openness.

It may be helpful here to clarify a few points about what makes banking sector reforms distinct from FDI reforms. Financial repression involves limiting foreign entry into the domestic banking sector in order to protect local private and, quite often, state-owned banks. Therefore, a component of banking sector reforms entails lifting restrictions on foreign equity in domestic financial institutions. Why, then, is it appropriate to conceptualize banking sector reforms as distinct from broader FDI reforms? Why should we not consider differences between regulations regarding financial services versus other sectors as primarily a function of sectoral characteristic

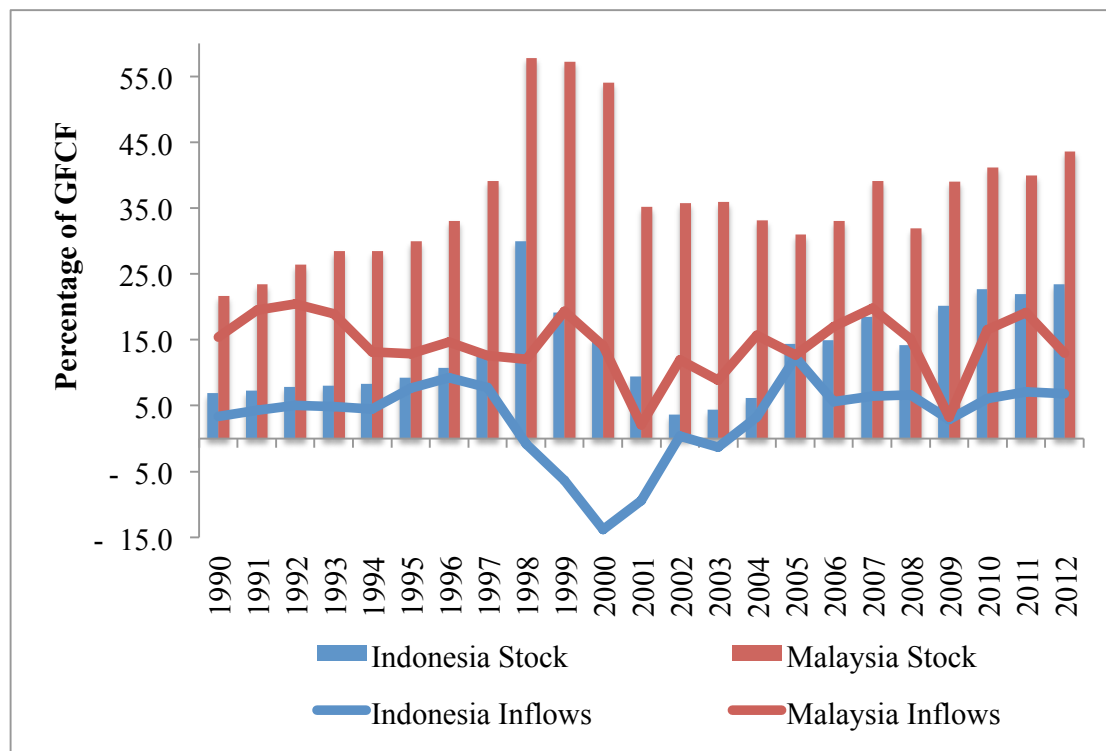
that render some industries better able to successfully lobby for protection? First, the laws and agencies that administer financial sector regulations including foreign equity restrictions are separate from investment policies regarding other sectors of the economy. In both countries, regulatory authority over the financial system rests with the central bank and the finance ministry. Investment policy screening authorities have never had jurisdiction over foreign equity in financial institutions. Second, banking sector reforms have broader implications for how capital is allocated across all industries in a domestic economy. Financial sector development is considered key for both attracting FDI inflows (Campos and Kinoshita 2010) and for creating positive spillovers from foreign investment (Alfaro et al. 2004). These findings have generally been met with puzzlement since multinationals have deep pockets and access to home country financing and therefore should not be constrained by local credit. Since banking sector reforms can diminish cheap access to capital for politically connected firms, we should expect liberalizing changes to the banking sector to make it more difficult to develop without direct foreign investment.

Case Selection

Indonesia and Malaysia are ideal for compared comparison of my theory for several reasons. First, these countries have common political, macroeconomic, and policy characteristics that support a “most similar” case design. They are neighboring island nation-states with non-contiguous territory. Both have a post-colonial history of hegemonic party autocracy with long-tenured executives. Both have crafted development policies within the context of a dominant political cleavage between poorer indigenous groups and an ethnically Chinese capitalist class. Both also have substantial natural resource wealth in the form of crude oil and timber; such

wealth has often been associated with more restrictive policies toward foreign investment.⁶⁴ These shared characteristics provide important controls for potentially relevant factors such as ethnically-patterned ownership of key sectors of the economy as well as the role of natural resources in cushioning external financing needs during commodity booms and balance of payment-induced foreign investment needs during periods of low global petroleum prices. Since Indonesia and Malaysia share these characteristics, the cause of any variations in FDI policy between them must not be driven by ethnic or natural resource factors.

Figure 5.2 FDI Inflows and Stocks as Percentage of Gross Fixed Capital Formation (GFCF), 1990-2012



Source: UNTAD, 2013.

Additionally, Indonesia and Malaysia's economic, political, and geographic proximity allow me to control for a variety of shared external economic pressures. While Malaysia

⁶⁴ See, for example, Kobrin (1987) for an early discussion of how extractive industries face more intractable obsolescing bargaining dynamics vis-à-vis governments.

embarked on an export-oriented growth strategy earlier than did Indonesia, by the mid 1980s both countries had undergone partial FDI liberalization to selectively promote foreign investment in export-oriented activities. Figure 5.2 reports FDI inflows and stocks from the 1990 onward for both countries. Table 5.2 reports international investment inflows and economic growth in each country from 1980 to 2010. Indonesia's negative flows in 1998-2002 indicate falling capital stock.

It is important to recognize that many global factors have influenced the rise of development strategies that rely on integrated multinational production chains. Global macroeconomic conditions in the mid to late 1980s were particularly conducive to foreign financed export-oriented strategies in Southeast Asia. Japanese and Newly Industrializing Economies (NIEs) firms faced a complex of factors that encouraged offshoring. Appreciating home currencies, tariff barriers in the Organization for Economic Co-operation (OECD), and higher local wages made these firms relocate production. The 1985 Plaza accord in particular created a Japanese outward investment boon as the yen appreciated. Concurrently, NIEs graduated out of preferential market access to the OECD, which also incentivized assembly in countries that still qualified for tariff reductions.⁶⁵ Due to export-platform production strategies, Malaysia and Indonesia were both attractive hosts because of their low wages and geographic proximity to the rest of the supply chain (ASEAN 1999).

It would be a mistake, however, to conclude policies toward FDI in Malaysia and Indonesia dramatically liberalized over this time period. These countries selectively allowed specific multinationals entry into the domestic export manufacturing through joint ventures and with substantial performance requirements. At the same time, these countries' banking sectors

⁶⁵ These preferential systems included the Generalized System of Preferences (GSP) and the Multi Fibre Arrangement (MFA).

were dominated by state owned banks, excluded foreign banking firms, and were used by their respective governments to allocate credit preferentially to politically and developmentally important sectors and firms. These restrictions contributed to increased bank leverage and asset bubbles as loosening of short-term capital account restrictions allowed protected local banks to borrow internationally cheaply and lend domestically at large profits.

In Chapter 6 we will see that, in both countries, political leaders made a conscious choice in the wake of financial crisis between protecting either the banking sector or the real sector from foreign ownership. Essentially, policymakers in a constrained financing environment faced a choice; would they encourage short-term inflows to allow banks to continue to finance domestic investment requirements, or would they protect local banks while loosening restrictions on foreign firms' direct investments in the real sector? This tradeoff is documented in first hand accounts of policymaking as well as reporting on interest group lobbying during and after the crisis. When governments chose to protect the banking sector, state technocrats as well as industry leaders pushed for increased liberalization of FDI in the real sector in order to spur domestic capital formation. When governments instead allowed foreign banks to inject capital into ailing banks, they had the financing capacity to retain state-owned banks. Credit allocation continued to be driven by political rather than market relationships, and this muted societal pressures for lifting restrictions on FDI into other sectors.

Overview of Policy Periods

Table 5.1 provides an overview of banking sector and FDI policy developments in Indonesia and Malaysia in three time periods: 1965-1985; 1985-1997; 1997-2013. In a post-colonial context, Indonesia's New Order regime fostered close ties between political and military bureaucrats and ethnic Chinese local capitalists. An open capital account combined with a state-

dominated banking system allowed the regime to largely self-finance development without relying on FDI. In contrast, a set of political conditions that encouraged Malaysia's dominant political party to pursue an expansive economic affirmative action program required the government to pursue FDI as a means of limiting the economic power of ethnic Chinese Malaysians.

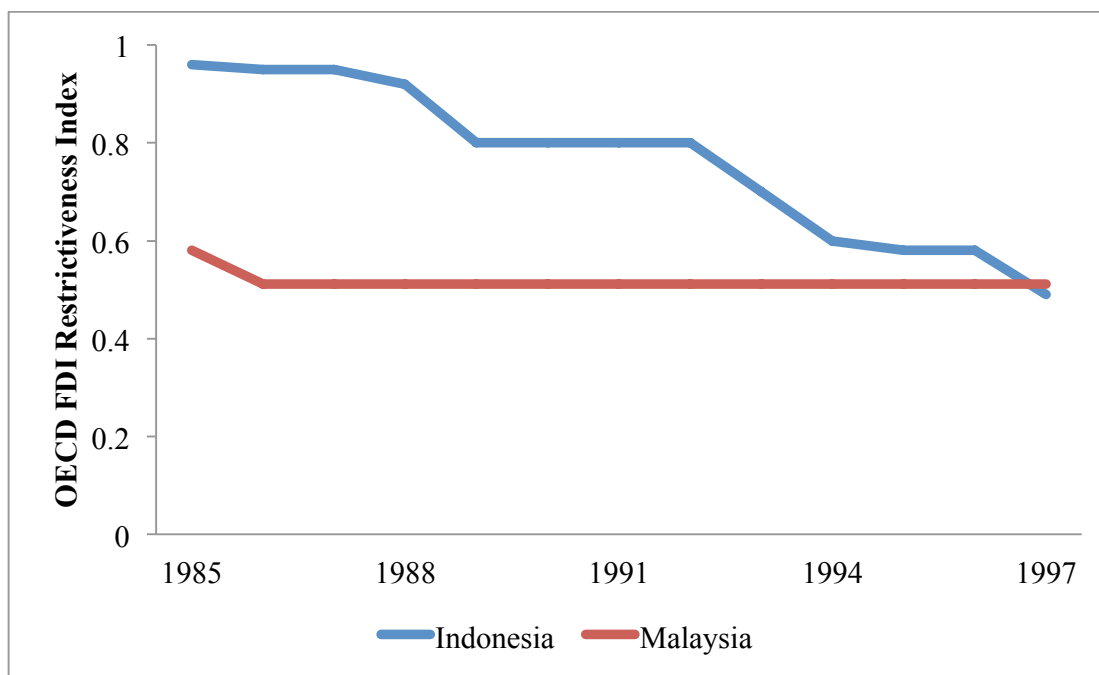
Table 5.1 Indonesia and Malaysia Banking and FDI Policy Environments 1965-2013

	1965-1985	1985-1997	1997-2013
Indonesia	<ul style="list-style-type: none"> • Military - ethnic Chinese alignment • Growth of state-owned banks • Highly restrictive FDI policy 	<ul style="list-style-type: none"> • Banking deregulation • Growth of banking conglomerates • Partial FDI liberalization 	<ul style="list-style-type: none"> • State bank consolidation • IMF-imposed FDI liberalization • Subsequent FDI policy backtracking
Malaysia	<ul style="list-style-type: none"> • <i>Bumiputera</i>-driven NEP • Growth of state-owned banks • Partial FDI liberalization 	<ul style="list-style-type: none"> • Prudential regulation • Privatization-led Stock market boom • Little FDI policy change 	<ul style="list-style-type: none"> • Bank privatization and restructuring • Prudential regulation • Successive FDI liberalization

Negative economic shocks in the 1980s led Malaysia to make relatively minor changes to banking regulation while also developing a relatively large domestic stock market to facilitate privatization of state-owned industry. As a result, Malaysia's FDI policies during the 1980s are best described as maintaining a partial openness strategy of courting high-value manufacturing FDI while greatly restricting all other forms of direct investment by foreign entities. Indonesia's response to its much more serious economic shocks in the 1980s was to pursue banking sector deregulation, which led to a massive increase in domestically-owned private banks and a decrease in the state's control over credit allocation. As a result, the 1980s and early 1990s were characterized by elite-driven selective FDI liberalization, resulting in a more open but fundamentally dualist investment policy position by 1997. In other words, by 1997, Indonesia

and Malaysia had similar levels of FDI restrictions, but Indonesia's path to limited FDI openness took longer than did Malaysia's and was largely driven by shifting elite preferences over FDI in the wake of a major deregulation of the Indonesian banking sector. Figure 5.1 illustrates this convergence in FDI policies through the late 1980s and early 1990s.

Figure 5.1 Indonesia and Malaysia FDI Restrictiveness 1985-1997



Source: OECD FDI Restrictiveness Index; OECD 2013, pg. 56

Divergent crisis response strategies to the 1997 Asian financial crisis led to substantial liberalization of credit allocation in Malaysia while Indonesia's foreign bank-led financial sector restructuring did little to force fundamental changes in the way banks make debt financing decisions and insulated the state from needing to privatize its extensive state-owned banking system. In fact, state-owned banks in Indonesia were able to consolidate in the aftermath of the crisis and subsequently increase their market dominance in domestic credit markets. As a result, Indonesian business interests have successfully blocked attempts to implement further large-scale liberalization of FDI beyond the initial IMF-imposed policy changes in 1998-9. In contrast,

the Malaysian business community has largely supported, and in many cases driven, more fundamental liberalization of FDI policy. These findings point to micro-level evidence to support the central hypothesis of this dissertation that financial sector liberalization shifts preferences of politically important business interests toward favoring opening to FDI while limiting the influence of groups that are less likely to support openness.

In the remainder of this chapter, I will trace the co-evolution of banking and FDI policy from the 1960s to 1997. Studying this time period allows me to provide the context of the initial political and economic conditions that led Malaysia to embrace a limited role for FDI earlier than did Indonesia. It also allows me to use variations across time in banking sector developments in each country to assess the effects of banking policy on the timing of FDI policy change. The developments over this time period provide important context to the policy responses to the 1997 crisis, which are analyzed in Chapter 6, while also highlighting important within-country variation over the direction and pace of banking sector and FDI policy reforms.

Throughout this analysis, I focus primarily on the ways in which banking sector policy choices affected subsequent reforms of FDI policy. I draw upon a variety of sources including central bank reports, first-person accounts of crisis response, newspaper coverage of the politics of reform, reports from key lobbying groups and international economic institutions, as well as other studies of both banking sector and FDI policy reform. While the link between banking and FDI policy has rarely been directly assessed in previous research on these subjects, close analysis of the process of these reform policies reveals just how interrelated these two issue domains are to interest groups and policymakers.

Table 5.2 International Investment Flows 1970-2012

	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99	2000-04	2005-09	2010-12
Malaysia									
FDI inflows	2.86	3.07	4.05	2.31	7.10	4.56	2.75	3.10	4.27
Total external debt	14.23	23.36	44.58	61.36	36.65	47.39	43.93	33.37	33.71
Portfolio Equity							1.59	-0.92	
GDP Growth	8.79	7.22	6.87	4.88	9.31	5.19	5.47	4.11	6.06
Indonesia									
FDI inflows			0.24	2.69	1.17	1.09	-0.81	1.72	2.15
Total external debt	28.14	34.49	29.99	56.85	60.74	89.71	65.86	37.06	27.94
Portfolio Equity					1.11	-1.18	0.28	0.30	0.15
GDP Growth	8.21	7.42	6.72	6.04	7.99	1.68	4.76	5.64	6.31

Source: World Development Indicators (<http://data.worldbank.org/data-catalog/world-development-indicators>); averages author's own calculation; all flows as % of GDP

Post-Colonial Adjustment and the Oil Boom: Banking and FDI policies 1965-1985

In this section, I trace the development of Malaysia and Indonesia's banking and FDI policies in an era marked by high global liquidity, economic growth, and commodity prices. During this time, the fundamental aspects of both countries' post-colonial political economy crystalized.

Post Sukarno, Indonesia's New Order regime guided the country through an investment policy designed to foster party loyalty while also placating ethnic Chinese businessmen who were an important lending source for the state. As a result, Indonesia adopted an open short-term capital account, a rather restrictive stance on FDI, and a banking system dominated by the state and its politicized credit allocation decisions. High oil prices at the end of the 1970s only increased corruption in state lending decisions, and set the stage for later needs to reorganize the banking sector.

Malaysia's hegemonic party regime established a post-colonial policy of racial economic affirmative action, which drove its industrial policy of guiding domestic control over the commanding heights of the economy. Using a combination of state- and domestically-owned banks and industrial firms, the government pursued a goal of dividing equity ownership into three roughly equal parts between ethnic Malaysians, ethnic Chinese and Indian Malaysians, and foreign investors. As with Indonesia, the state became heavily involved in financial intermediation processes and promulgated laws designed to attract FDI under very strict guidelines to priority sectors and with the expectation of foreign divestment once sufficient technology transfer was complete.

In both countries, this time period was marked by the political and economic emergence of a narrow set of elites who benefitted greatly from protection from foreign firms, especially

since their financing needs were easily met by subsidized credit programs. The growth of these protected groups meant anti-FDI elite became firmly entrenched in the political landscape of both countries during this time.

Indonesia

In the immediate aftermath of decolonization, Indonesia's banking sector under Sukarno's Guided Democracy government was highly dysfunctional and dependent on the state (Cook 2008). By 1965, series of post-colonial bank nationalizations, mergers, and state directives had created Bank Negara Indonesia (BNI), a massive banking institution that combined all state banks with the central bank (Bank Indonesia, BI) through which the regime controlled all aspects of domestic credit allocation. Sukarno's government used its control over the banking sector to finance a wide range of expensive development projects, and this ultimately led to high levels of inflation. To combat the ill effects of inflation, BI propped up an overvalued rupiah through a complex web of multiple exchange rates. These policies led to a string of recurring balance of payment crises that fractured an already fragile coalition between the military and the Communist party, resulting in a military coup mounted by Soeharto that collapsed the Sukarno regime (Haggard and Maxfield 1996, Palmer 1978).

When Soeharto's New Order came to power, it quickly identified banking sector reform as essential to attracting and retaining short-term mobile investment (Rosser 2002). To support needed reforms, Soeharto quickly filled bureaucratic posts with neoliberal policy advisors who pushed for a tight monetary policy and capital account openness to stabilize the economy (Chwiero 2010). The resulting policies were some of the most liberal for the time. Soeharto committed in 1966 to abandon the multiple exchange rate system and began to devalue the rupiah and liberalized foreign exchange markets. In 1968, the regime allowed bank deposits and

loans denominated in dollars (Arndt and Suwidhana 1982). In 1971, the regime made the currency fully convertible (Haggard and Maxfield 1996).

With the banking sector stabilized, the New Order regime turned to a series of banking sector reform laws promulgated in 1967-68 designed to break up BNI into specialized state banks, restore a degree of independence to BI, and create a general banking law that would allow for private banks (Rosser 2002). These reforms also reopened Indonesia's banking sector to foreign banks in a limited way. By 1969, 11 foreign banks had established operations in Jakarta. However, as the immediacy of the 1965 balance of payment crisis receded, political support for reform softened. Acting in response to domestic state and private banks who were concerned that foreign banks would undermine state control of credit allocation and drive domestic private banks out of business, the government instituted a set of policies that gave state banks access to increasingly generous credit terms and prevented any additional foreign bank from entry (Arndt 1971).

Soeharto's military regime found natural allies in the ethnic Chinese capital class, who were eager to support the New Order regime since they were otherwise politically vulnerable. The ethnic Chinese had mobile assets, so capital account openness provided a signal to them that their investments were safe and they would be able to move funds overseas if economic conditions deteriorated (Haggard and Maxfield 1996). Capital account openness provided both the regime and the ethnic Chinese financiers access to abundant, cheap international capital. The financiers were able to use their privileged position to extract rents from the mismatch in interest rates on international capital and domestic interest rates. Meanwhile, state banks also benefited from access to cheap credit and funded politically driven development projects (Pepinsky 2009, Sharma 2001, Soesastro 1989). The regime was able to construct an expansive patronage

network by fostering tight links between public and domestic finance (MacIntyre, 1993). Public investment banks channeled easy credit to loyal regime supporters and private banks used their inexpensive sources of capital to partner with military leaders and private entrepreneurs in industrial expansion (MacIntyre 1993, Pepinsky 2009, Winters, 1996).

This alliance was possible because the regime retained highly restrictive measures on foreign entry into the financial sector (Pepinsky 2013, 2009; Soesastro 1989). In addition to limits on ownership and branching of foreign bank subsidiaries, the regime placed highly restrictive limits on foreign ownership of stock exchange assets while providing preferential credit conditions to domestic banks. While the reforms of the late 1960s and early 1970s eased some restrictions on foreign banks, foreign banks were not allowed to branch outside of Jakarta. This policy allowed state deposit banks to maintain monopoly control on deposit banking throughout most of the country, especially in rural areas where credit allocation decisions drove patron-client networks (Haggard and Maxfield 1996, Winters 1992, MacIntyre 1993).

Capital account openness paired with policies designed to retain the regime's hold on investment allocation decisions provided politically connected firms with access to development financing without needing to find foreign equity partners. The state banks' ability to channel investment into development projects meant it could industrialize indigenously. Popular support for indigenous, or *pribumi*, industrial ownership was particularly salient given inter-ethnic dynamics of the majority *pribumi* population, which was relatively rural and poor in comparison with the ethnic Chinese business class. The state managed these intergroup tensions through a vast preferential credit system that provided subsidized credit to state-owned enterprises and indigenous entrepreneurs while granting political-bureaucrats wide authority in granting loans for political purposes and often in exchange for bribes (Rosser 2002, 56). As the credit allocation

process became increasingly relationship-based, the ethnic Chinese capitalists with ties to political officials received preferential loans from state banks either directly (MacIntyre 1993, 151) or through indigenous intermediaries, who profited handsomely from such arrangements.⁶⁶ Bad debts, which were estimated to top 30 percent of loans outstanding in the late 1970s, were easily written off given Indonesia's petrodollar glut.

Within the context of state-controlled credit allocation, the government promulgated the 1967 Law on Foreign Investment, which complemented policies of capital account openness by establishing foreign firms' ability to remit profits and dividends and to repatriate capital (Haggard and Maxfield 1996). However, while the law opened several sectors to foreign investment conditionally, it concurrently maintained a large list of restricted sectors as well as policies requiring divestiture over time and imposed restrictive licensing requirements (Rajenthiran 2002, Tambunan 2011). The Indonesian Investment Coordinating Board (Badan Koordinasi Peranman Modal or BKPM) was established in 1973 to administer the Foreign Investment Law, including investment screening, licensing and permits, and granting of incentives. Several sectors including natural resource extraction, manufacturing, and finance were also subject to sector specific laws and screening and the ministerial level (Rajenthiran 2002). The majority of FDI entering Indonesia through the 1970s was in the primary sector, concentrated in oil and natural gas extraction. Moreover, increased foreign exchange revenue in the 1970s from high world oil prices led to subsequent increased restrictions on FDI (OECD 2010, Rajenthiran 2002, Tambunan 2011).

⁶⁶ *Far Eastern Economic Review*, 27 March 1981

Malaysia

Central to Malaysia's policies over equity control of financial and industrial assets is the National Economic Plan (NEP), which was inspired by widespread riots in 1969 and announced in 1971. The NEP sought to counterbalance the relative poverty of indigenous groups (*bumiputera*) by mandating that foreign investors and ethnic Chinese and Indian capitalists transfer assets to *bumiputera* interests such that by 1991, *bumiputera* ownership over Malaysian capital assets would increase from 2.4 percent to 30 percent, foreign investment would decline from 60 percent to 30 percent, and ethnic Chinese and Indian interests could control the remainder. This affirmative action program thus sought to facilitate massive redistribution of assets to a large, politically important, and economically disadvantaged group. At the same time, the program was careful to provide assurances of non-expropriation to non-*bumiputera* Malaysians, who have traditionally been powerful local industrial and financial capitalists and important supporters of Malaysia's long-standing ruling party.

The NEP had implications for equity restrictions both in the financial and real sectors. Through the formation of state-run banks and tight control over banking licenses, the share of *bumiputera* ownership of bank equity rose from essentially zero in 1965 to 77 percent of local banks by 1982 (Hara 1991).⁶⁷ The Malaysian government formed Bank Bumiputra in 1966 to provide state-supported financial services for the *bumiputera* community. In quick succession, the financial sector saw state maneuvers designed to transform the equity structure of Malaysian banking. In 1966, citing prudential regulatory problems, the Malaysian central bank (Bank Negara Malaysia, BNM) took control over Malayan Bank, the largest and fastest growing local bank that also happened to be owned by ethnic Chinese investors.

⁶⁷ Prior to independence in 1957, foreign banks had an even larger stake in the financial system, holding over 90 percent of bank assets in the country (Detragiache and Gupta 2004)

At the same time, the government of Malaysia pursued bank licensing and equity ceiling strategies to encourage the growth of *bumiputera* banks and limit foreign competition. The Bank of Nova Scotia received a license for a new bank branch in 1972, after which the government informally froze foreign bank licenses. Incumbent foreign banks were also prevented from expanding, as they were not granted new branch licenses. The Banking Act of 1973 gave the Malaysian Ministry of Finance the authority to withdrawal licenses of banks controlled by foreign countries. This led to the localization of foreign banks that were nationalized in their home countries, including Perwira Habib Bank (Pakistan), Banque de L'Indochine et de Suez (France), and three Indian banks that merged and localized into the United Asian Bank (Cook 2008, 72). In addition, the Foreign Investment Committee (FIC), tasked with screening all potential foreign direct investment, categorized banking as a strategic sector and penalized banks that violated a 30 percent ceiling on foreign equity. In the spirit of the NEP, BNM encouraged incumbent foreign and locally owned banks to divest ownership to *bumiputera* interests in line with the 30 percent equity target. While no legislation mandated this restructuring, banks felt failure to do so would deteriorate their relationship with BNM (Cook 2008).

As a result of these interventions, the equity structure of the Malaysian banking sector changed dramatically. In 1970, foreign banks accounted for 60 percent of outstanding deposits and loans. By the mid 1980s, foreign banks' market share dropped to 25 percent. Over the same time, the number of foreign banks in Malaysia fell from 22 to 16. Throughout the first 15 years of the NEP, the banking sector experienced an extended period of consolidation that favored *bumiputeras*. In 1965, all locally-owned large banks in Malaysia were controlled by ethnic Chinese investors. In 1990, only one of Malaysia's largest ten banks was predominately owned by ethnic Chinese investors (Searle 1999).

It is important to note strict limitations on concentrated bank ownership that differentiates the Malaysian financial sector from others. The 1973 Banking Act, under Article 23B, capped limits on individuals to a maximum of 10 percent equity stake in a particular bank and corporate entities to a cap of 20 percent ownership. This means Malaysian banks have a diluted ownership structure that encourages consortia, and can facilitate the NEP's goal of shared equity ownership between *bumiputeras*, non-*bumiputera* Malaysians, and foreign investors. However, the Minister of Finance retained authority to waive Article 23B restrictions and displayed a pattern of doing so when the result was equity consolidation of *bumiputera* interests at the expense of ethnic Chinese and Indian investors (Cook 2008).

The NEP also guided policies toward foreign ownership in the real economy. The government formed the FIC in 1974, which was tasked with screening all incoming FDI to ensure the central objective of the NEP that *bumiputeras*, non-indigenous Malaysians, and foreigners hold 30, 40, and 30 percent of equity assets in Malaysia, respectively.⁶⁸ The FIC was comprised of senior-level bureaucrats in the Economic Planning Unit and chaired by the Prime Minister and reviewed all proposed mergers and acquisitions by foreign interests. The FIC applied a standard set of guidelines to all proposed foreign investments that required approved projects to advance the equity goals of the NEP and to transfer technology and knowledge to

⁶⁸ Some argue Malaysia has held a liberal stance toward FDI since colonial times (Narayanan 1996). This claim is largely predicated on the governments' willingness to promote some types of FDI, especially in the wake of the NEP. Indeed FDI became a more important source of fixed capital formation with the passage of the NEP since ethnic Chinese domestic entrepreneurs were largely disadvantaged by the ethnically-based redistribution scheme. However, FDI was always heavily regulated in Malaysia, as strict equity ceilings and centralized screening indicate. The Malaysian experience with FDI is a reminder that domestic capitalists can often benefit from foreign equity participation, especially if FDI enters through minority partnerships. Evans (1979) study of capital-government relations in Brazil makes a similar point by emphasizing the role of the state (and the financing capacity of the state) in forging alliances between local and foreign capital.

bumiputera interests. The FIC requirements reflected not just the NEP's affirmative action policies but also the government's commitment to an import-substituting industrialization strategy in the post-colonial era.

Indigenization of both the real and financial sectors involved heavy government involvement in economic guidance. In particular, the government used directed credit requirements and foreign firm financing restrictions to channel investment into preferred sectors and help develop local banks. In 1975, the government implemented a number of these programs including a requirement that 50 percent of all bank lending had to benefit *bumiputera* businesses; a requirement that was reduced to 20 percent in subsequent years (Ang 2009, 50). The same year, the government also passed policies that set minimum lending requirements to priority sectors including agriculture, manufacturing, and small and medium-sized enterprises (SMEs). These policies made it easier for the government to retain limits on foreign investment since they reduced the cost of debt financing to large and politically connected indigenous firms. Largely due to these programs, lending to the *bumiputera* community rose from 4 percent of total loans in 1968 to 28 percent in 1985 (Jesudason 1989).

The success of the NEP in developing a large and prosperous “*Bumiputera* Commercial and Industrial Community” was in large part dependent on the development of state- and *bumiputera*-owned banks that would be willing to extend substantial capital to *bumiputera* industrial and commercial interests. To facilitate the maturation of an indigenous banking sector, the government required all foreign firms operating in Malaysia to obtain at least 50 percent of local finance needs from Malaysian banks. This requirement may have crowded out credit needs of local firms, but also allowed locally-owned to compete with foreign-controlled financial firms for the most lucrative clients while also helping indigenous firms grow technical and human

resource capacity to service the most sophisticated customers (Cook 2008, 72).

Crisis, Deregulation, and Credit Booms: Banking and FDI policy 1985 -1997

Through the 1970s, riding high on a global commodity price boom, both Indonesia and Malaysia consolidated economic policies designed to benefit politically important domestic constituents. In Indonesia, this manifested through the tight link between the military, bureaucrats, and ethnic Chinese capitalists in urban areas and the party and *pribumi* planter interests in rural settings. In Malaysia, the ruling party cultivated a rising *bumiputera* industrial class while carefully constructing industrial policy to allow ethnic Chinese entrepreneurs and foreign investors to contribute to fixed capital accumulation. In both countries, these strategies required state control over credit allocation decisions, mainly through large state banks, and strict limits on FDI.

The global economic environment that funded such *dirigiste* economic strategies in the 1970s changed drastically in the early 1980s with a U.S. instigated global recession that rippled throughout global credit and commodity markets. With mounting structural pressures, both Indonesia and Malaysia struggled to maintain political control over credit allocation. Each responded to their balance of payment fragilities and economic recessions by addressing weaknesses in their banking sectors and in their exclusionary FDI policies. However, while Indonesia pursued banking deregulation that ultimately shifted market power from the state to politically important domestic conglomerates, Malaysia responded with a series of prudential regulations designed to limit bank leverage and consolidate the increasingly unwieldy sector. It also raised revenue through a series of real-sector privatizations through public offerings that transferred wealth to the politically influential *bumiputera* class and also led to an equity market boom.

As a result of balance of payment pressures and crisis-induced banking reforms, both countries relaxed equity restrictions on export-oriented FDI projects, particularly those located in export processing and bonded zones. However, while Malaysia entered this time period with a more liberal FDI policy stance than Indonesia, the mid-1980s until the 1997 financial crisis marked a period of sustained opening of Indonesia's investment climate such that it was slightly more open to FDI than was Malaysia on the eve of the Asian financial crisis.

Indonesia's liberalizing trend during this time was driven by shifting policy preferences of the country's rapidly growing and politically connected conglomerates. Banking deregulation during this time period shifted credit allocation decision-making from state banks toward private domestic banks run by conglomerates owned by military officials and ethnic Chinese capitalists close to the Soeharto regime. Deregulation also limited the government's ability to use directed credit schemes to generate economic growth. As a result, conglomerates and small *pribumi* industrialists lobbied for targeted relaxation of foreign equity restrictions. As a whole, the Indonesian government pursued a degree of liberalization in sub-sectors that conglomerates wanted opened to foreign investors and maintained a restrictive stance in areas of the economy in which conglomerates preferred continued protection while smaller indigenous firms preferred increased openness.

Malaysia's FDI policy during this same time period underwent far less change. This is unsurprising given it responded to banking sector weakness by reasserting state control over lending procedures and pursued, albeit with limited success, policies designed to consolidate the banking sector rather than expand the number of domestic operating banks. Thus, over this time period, the Malaysian government continued to view foreign capital as important in limiting the economic and political influence of the ethnic Chinese and Indian minorities. It also

implemented a new foreign investment law designed to attract FDI in high-skill, export-oriented manufacturing. However, by implementing relaxation of equity restrictions only in export processing zones, limiting foreign ownership even in export-generating activity to 80 percent, and refusing to open additional subsectors to FDI, Malaysia's investment policy during this time is best described as status quo maintenance rather than as a period of substantial liberalization.

Indonesia

In the context of high oil prices, the Indonesian economy grew quite rapidly through the early 1980s (see Table 5.2). A series of balance of payment fragilities began to emerge intermittently in the late 1980s. When world oil prices began to drop, balance of payment pressures devolved into capital flight at the end of 1986 and again in 1987 (Haggard and Maxfield 1996). In responding to the crisis, technocrats and political elites focused on the need to liberalize the financial sector (Rosser 2002). Deregulation would change the credit allocation landscape in Indonesia considerably, and in ways that would benefit large conglomerates at the expense of small indigenous firms dependent on access to subsidized loans from state banks. Liberalization of banking licenses would allow conglomerates to establish new banks to provide easy financing to linked entities, while removal of credit ceilings and interest rate controls would allow these private banks to expand their loan portfolio and compete with state-owned banks for business. Local business interests, especially large conglomerates with close ties to the regime, were vocal proponents of such deregulatory policies.⁶⁹

With overwhelming support of politically connected conglomerates and the political bureaucrats tied to these large firms, the government pushed through a series of two deregulatory

⁶⁹ *Tempo*, 23 April 1988; Joseph P. Manguno, "Indonesia Loosens Credit, Interest Rates in Hopes of Boosting Domestic Investment," *Asian Wall Street Journal*, 6 June 1983.

banking reforms in 1983 and 1988. The 1983 reforms removed credit ceilings and interest rate controls and substantially limited central bank lending through direct channels and liquidity credits (Rosser 2002, 61). The October 1988 reforms (Pakto 88) contained financial reforms that deregulated the domestic financial sector while simultaneously maintaining an environment highly restrictive of foreign banks. The measure abolished Bank Indonesia's role in approving foreign loans, removed ceilings on funds they could raise overseas, and eliminated several ownership restrictions including stock market participation. (Haggard and Maxfield 1996, Pepinsky 2013, Soesastro 1989). Local business elites, including ethnically Chinese business owners largely supported these reforms because deregulation allowed large conglomerates to establish small private banks to serve as a primary source of cheap credit for their affiliated businesses (Rosser 2002). In response to the reforms, a manager of one large private domestic bank said, "This is the freest we've ever been."⁷⁰ Industry groups such as the Indonesian Private Bankers Association, Perbanas, were similarly jubilant at the news of reform.⁷¹ The number of small private banks ballooned under the new regulations, expanding from 111 in 1988 to 240 in 1995 (Enoch et al. 2003). Under liberalization, financial sector growth averaged 12.1 percent for most of the decade (Cook 2008).

Despite these reforms and a clear rhetorical commitment to increase financial openness, Pakto 88 retained the New Order regime's largely exclusionary stance toward direct entry of foreign financial firms (Pepinsky 2009, Sharman 2001, Winters 1996, Soestra 1989). Even though the reforms allowed increased branching capabilities of foreign banks, licensing laws

⁷⁰ Joseph P. Manguno, "Indonesia Loosens Credit, Interest Rates in Hopes of Boosting Domestic Investment," *Asian Wall Street Journal*, 6 June 1983.

⁷¹ Joseph P. Manguno, "Indonesia Loosens Credit, Interest Rates in Hopes of Boosting Domestic Investment," *Asian Wall Street Journal*, 6 June 1983.

prohibited entry of new foreign banks so only foreign financial firms already operating in Indonesia benefited from this reform. The extent of closure is evident from ownership figures of banks in 1996. While 160 private domestic banks operated in Indonesia in 1996, only 34 joint ventures between domestic and foreign banks and 10 majority-owned foreign banks existed (Sharma 2001, 86). Table 5.3 further illustrates the differential effects of banking deregulation on the role of state, private local, and private foreign banks. Reforms shifted market share from state to private domestic banks while foreign banks remained largely marginalized.

Table 5.3 Mobilization of Deposits by Bank Type (percentage)

	1982	1988	1990	1992	1994	1995	1996
State Banks	71	60	50	47	37	35	32
Private Domestic Banks	14	30	40	43	53	55	59
Foreign and Joint Venture Banks	10	7	7	7	6	6	6
Regional Development Banks	5	3	3	3	4	4	3

Source: Bank Indonesia, *Indonesian Financial Statistics*, various editions in Rosser 2002, pg. 63

The enthusiasm local political and economic elites displayed over banking deregulation did not extend to regulatory reform. Bureaucrats and indigenous groups lobbied to maintain preferential credit programs while conglomerates fought to preserve their discretionary authority over raising funds overseas and lending to their affiliates without substantial regulatory oversight (Rosser 2002). Since no politically important societal group supported prudential regulatory reform, the late 1980s through the mid 1990s saw rapid expansion of credit as conglomerates run by ethnic Chinese used their privileged position to lend cheaply to their affiliates and the state perpetuated preferential credit schemes in priority sectors such as agriculture to mute inter-ethnic tension and underlying social unrest (Habir 1984, 130; Rosser 2002, 63).⁷²

⁷² *Far Eastern Economic Review*, 22 September 1983.

The New Order had always worked to balance their tight political and economic alliance with the ethnic Chinese business community with a need to address *pribumi* concerns, especially in rural areas. Banking deregulation threatened social cohesion because lifting credit controls effectively priced indigenous firms out of the lending market while benefiting larger ethnically Chinese businesses (Rosser 2002). Therefore, the government continued to provide preferential credit to high priority sectors such as agriculture, cooperatives, and manufacturing exports even as deregulatory pressures forced it to cut credit programs in trade manufacturing, construction, and services. To further offset *pribumi* concerns, the government maintained its medium-term investment program (KIB), which was available only to indigenous Indonesian and had been implemented in 1974 in response to violent ethnic riots (Cook 2008, Habir 1984).

However, continued downward pressure on oil prices limited the government's ability to continue such programs. In 1990, it further limited preferential credit to agriculture, subsidized food distribution, cooperatives, and medium-term investment credit. To offset these cuts, the government required private banks to direct 20 percent or more of their loan portfolios to small *pribumi* commercial interests (Rosser 2002, 65). Even with pressure from declining revenue and technocrats in BI, senior government officials and the conglomerates whose continued support the New Order regime relied upon were able to maintain access to a more limited preferential credit program that facilitated the continuance of patrimonial ties (MacIntyre 1993, 159). In other words, the contraction of preferential credit squeezed *pribumi* interests from the benefits of the program but did not decrease the regime's ability to control credit allocation processes to favor political allies.

As with the politics of preferential credit programs, there was also near universal domestic opposition to prudential regulatory reforms. Technocrats in BI wanted to pair the

banking deregulations of 1983 and 1988 with a series of prudential requirements that would regulate lending limits, capital adequacy requirements, loan-to-deposit ceilings, and lending decision processes in state banks (Bihandi 1995, 179; Rosser 2002, 66; Wardhana 1994, 80). The *de jure* prudential requirements in these packages were very weak by international standards. Capital adequacy ratios were set below Basel I standards, legal lending limits were set high enough to allow banks to lend up to 50 percent of their portfolios to a combination of firms within a single conglomerate, and even these regulations were largely unenforceable due to long compliance periods and regulatory capacity problems associated with the rapid growth in the number of banks (Cole and Slade 1996, 91; Rosser 2002, 67; Symons and White 1989, 1974-5). State officials as well as conglomerates also strongly opposed regulatory clean up of state-owned banks because both groups benefitted from the patrimonial system of access to subsidized credit in exchange for political support and economic favors (Rosser 2002, 67-8).

The rapid expansion of ethnic Chinese conglomerates during this period, enabled through largely under-regulated lending from affiliated private banks and amplified through increased public offerings on the burgeoning Jakarta stock exchange, led to increased societal tension as *pribumi* populations increasingly resented the economic fortunes of the large and non-indigenous domestic capitalist class.⁷³ Banking deregulation had made credit more expensive, thereby benefiting the large firms with deep pockets while freezing smaller indigenous firms out of lending markets. Large firms were willing to pay the higher costs of credit in order to limit their competition from smaller firms, consistent with the theories of support for financial underdevelopment discussed in Chapter 2 (Rajan and Zingales 2003). This dynamic was

⁷³ “Indonesian Big Business ‘Affecting Growth of Small Firms,’” *The Straits Times*, 28 December 1993.

strengthened by continued limits on foreign bank branching, which meant large conglomerates with access to international capital intermediated through affiliated banks had important advantages in an otherwise limited financial system. Soeharto sought to dull the anti-conglomerate rhetoric advanced by small and medium *pribumi* businesses that had pressed the government to limit lending to non-*pribumi* interests and to find ways to actively promote the development of indigenous firms.⁷⁴ The easiest way to satisfy these concerns, and indeed the preference of the vocal *pribumi* business owners, was to provide these groups increased access to preferential credit through the state-owned banks and to extend several procurement contracts to indigenous firms (Robison 1996, 95).

In this political climate, banking regulation expanded conglomerates' access to finance, increased private domestic banks' ability to rapidly expand their lending portfolios through borrowing internationally, and placed additional pressure on the government to combat inter-ethnic tensions through extending preferential credit to *pribumi* firms. The inherent instability of such unchecked financial expansion quickly became clear through a series of near-bank collapses through the early 1990s. A stricter banking regulation passed in 1991, but included a lengthy compliance schedule and did not provide regulators with the capacity to adequately enforce lending limits (Rosser 2002, 74). The build up of over-leverage private domestic banks and unserviceable debts in state banks left the domestic financial sector increasingly vulnerable and set the stage for a severe banking crisis after the 1997 currency crisis.

The decade preceding the crisis, then, consisted of substantial banking deregulation that shifted credit allocation power from the state to conglomerates. At the same time, the regime retained a more limited ability to provide targeted preferential credit to favored firms. Given the

⁷⁴ *Tempo*, 20 July 1991.

central thesis of this dissertation, we should expect the loosening of state control over credit allocation would result in a period of policy opening toward FDI as firms would increasingly look to foreign sources of investment, at least in areas that were no longer supported by preferential credit arrangement. Indeed, Indonesian FDI policy during this time conforms to expectations.

Table 5.4 highlights investment policy changes from 1986 to 1996. Indonesia began the 1980s as much more closed to FDI than its geographic and economic neighbors in island Southeast Asia. By the eve of the 1997 financial crisis, it has closed the gap in FDI restrictiveness and had become slightly more open to foreign investment than Malaysia. However, the reforms to FDI policy made during this time are best described as moving the country from an unconditionally closed to a partially open investment environment. A series of laws and decrees opened the economy to FDI in export-generating activities, primarily as a way to generate foreign exchange at a time in which declining oil prices placed greater urgency on the regime to diversify exports (Rosser 2002, 128-9). It is important to note that some relaxation of restrictions on export-oriented firms preceded the 1988 banking reforms. However, the 1986 loosening of restrictions on export-oriented FDI were minor compared with the 1989 switch from a positive to a negative list. This change, which occurred in the wake of the 1988 banking reforms, fundamentally altered FDI policy from a system in which foreign entry was only allowed if an industry was explicitly opened to a system in which foreign entry was only denied if the government enacted specific industry-level controls.

Table 5.4 Investment Policy Changes 1986-1996

1986	Relaxation of limits of foreign ownership for export-oriented firms
	Several sectors previously closed to FDI are opened, including retail trade
1987	Foreign investors allowed on stock exchange

1988	16-year ban on foreign bank entry removed
	Joint ventures allowed to distribute their products locally
1989	Switch from Positive to Negative List, with hundreds of sectors opened to foreign investment under certain conditions (e.g. export requirements, co-operation with SMEs)
	Foreigners allowed to purchase 49% of shares of listed companies
1994	Minimum capital requirement for foreign investment eliminated
	Nine strategic sectors opened to 95% foreign ownership
	Up to 100% foreign ownership permitted throughout Indonesia (80% previously)
	Divestiture requirement reduced to only a token amount of local equity
	Domestic partnership requirements relaxed
1995	Ten sectors removed from Negative List, including motor vehicles

Source: OECD 2010, 45

Since Japan was the largest potential source of FDI at the time, most of the regulatory reforms were drafted in response to Japanese government and business officials who focused on minimum investment and divestment requirements as being the largest impediments to Japanese FDI, which was mainly done by small and medium export manufacturers.⁷⁵ However, despite a clear commitment to fostering a more welcoming environment for manufacturing exporters, the regime maintained tight restrictions on investment in domestic-oriented industries and agriculture that still benefitted from Indonesia's circumscribed directed credit program (Rosser 2002, 134-42).

Government-industrial relations over FDI policy reform reflected the shift in economic and political power engendered by banking deregulation. Domestic conglomerates supported these limited reforms because most foreign firms were required to enter joint ventures with local firms, which facilitated technology transfer from foreign companies to conglomerate affiliates (U.S State Department 1990). These conglomerates were in a stronger negotiating position due to their leadership gains in Indonesia's main chamber of commerce, KADIN, which previously

⁷⁵ *Jakarta Post*, 28 August 1986

had never confirmed non-indigenous businesspeople to the organization.⁷⁶ Liberalization of SME FDI reflected the dual reality of a *pribumi* capital class that was severely weakened by a credit environment that favored large, ethnically Chinese conglomerates over small firms and by a subsequent need to finance SME business expansion through joint ventures rather than bank loans.⁷⁷ Additionally, the government retained extensive screening of all FDI project proposals, and the conglomerates' close political ties meant they could easily lobby investment board officials to block foreign projects that would disadvantage them. A prime example of the conglomerates' power is the government's decision to ban new foreign-funded projects in palm plantations in early 1997 at the urging of ethnic Chinese interests. *Pribumi* SME business owners protested the move, arguing the freeze of "all new foreign investment in palm plantations opens the possibility of monopolies" since only seven ethnic Chinese conglomerates held licenses for palm plantations after the ban was implemented.⁷⁸

Thus, FDI policy changes during the period prior to the 1997 crisis offered tentative openness to export-oriented projects, while maintaining heavy state control over individual projects and requiring foreign investors to substantially cooperate with local firms. These changes in FDI policy reflected the policy preferences of business elite; *pribumi* labor groups resented the continued economic success of ethnic-Chinese and foreign firms in the country and

⁷⁶ Maggie Ford, "Ethnic Chinese Get Senior Indonesian Chamber Posts," *Business Times*, 5 February 1994.

⁷⁷ Douglas Wong, "Indonesia Now More Attractive for Investment," *The Straight Times* 13 January, 1995.

⁷⁸ Vice chairman of KADIN, Adiwarsita Adinegoro, quoted in "Indonesia Seeks to Limit Foreign-Owned Plantation; Jakarta Hopes to Overtake Malaysia in Palm-Oil Production," *The Nikkei Weekly*, 14 April 1997.

worker demonstrations and riots were a continual threat, especially in areas outside Jakarta.^{79,80} In sectors in which conglomerates benefitted from FDI restrictions, especially agribusiness, the New Order regime was quick to erect barriers to foreign investment. The liberalization of FDI was carefully paired with new SME credit programs designed to decrease *pribumi* anger over the ethnic Chinese conglomerates' outsized benefits from new FDI policies.⁸¹ Importantly, investment incentives for foreign companies were revoked in 1984 and only reinstated in 1996 when stressed state-owned bank balance sheets severely reduced the ability of the government to extend preferential credit to priority sectors (OECD 2010).

Malaysia

Largely due to the success of the NEP in rapidly developing a burgeoning class of *bumiputera* business elites, the Malaysian government's primary NEP policy goal in the 1980s was to divest its extensive holdings in banking and real sector interests to *bumiputera* owners. The realization of this objective was complicated by a recession and debt crisis in 1985-6. As a result of a global recession brought on by U.S. monetary contraction, export commodity prices collapsed in 1985. This put substantial pressure on the current account as export income fell by 6.2 percent in 1986. Public debt, driven by state borrowing to fund expansion of heavy industry, rose from 44 percent of GDP in 1980 to 112 percent in 1986 (Athukorala 2010, 3; Doraisami 2012, 7). More than half of this debt was denominated in foreign currency, which became problematic as the yen appreciated as a result of the 1985 Plaza accords. The government's weak

⁷⁹ Lee Kim Chew, "Medan Troubles Cast Shadow on Indonesia," *The Straits Times*, 25 April 1994.

⁸⁰ Lee Kim Chew, "Trying Times Ahead for Indonesia's Labour Movement," *The Straits Times*, 1 May 1994.

⁸¹ "Kadin, Golkar to Form Guarantee Fund New Year," *Business Times*, 1 October 1994.

fiscal position left it unable to pursue counter-cyclical fiscal policies in response to weakening aggregate demand and GDP growth fell sharply into negative territory in 1986, as table 5.2 indicates. Unemployment doubled to 8 percent in 1986 and the country experienced a banking crisis as non-performing loans accounted for 30 percent of all loan in 1987 and 1988.

As would be the case in 1997, the Malaysian government decided to manage post-crisis adjustment without IMF assistance. IMF loans could lessen fiscal distress, but would come with conditionality requirements that would severely undercut the NEP. The dominant party, Barisan Nasional (BN), relied on the political support of Malaysia's *bumiputera* majority and therefore was unwilling to pursue structural adjustment policies that would preclude continuance of economic redistribution policies (Narayanan 1996). However, the crisis weakened the government's ability to underwrite development through fiscal expansion and required the state to look elsewhere to generate investment finance. This imperative led to policy changes in three key areas: banking, privatization, and FDI.

The banking sector was substantially weakened due to high levels of non-performing loans and increased incidence of corporate bankruptcies. In response, the government moved to increase BNM regulatory banking oversight and facilitate local bank consolidation. They did this by temporarily imposing interest rate controls and passing a series of financial sector regulatory reforms. In immediate response to the crisis, the government imposed interest rate controls to limit excessive credit rationing during the crisis. Interest rates had been liberalized since 1978, but the central bank imposed direct controls from 1985 to 1987. In February 1987, BNM implemented a base lending rate method of control until 1991 (Yusof et al. 1994). After 1991, interest rates returned to being determined by competitive market rates. This policy liberalization

reflected a return to strong economic growth along with a surge in inward foreign capital flows and increasingly stringent banking regulations.

Most important in these regulatory reforms was the October 1989 Banking and Financial Institution Act (BAFIA), which provides enhanced power for licensed institutions' auditors while increasing BI's authority to bail out ailing banks. Local bankers greeted the reforms warmly, especially after amendments dropped initial language that many believed gave BI sweeping authority in determining when a bank would be subject to takeover.⁸² BAFIA also limited private foreign borrowing to prevent the banking sector, which was benefitting from an increasingly liberal short-term capital account, from taking on too much short-term foreign debt. This would later help insulate Malaysia from the worst of the 1997 financial crisis; South Korea, Indonesia, and Thailand faced higher bank losses due to the extent to which banks were overleveraged to foreign creditors. However, as will be seen below, BAFIA limited foreign debt issuance but it did not limit capital-raising through equity markets. Thus, domestic intermediation of foreign capital in Malaysia in this period was done primarily through equity markets (Pepinsky 2012).

As the banking crisis subsided, the government tried to facilitate local bank consolidation to enhance capitalization, simplify regulatory oversight, and further consolidate bank equity holdings in the hands of well-connected *bumiputeras*. The central bank had frozen issuance of new banking licenses in 1982, which meant that banks wishing to consolidate had to obtain permission from the Minister of Finance Anwar Ibrahim. As a result, banking sector restructuring in the early 1990s mainly benefitted state- and *bumiputera*-owned firms. Table 5.5

⁸² Wong Sulong, "Malaysia to Tighten Banking Laws," *Financial Times*, 23 October, 1985.

documents all banking sector acquisitions from 1992 to 1994; only two of the seven mergers resulted in non-*buiputera* ownership.

Table 5.5 Banking Acquisitions 1992-1994

Acquired Bank	Ethnicity	Acquirer	Ethnicity	Year of Transfer
D&C	Chinese	RHB	<i>Bumiputera</i>	1990
Bank Utama	<i>Bumiputera</i>	Cahaya Mata Sarawak	<i>Bumiputera</i>	1992
Kong Ming	Chinese	EON	State (<i>Bumiputera</i>)	1992
Security Pacific	Chinese	AMMB	<i>Bumiputera</i>	1994
MUI	Chinese	Hong Leong	Chinese	1994
UOB Kota Kinabalu, credit cooperatives	Chinese, foreign	Phileo-Allied	Mixed	1994
UMBC	State (<i>Bumiputera</i>)	Sime	State (<i>Bumiputera</i>)	1995

Source: Various editions of Bank Negara Annual Reports and Kuala Lumpur Stock Exchange Annual Company Handbook in Cook 2008, 76.

Through the rest of this period, the state remained committed to protecting its financial sector from foreign ownership. The U.S., China, and Australia specifically targeted Malaysia's banking sector during the financial services negotiations of the Uruguay Round. The government of Malaysia, like Indonesia, strongly resisted these pressures by leveraging their leadership in the South East Asian Central Banks Research and Training Centre (SEACEN), the developing G-15, and the United Nations Conference on Trade and Development (UNCTAD) to prevent meaningful liberalizing commitments. At the same time, the government implemented new regulations to prevent foreign banks from gaining advantages in the local market through technological advances. The growth of automated teller machines (ATMs) threatened to give foreign banks with superior technology systems an advantage vis-à-vis local banks. BNM defined off-site ATMs as separate branches, effectively preventing foreign banks from building out their ATM networks. BNM also issued directives preventing foreign banks from joining the

ATM interconnection network of local banks and from creating their own network. This ban remained in place until 2011 (OECD 2013, 216).

In addition to its efforts to shore up the banking sector in the wake of the 1985-6 crisis, the government of Malaysia also pursued a privatization agenda in which state assets were divested primarily to UMNO-linked companies. The method of divestiture was mostly by issuing stock through on the Kuala Lumpur Stock Exchange (KLSE). As a result of these offering, KLSE quickly grew into one of the largest stock exchanges in the world, relative to GDP with a market capitalization of \$200 billion just before the 1997 crisis (Delhaise 1998). By early 1997, it was the third largest exchange in East Asia in 1997 behind Tokyo and Hong Kong (Cook 2008, 75).

The quick rise of KLSE is important to understanding the politics of investment policy for two main reasons. The first is that it facilitated rapid expansion in foreign portfolio investment, which accounted for 60 percent of trading volume and 25 percent of ownership in 1997 (Cook 2008, 75). The increase in portfolio investment meant short term foreign investment quickly became an important source of inward investment, accounting for 43.3 percent of total inflows in 1995 and up from 13.2 percent just the previous year (Athukorala 1998). This inflow of foreign investment provided local banks with an inexpensive and seemingly limitless supply of capital to increase lending capacity.

Banks were particularly willing to leverage themselves in this way due to a two-tiered regulatory system introduced in December 1994 in which more highly capitalized banks could provide foreign exchange accounts of unlimited size. The purpose of this policy was to encourage consolidation, but banks were able to increase market capitalization to gain tier one status without relinquishing managerial control by offering new shares and then borrowing from

foreign sources to buy these shares. As long as KLSE continued to climb in value, banks had the collateral necessary to borrow these funds. As a result, only one bank merger occurred between 1994-1997 and credit surged.

The 1985-6 crisis also led the government of Malaysia to modify its restrictive stance toward FDI in order to upgrade its exports from commodity-driven to higher-tech manufacturing. This change was largely due to the need to generate exports to offset persistent current account deficits made worse by a global recession and a concern that commodity markets were too volatile to count on for generating foreign exchange. FDI was needed to supplement domestic capital due to the government's weak fiscal position, a banking sector unwilling and unable to lend sufficient amounts need for industrialization immediately following the crisis, and a need for technology transfer to rapidly switch from an export sector dominated by processing primary products like palm oil to one engaged in manufacturing higher-valued added products like electronics (Ang 2009, Athukorala 2010, Doraisami 2012).

However, rather than pursuing full liberalization of its FDI regime, the government of Malaysia implemented a modified version of its partially open policy framework by incentivizing export-oriented FDI while maintaining high levels of restrictions in other sectors. The 1986 Promotion of Investment Act (PIA) is illustrative of this strategy. PIA permitted exporters and firms transferring high levels of technology and knowledge to retain higher levels of foreign equity than previously allowed. Firms exporting 80 percent or more of their goods were exempted from joint venture requirements. The government relaxed equity restriction in no other industry sub-sectors during this time and the FIC continued to screen all foreign equity acquisitions. The government also retained screening authority over wholly-owned foreign affiliates in the export-oriented manufacturing sector through the Malaysian Industrial

Development Authority (MIDA), which issued manufacturing licenses and determined investor eligibility for investment incentives. Domestic business interests remained central to the development of investment rules throughout the period, lobbying for policies that would incentivize technology transfer to local firms while also allowing domestic industry to set the terms of joint ventures with foreign investors.⁸³ And, while domestic firms welcomed high-skill manufacturing FDI, local business groups were concurrently able to push through more equity restrictions on market-oriented FDI such as in the distribution industry.⁸⁴

Thus, at the time of the 1997 financial crisis, the investment climate in Malaysia was characterized by extensive government guidance over credit allocation decisions and foreign investment activity. Interest rates were liberalized and prudential regulation prevented gross excesses in bank leverage, but a government-driven stock market boom further fueled by high levels of foreign investment inflows created a rapid expansion of credit on which well-connected firms were best poised to capitalize. Additionally, state-owned banks remained central to the banking sector as well as legacy *bumiputera* banks that had been formed in the 1970s to support the NEP. FDI was encouraged in export-oriented activities, but with extensive government oversight. FDI in other sub-sectors was severely circumscribed. As we will see in Chapter 6, this policy environment drastically changed in the wake of the 1997 crisis. As the government relinquished its control over the banking sector, important voices in commerce and industry lobbied for increased openness for FDI to help finance further economic expansion. Overtime, these voices triumphed over poorer *bumiputera* community members who viewed foreign firms with suspicion.

⁸³ “Industries Seek More Investment From Abroad,” *The Nikkei Weekly*, 26 September, 1992.

⁸⁴ Esther Tan, “Guidelines on Wholesale, Retail Trade Out Soon,” *New Straits Times*, 5 March 1996.

Conclusion

In this chapter, I traced the co-evolution of banking sector and FDI policies in Indonesia and Malaysia from 1965 to the eve of the 1997 Asian financial crisis. While Malaysia had initially developed a more open, but fundamentally intermediate, stance toward foreign investors in order to limit the economic and political power of ethnic Chinese capitalists, Indonesia experienced a policy shift from a mostly closed to a conditionally open FDI climate through this time period. I show how banking sector deregulation in Indonesia in response to substantial balance of payment weakness shifted elite policy preferences toward conditional openness. As credit allocation decisions became increasingly driven by private banks rather than state-owned banks, and as state financing constraints limited the availability of preferential credit, industrial elite and state bureaucrats became increasingly willing to raise equity ceilings on foreign investors, especially in the manufacturing sector. At the same time, the state retained ultimate authority over foreign investment projects through its centralized screening capacity and showed its willingness to block investment projects that would threaten domestic industrial elites.

Malaysia experienced status quo maintenance with respect to its FDI policies through the 1970s and 1980s. This is unsurprising given the fact it did not experience substantial changes to its banking sector regulatory regime during this time period. Malaysian officials responded to banking sector weakness in the 1980s with increased prudential regulation, but these steps were mostly supported by domestic capital because the regulations provided the central bank with increased bail-out authority and limited the growth of foreign banks by requiring them to incorporate locally. These policy initiatives did little to change the fundamental nature of the domestic credit allocation process, and therefore did not generate substantial changes in elite preferences over FDI openness. However, the banking policies of the late 1980s and early 1990s

did help insulate the Malaysian banking sector from the very worst of the 1997 crisis. We will see in the next chapter how Malaysia's ability to weather the crisis without IMF assistance actually facilitated major liberalizing changes in the banking and FDI policy spaces.

The processes through which Indonesian and Malaysian banking and FDI policies did or did not change through the 30 year period prior to the Asian financial crisis provide us with important insight into how status quo and reformist pressures are created and sustained. A central argument of this dissertation is that FDI policy reform occurs when elites' financing strategies shift their policy preferences over openness. This explanation of change is quite different from extant theories of FDI policy reform, which emphasize changes in political institutions that shift power from capital to labor. Indeed, these cases provide some insight into how elites' stated preferences over FDI shift as global conditions and domestic credit allocation processes change. The next chapter illustrates this dynamic more starkly by examining how crisis policy responses modified elite preferences over foreign investment post 1997.

CHAPTER 6: CRISIS, REFORM & POLICY DIVERGENCE - MALAYSIA & INDONESIA 1997-2013

“WE NEED TO USE FOREIGN INVESTMENT IN A SMART WAY, LIKE CHINA HAS DONE. BUT INDONESIA HAS TO DECIDE WHICH AREA IT WANTS TO PROMOTE AND SPECIALIZE IN.”

Yuri Sato, Economist for Indonesia
Chamber of Commerce and Industry (KADIN)
November 7, 2009

“[MALAYSIA SHOULD ADOPT] A TRULY LIBERALISED POSITION TO FOREIGN EQUITY AND OWNERSHIP NOT ONLY IN THE MANUFACTURING SECTOR BUT ALSO IN THE SERVICES SECTOR. . . . THIS IS NOT A TIME FOR FAINT-HEARTEDNESS BUT FOR MEETING THE IMMEDIATE CHALLENGES WITH PRAGMATISM, INNOVATION, AND FUNDAMENTAL CHANGE”

Malaysian International Chamber of
Commerce and Industry
April 8, 2002

Introduction

In the previous chapter, I traced the co-evolution of banking sector and FDI policies in Indonesia and Malaysia from the late 1960s to the eve of the 1997 Asian financial crisis. While regime management of inter-ethnic political cleavages initially led the Malaysian government to cautiously embrace high regulated foreign investors as a way of limiting the economic dominance of non-*bumiputera* capitalists, Indonesia's tight alliance between the military, ruling party, and ethnic Chinese financiers provided the political logic for largely excluding foreign capital from direct investments in the local economy. The Indonesian government's policy of

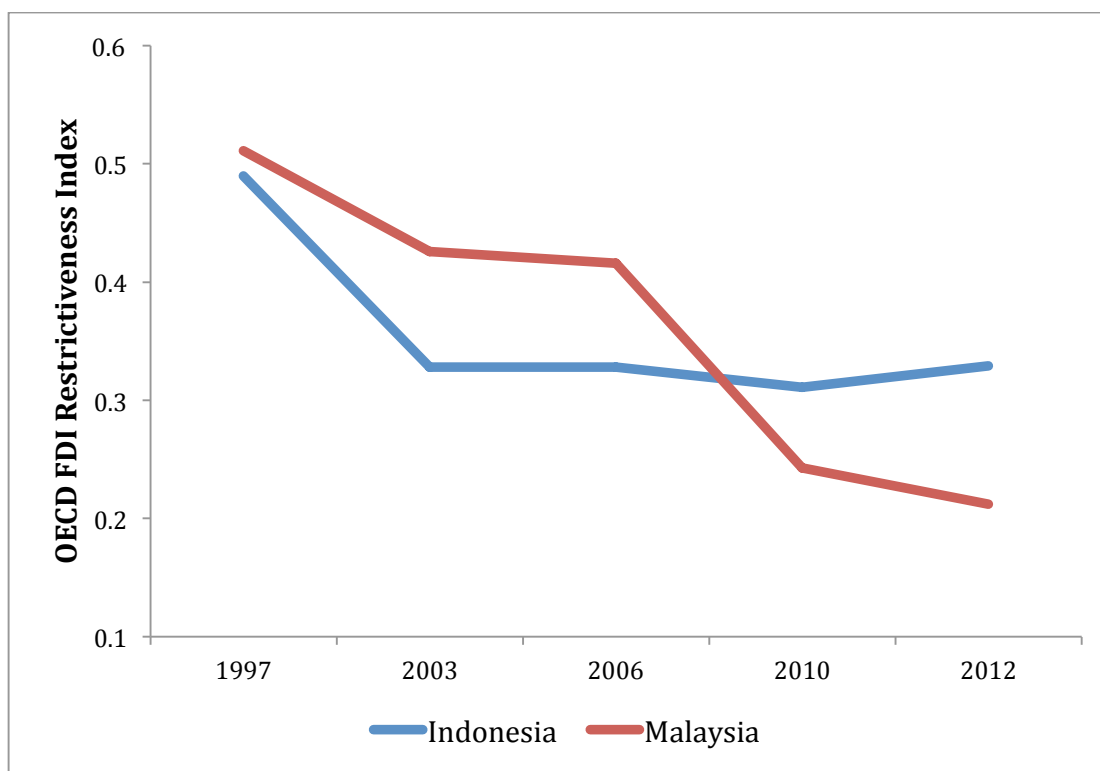
banking deregulation in the 1980s in response to tight global credit conditions and elite interest in establishing private banks linked to powerful domestic conglomerates, however, created local elite support for limited FDI reforms such that by 1997 Indonesia's FDI policies were slightly less restrictive than were Malaysia's.

In this chapter, I demonstrate how divergent crisis response strategies to the 1997 Asian financial crisis led to substantial liberalization of credit allocation in Malaysia while Indonesia's foreign bank-led financial sector restructuring did little to force fundamental changes in the way banks make debt financing decisions and insulated the state from needing to privatize its extensive state-owned banking system. As a result, Indonesian business interests have successfully blocked attempts to implement large-scale liberalization of FDI beyond the initial IMF-imposed policy changes in 1998-9. In contrast, the Malaysian business community has largely supported, and in many cases driven, more fundamental liberalization of FDI policy. These findings point to micro-level evidence to support the central hypothesis of this dissertation that financial sector liberalization shifts policy preferences of politically important business interests toward favoring opening to FDI.

Figure 6.1 shows Indonesia and Malaysia's level of FDI restrictiveness starting in 1997 onward. In early 1997, Indonesia and Malaysia had similar levels of openness to FDI. Both had centralized screening requirements, often required foreigners enter joint partnership with local firms, and heavily targeted export-oriented manufacturing while denying entry to other investors. However, their policies toward FDI have since diverged. Malaysia has experienced sustained movements toward more openness over time and now has an FDI policy that is at the average level of openness for a panel of 52 advanced and emerging economies. Indonesia, in contrast, experienced a small and immediate decrease in its restrictiveness score followed by a decade

without change to its level of openness. Since 2010, Indonesia has actually become slightly more restrictive of FDI. In 2012, its restrictiveness was one standard deviation above the average level of restrictiveness in 52 advanced and emerging economies. In other word, Indonesia and Malaysia's level of openness was identical in 1997 and today shows substantial divergence with Malaysia being much more open than Indonesia.

Figure 6.1 FDI Restrictiveness Index, 1997-2012



Source: OECD FDI Restrictiveness Index: <http://www.oecd.org/investment/fdiindex.htm>

The timing of this divergence follows a common, arguably exogenous, shock in 1997 when a twin currency and banking crisis originating in Thailand spread throughout Southeast Asia. Subsequently, Malaysia and Indonesia each pursued different crisis response strategies. Indonesia accepted IMF loans and recapitalized ailing private banks through opening the banking sector to foreign ownership. At the same time, the Indonesian government refused to privatize its large state-owned banking sector and used the crisis to consolidate state-owned banking assets.

Malaysia eschewed IMF funding and instead self-financed banking sector recapitalization while also privatizing state owned banks and pursuing prudential regulatory reform. The difference in crisis response meant that the Indonesian government and powerful domestic industrial-financial conglomerates still retained an important degree of control over domestic credit allocation while the credit allocation process in Malaysia became more market-based.⁸⁵ I argue below how these different outcomes affected key societal groups' preferences over an alternative source of investment finance – FDI.

The post-crisis experience of Indonesia and Malaysia is a hard test of my theory for several reasons. First, Indonesia experienced two political developments commonly associated with FDI liberalization – democratic transition and IMF conditionality – while Malaysia did not. Thus, if existing theories of FDI liberalization have more explanatory power than does my financing opportunity cost theory, we would expect Indonesia to have liberalized to a greater extent than Malaysia. Additionally, because Indonesia recapitalized banks by reducing restrictions on foreign ownership of banks while Malaysia retained its policies of protecting local banks, one might expect that Indonesia was more willing to open its economy to foreign investors either due to the political triumph of liberalizing technocrats or simply due to desperation in the midst of crisis. Finally, Indonesia and Malaysia are neighbor states with reasonably similar export potential. Previous research has found cross-border policy diffusion to have statistically significant effects on FDI policy (Vadlamannati and Cooray 2012). Therefore,

⁸⁵ There is a large and growing literature on comparative financial systems that characterizes domestic systems as “bank-based” or “market-based” (See Demirguc-Kunt and Levine (2001), Hardie and Maxfield (2011), and Rajan and Zingales (2003) for reviews.) My terminology above should not be construed as building upon this literature. Instead, I merely mean to distinguish between financial systems in which political relationships are important for obtaining credit and financial systems in which market mechanisms influence financing decisions, especially in terms of risk assessment.

given Indonesia and Malaysia's geographic proximity and economic similarities, we should expect these countries to hold very similar policies toward FDI.

Below we will see that, in both countries, political leaders made a conscious choice between protecting the banking sector or the real sector from foreign ownership. This tradeoff is documented in first hand accounts of policymaking as well as reporting on interest group lobbying during and after the crisis. When governments chose to protect the banking sector, state technocrats as well as industry leaders pushed for increased liberalization of FDI in the real sector in order to spur domestic capital formation. When governments instead allowed foreign banks to inject capital into ailing banks, they had the financing capability to retain state-owned banks. Credit allocation continued to be driven by political rather than market relationships, and this muted societal pressures for lifting restrictions on FDI into other sectors.

The Asian Financial Crisis and Bank Recapitalization Strategies

As detailed in Chapter 5, the 1980s and early 1990s were a time of rapid economic growth and financial expansion in Indonesia and Malaysia as well as the entire region. The causes and key events of the financial crisis that swept through east Asia in the summer of 1997 are well documented elsewhere, and I will limit my focus here on crisis response strategies in Indonesia and Malaysia's banking sectors subsequent reforms to FDI policy. Both countries experienced substantial pressure on their currency pegs; financial sectors highly leveraged in foreign currency quickly transformed currency crises into banking crises as foreign liabilities skyrocketed and banks struggled to remain solvent as their balance sheets quickly deteriorated. As their twin currency and banking crises worsened, the Indonesian and Malaysian governments experienced rapidly building technocratic and political pressures to deal with their collapsing banking sectors while managing popular and elite preferences over how to pay adjustment costs.

While Indonesia turned to the IMF, Malaysia managed its crisis response without conditional lending. Perhaps un-intuitively, the result was that Malaysia underwent a fundamental change to the way the domestic economy intermediated finance while Indonesia's embrace of foreign banks actually provided the state space to consolidate and strengthen state-owned banks.

Indonesia

While the balance of payment crises in the late 1980s led to domestic financial liberalization, the external pressures were small enough and the regime strong enough, that the episode did not fundamentally weaken the alliance between the regime and domestic banks. The Asian financial crisis, however, placed much greater external pressure on the government and fatally weakened domestic banks. The crisis began in earnest in August of 1997 when the government gave up defending the rupiah's peg and allowed it to freely float. The next two years consisted of a severe economic contraction as the money supply dwindled, the government faced severe fiscal constraints, financial intermediation halted, and negotiations with the IMF for emergency lending led to huge popular protests and social unrest. When the worst of the crisis was over, over 80 million Indonesians or 40 per cent of the population had fallen below the poverty line, Soeharto's thirty-two year rule was over, foreign banks had mostly replaced private domestic institutions, and state-owned banks consolidated their substantial market share over domestic lending activities.

The crisis of 1997-1998 decimated the domestic financial sector, which had experienced substantial overheating through the early 1990s due to poor regulations and politically connected lending decisions. At the time of crisis onset, the Indonesian banking sector comprised 90

percent of all domestic financial assets (Dobson and Jacquet 1998), the country had no system of deposit insurance, and local banks had the lowest capital adequacy ratios in the region (Sorsa 1997). Lax regulations on domestic banks' foreign borrowing contributed to the highest foreign debt to foreign reserves ratio in the region, high levels of public debt denominated in foreign currency, and comparatively low levels of foreign reserves (Cook 2008). Moreover, domestic lending was so concentrated and so politically driven that as the crisis took hold, the largest 21 debtors were responsible for a third of the value of all non-performing loans (NPLs) in the banking sector and all of these large debtors had substantial political and business ties to the Soeharto regime (Asami 2000).

When BI abandoned its commitment to maintain the rupiah's value in August 1997, bank balance sheets quickly deteriorated as the value of foreign denominated liabilities grew 48 percent in 1997. By the end of the year, NPLs topped 32 percent of outstanding debt (Cook 2008). Facing increasing strains on BI resources as local banks drew on central bank overdrafts, the Soeharto regime announced the first of four IMF emergence assistance packages in October 1997. The initial loan package was a result of negotiations in which the IMF conditioned assistance on closing politically connected insolvent banks. When the government closed 16 small local banks that represented less than three percent of total domestic bank assets, investors responded with a run on private banks to shift their funds into state banks that were assumed to implicitly guarantee deposits (Chou 1999). As a result, the private domestic banks, many of which were affiliated with large conglomerates and tightly connected to the Soeharto regime, bore the brunt of the banking crisis.

One of the banks subjected to closure, Bank Andromeda, was owned by one of Soeharto's sons. In December 1997, the bank was permitted to remain open by purchasing

another bank license, which cemented IMF concern that conditions would not be followed and popular opinion that the cause of the crisis was not international financial markets but a deeply corrupt New Order regime that maintained power through its patrimonial control over domestic finance (Milner 2003). The status of bank closures remained a constant source of friction between the Soeharto regime and the IMF during bailout negotiations. On 9 March 1998, the IMF refused to release a \$3 billion tranche citing Soeharto's unwillingness to abide by the loans conditions. At the same time, popular protest over rising food prices and IMF demands to end food and fuel subsidies placed additional pressure on the regime. Student protests over IMF conditions on subsidies erupted in January of 1998, preceded by a run on food supplies. The ensuing riots led the US to provide a \$70 million food and medical aid package in an attempt to quell unrest. On 8 April 1998, only after the sustained popular protests, Soeharto conceded to IMF pressures and agrees to more bank closures in exchange for the IMF dropping conditions over food and fuel subsidies.

The shift in content in Letters of Intent between the government of Indonesia and the IMF during this time is particularly instructive. The 31 October 1997 letter emphasizes improving the government's fiscal position by eliminating fuel subsidies, has a section on reducing equity restrictions on foreign direct investment, and in its section on social safety nets emphasizes the potential benefits of rupiah depreciation in increasing agriculture exports. Concerns about social spending are relegated to educational and medical spending:

Indonesia has made significant progress in alleviating poverty over the past 30 years. Yet, large numbers of poor still remain, and it is imperative that the adjustment program does not result in a worsening of their economic and social conditions. The depreciation should benefit the rural poor by raising output prices in the export-oriented agricultural sector. Measures necessary to achieve fiscal targets will protect expenditures on health and education.

The 10 April 1998 letter includes a lengthy section on the need to support the food and fuel needs of Indonesia's poor through subsidies. The section on liberalizing foreign investment is replaced with a commitment to supporting the development of small and medium scale enterprise and cooperatives through preferential credit allocation. The social safety net section explicitly states:

It is imperative that the adjustment program does not result in a worsening of the economic and social conditions of the poor. Our policies stated previously on providing a social safety net will be continued and strengthened. As noted above, budgetary subsidies on food, fuel and electricity have been increased. The Government also is broadening subsidized credit schemes for small- and medium-size enterprises where most of the non-agricultural labor force is employed.

Increased popular pressures, coupled with IMF negotiations that forced the Soeharto regime to choose between popular demands and protecting its allies in the domestic financial sector, proved fatal. Soeharto resigned in May of 1998. The domestic banking elite no longer had privileged political access and many fled the country (Pepinsky 2009). Without Soeharto and the financial interests that supported his regime, the new government quickly lifted foreign ownership restrictions in the financial sector. The IMF and technocrats in the newly created Indonesian Bank Restructuring Agency (IBRA) were key actors in implementing this policy (Sato 2003).

The IBRA was created in February 1998 as an asset management corporation tasked with socializing bank recapitalization by acquiring NPLs from distressed banks. It quickly acquired close to 500 trillion rupiah in bank assets, gained controlling stakes in 54 banks, and controlled close to 80 percent of bank assets by the end of its acquisitions (Claessens et al. 2000). In the process, the agency was repeatedly accused of political favoritism and many believed it bailed out insolvent banks alongside illiquid ones (Cook 2008). In May of 1999, the Bank of Indonesia issued a directive allowing up to 99 percent foreign ownership of local banks (from 49

percent).⁸⁶ Additionally, conditions on foreign branching were eliminated (Tambunan 2011).

Foreign banks were not eligible to sell NPLs to IBRA, but were the primary buyers of previously nationalized local private banks when IBRA initiated sales starting in 2002. Table 6.1 provides the details of these sales.

The decision to liberalize foreign equity ceilings in the banking sector marked an important, but circumscribed, change in domestic banking market structure. The Habibie government was in large part forced to open the banking sector to further foreign participation due to the extent to which private local banks were unable to raise funds necessary to submit tender offers. Financial interests strongly opposed this move, but had lost their key ally when Soeharto resigned; many of them subsequently fled the country (Pepinsky 2013b). At the same time, IMF conditionality made substantial government borrowing to facilitate local control over private banks untenable. Democratization also made it difficult to provide public support of local private banks since public perception painted these banks as corrupt vestiges of Soeharto's patrimonial practices. As a result of IBRA sales of previously nationalized private banks to foreign entities, by the end of 2002 foreign banks controlled more than 30 percent of total banking sector assets (Sato 2005). However, as table 6.1 suggests, ownership structures of banks with foreign participation remained far below legal limits; most foreign banks obtained equity positions just large enough to confer majority status. Moreover, the government retained centralized control over acquisitions by foreigners; all equity acquisitions over 25 percent required BI authorization (Robson and Loveless 2013).

⁸⁶ The Banking Law No. 7 of 1997, which was amended by Law No. 10 of 1998 began restructure the banking sector, but it was not until this 1999 decree that foreign equity participation was expanded.

While the government ceded market share from private local banks to foreign ones, it also used the financial crisis to consolidate its control over state-owned banking institutions. The original IMF lending agreement from October 1997 emphasized a need to consolidate and privatize state-owned banks. In October 1998, the government directed its three weakest state-owned banks to merge into Bank Mandiri, which immediately became the largest bank in Indonesia (Cook 2008). However, the government never followed through with a comprehensive bank privatization program and to date no state-owned banks have sold off controlling shares to local or foreign private interests (Robson and Loveless 2013). In 2003, the government did sell a 40 percent stake in state-owned Bank Rakyat Indonesia to multiple investors, but did so in a way to ensure continued state control over operating decisions (Cook 2008). Announced plans to pursue further bank privatizations including BI were permanently put on hold during the 2008 global financial crisis. As a result, the banking sector in Indonesia has a strong state and foreign presence with an absence of significant private domestic bank holdings.

The continued dominance of state-owned banks means that large and well connected domestic firms continue to receive preferential lending terms while small and medium enterprises are largely frozen out of credit markets (ADB 2005). The transfer of market share from private domestic to foreign banks has resulted in a decline in local private bank market share from 52 percent in 1996 to 35 percent in 2000 (Sato 2005) and a banking structure in which one third of all banks have some amount of foreign equity participation and 10 of the 15 largest banks in the country have significant foreign ownership (Robson and Loveless 2012).

Table 6.1 Indonesian Sales to Foreign Banks

<i>Bank [Former Owner]</i>	<i>Old Ownership Structure (end of 1997)</i>		<i>New Ownership Structure (end of 2003)</i>	
	<i>Shareholders</i>	<i>Share</i>	<i>Foreign Shareholders</i>	<i>Domestic Shareholders</i>
Bank Central Asia (BCA) [Salim]	Soedono Salim	23	Farindo Investments (Mauritius)	52 IBRA
	Second son of Salim	23	Consortium of Farallon Capital Management of the United States and Djarum Group of Indonesia	Second Son of Salim
	Third son of Salim	23		Third son of Salim
				1.84
Bank Danamon Indonesia [Danamon]	PT Danamon International	48	Asian Financial (Indonesia) Pte. Ltd	51 IBRA
	Publically listed shares	52	Consortium of Temasek Group of Singapore and Deutsche Bank of Germany	Publically listed shares
				0.9
Bank Niaga [Tirtamas]	PT Tunasmas Padurata	39.5	Commerce Asset-Holding Bhg	51 IBRA
	RHB Bena Sdn Bhd	20	(Consortium of Malaysian investors)	Others
	PT Austindo Teguhjaya	10.5		4
Bank International Indonesia (BII) [Sinar Mas]	PT Sinar Mas Multiartha	51	Sorak Financial Holdings Pte. Ltd	51 IBRA
	Publically listed shares		(Consortium of Temasek Group of Singapore and Kookmin Bank of Korea)	Others
				6.5
				42.5

But, continued state presence in the sector as well as BI screening over significant foreign banking acquisitions mean that the Indonesian banking sector has undergone a far less radical transformation with respect to how credit allocation decisions are made than one might initially assume. The state's continued fundamental control over credit allocation is also highlighted by several recent banking law decisions that are making the domestic banking sector less open to foreign equity. A 2012 decision to halt a foreign acquisition of Bank Danamon along with a new complex banking law that limits individual firms and individuals' bank equity holdings has made it impossible for a foreign bank to take immediate majority ownership in an Indonesian bank (Robson and Loveless 2012). In other words, Indonesia's banking sector reforms in the wake of the 1997 crisis introduced foreign equity participation in the sector without fundamentally weakening the state's substantial control over credit allocation. Local banks linked to family-owned conglomerates lost their ability to provide cheap leverage to their business partners, but state-owned banks are still large players in the domestic credit market and continue to provide substantial lending services to well-connected firms.

Malaysia

Malaysia pursued a different response to its twin banking and currency crisis. Unlike Indonesia, it resisted IMF concessional lending in favor of a heterodox policy response aimed at protecting the domestic banking sector from foreign takeovers and preserving macroeconomic policy autonomy. Malaysia's go-it-alone strategy in large part reflected its relatively strong fiscal position and the fact that its banks were not as deeply distressed as were Indonesia's, primarily because prudential regulation prevented Malaysian banks from amassing the same level of foreign-asset denominated debt from abroad. It also reflected considerably more preference homogeneity among business elites. Most Malaysian firms preferred adjustment through

temporary capital controls and a re-pegged ringgit, primarily because the most politically important business interests had predominately fixed capital assets (Pepinsky 2012). Mobile asset holders who were disadvantaged by capital controls were mostly ethnic Chinese Malaysians and largely marginalized from politics (Pepinsky 2008a, 2012).

The politics of rejecting IMF assistance clearly reflected a commitment to the NEP. In Prime Minister Mahathir's 19 June 1998 address to the UMNO General Assembly, he stated:

[I]f we have to resort to the International Monetary Fund assistance ..., the conditions imposed by the IMF will require us to open up our economy to foreigners. There will not be any *Bumiputera* quota as the New Economic Policy is an injustice, and unacceptable to their liberal democracy (as quoted in Athukorala 2010, 16).⁸⁷

At the same time, the Malaysian government's decision to protect local banks meant it did not have access to foreign bank assets. As a result, while the goals of local equity ownership were deepened in the financial sector, the ensuing credit crunch led to a relaxation of foreign equity restrictions in the real sector (Cook 2008). In other words, Malaysia *did* open its economy to foreign equity as a result of the crisis. However, the process of opening was deliberate and unfolded as credit conditions made Malaysian business groups embrace liberalization.

Indonesia chose to recapitalize banks through foreign acquisition. Malaysia, in contrast, used two state-owned special entities to facilitate consolidation and recapitalization. First, through a special act of parliament the government created *Pengurusan Danaharta Nasional* (Danaharta) in 1998 as a special vehicle owned by the Ministry of Finance and tasked with acquiring NPLs from local banks at a discount. This allowed banks to clean up their balance sheets and unload toxic assets. Danaharta acquired NPLs with a face value of 47.49 billion ringgit or 43 percent of all NPLs in Malaysia at an average discount of forty percent. BNM

⁸⁷ Dato' Seri Bin Mohamad Mahathir, *Currency Turmoil: Selected Speeches and Articles by Prime Minister of Malaysia*, (Kuala Lumpur: Lomkokwing Integrated), 60-61.

subsequently established a special purpose vehicle, Danamodal, to provide liquidity to local banks. Over the course of the crisis, Danamodal injected close to 8 billion ringgit into ten of the largest Malaysian banks. Both entities were funded by state-guaranteed local bond issues that were mostly held by state pension and investment funds. In this way, the Malaysian government chose to socialize the cost of bank recapitalization rather than open the banking sector to foreign equity. The total cost of recapitalization reached 60 billion ringgit. Danamodal closed out its mandate in 2003; Danharta followed in 2005.

The government also intervened to guide bank consolidation. However, while Indonesia's crisis response led to an increased importance of both foreign and state banks, consolidation in Malaysia did not fundamentally alter the distribution of bank equity among the state, local, and foreign investors. Instead, BNM issued a plan in July of 1999 in which small local banks would be required to merge quickly with six chosen "anchor" banks. Many banks balked at this plan both because the BNM mandate did not allow banks to negotiate their own mergers but also because the choice of anchors was seen as a way for the new Finance Minister Diam Zainuddin to punish political allies of the disgraced former Finance Minister and Deputy Prime Minister Anwar Ibrahim.⁸⁸ Subsequently, BNM modified the plan to allow existing banks to choose which of a list of ten anchor banks they would merge with. Table 6.2 shows the results of the consolidation.

⁸⁸ Anwar led a coalition of neoliberal reformers from within the UMNO to challenge Prime Minister Mahathir's response to the financial crisis. Central to his argument was the ruling party manipulated the NEP to further enrich well-connected *bumiputeras* while failing to lift ordinary citizens out of poverty. His orthodox economic preferences gained him vocal allies among foreign business communities and he was removed from his posts in September 1998. That October he was jailed after leading public rallies for reform.

Table 6.2 Final anchor bank groupings

<i>Anchor bank</i>	<i>Merged banks</i>	<i>Total assets (billion ringgit)</i>	<i>Anchor bank asset growth</i>
Malayan Bank	Pacific Bank, Phileo-Allied Bank	117.5	16%
Bumiputra-Commerce Bank Utama	None RHB Bank	82 64.9	- 656%
Public Bank	Hock Hua Bank	50.9	13%
Arab-Malaysian Bank	None	41.1	-
Multi-Purpose Bank	Sabah Bank, International Bank Malaysia	38.3	40%
Perwira Affin Bank	Bank Simpanan	33.1	34%
Hong Leong Bank	Wah Tat Bank	30.2	4%
Southern Bank	Ban Hin Lee Bank	25.1	77%
EON Bank	Oriental Bank	23.6	71%

Source: (Cook 2008, pg. 93)

Note: Asset growth calculation only includes commercial bank assets

Malaysia's statist approach to banking sector recapitalization and restructuring, along with its continued commitment to preserving high local equity ownership requirements in the sector have lead some to argue the financial crisis amounts to a missed opportunity for banking sector reforms (Cook 2008). However, this interpretation is misguided. While Malaysia remained restrictive of foreign entry,⁸⁹ crisis response led to greater banking sector reform in two key areas: privatization and prudential regulatory oversight. Both of these reforms led to increased competition and more market-based credit allocation decisions, which reflect in Malaysia's lower net interest margins compared with Indonesia (See table 6.3).

⁸⁹ And, as will be describe in greater detail below, the Malaysian financial sector has subsequently undergone multiple reforms that have reduced, but not eliminated, restrictions to foreign bank entry.

The first area of banking reform is privatization. Ownership structures of Malaysian banks are typically challenging to assess since banks are primarily owned through publically listed shares. Therefore, even though state investment vehicles frequently hold shares of banks, they do not hold majority positions. Before the crisis, the government of Malaysia held a significant equity stake in both Bank Bumiputra and Sime Bank. Both of these banks were heavily exposed to NPLs, and their size along with their quickly eroding balance sheets led the government to find local buyers for these institutions in 1998, before the creation of Danaharta and Danamodal. Bank of Commerce acquired Bank Bumiputra and RHB Bank acquired Sime Bank, each with generous terms from the government including a guaranteed ability to unload NPLs to Danaharta at face value (Cook 2008, 88-89). These mergers effectively diluted the government's equity share in these banks to the point that the state owned less than 30 percent of each of these merged banks; RHB's acquisition in 1999 by Utama Bank further reduced government's ownership in the banking system.

Some observers have emphasized the state's continued equity stakes in these banks through GLIC holdings in bank parent companies. However, while government ownership of banking assets in 2011 was close to 23 percent when measured on an effective interest basis (OECD 2013, 32), the state no longer has a majority stake in any domestic bank.⁹⁰ Furthermore, unlike typical models of state-owned banks, government ownership of banks in Malaysia is indirect; GLCs take equity participation through investment vehicles that make them primarily responsible to unit holders investing for profit rather than government officials (OECD 2013). Furthermore, unlike banks owned directly by state entities, banks in Malaysia with GLC equity

⁹⁰ Databases that define state-ownership as 50 percent or greater record Malaysia as having no state-owned banks. See, for example, Hankins and Minhaljek (2001).

participation do not benefit from soft financing constraints.⁹¹ In other words, while the Malaysian government does retain passive equity holdings in several domestic banks through its GLICs, the state relinquished much of its control over banks in response to the 1997 financial crisis. Unlike Indonesia, the Malaysian government does not operate banks and no banks in Malaysia enjoy an implicit and open-ended funding guarantee from the central government.

Second, the Malaysian government increased prudential regulation after temporarily easing rules on classifying non-performing loans during the height of the crisis.⁹² In 1997, Malaysia already complied with 23 of the 25 core principles of the Bank for International Settlements. However, the government responded to the financial crisis by deepening prudential regulations, particularly by shifting from a compliance-based to a risk-based approach to supervision. The government devised the Financial Sector Master Plan (FSMP) and a series of Capital Market Master Plans in consultation with the private sector to develop a plan for strengthening regulatory framework while deepening access to bank-based and market-based finance and gradually increasing foreign participation in the financial sector (OECD 2013). As a result, several programs aimed at increasing regulatory oversight were implemented in the following decade. In 2004, Malaysia adopted Basel II standards. In 2005, it created a deposit insurance system; Perbadanan Insurans Deposit Malaysia. The Central Bank Act of 2009 increased BNM's surveillance and supervisory capabilities. In 2010, the Credit Reporting Agencies Act created a centralized bureau for collecting information about creditworthiness. In

⁹¹ See Gonzalez-Garcia and Grigoli (2013) for a detailed discussion of soft financing constraints and state-owned banks. See Ramírez and Hui Tan (2004) for econometric evidence GLCs do not have preferential credit access in the Singaporean context.

⁹² BNM temporarily allowed banks to extend the arrears window on loans from three to six months (Cook 2008).

January 2012, Malaysia became fully compliant with International Financial Reporting Standards.

In particular, increased prudential regulation raises the cost of debt financing relative to equity sources of investment, at least for large firms that benefit from loose regulatory standards.⁹³ Indeed, we can see the effect regulatory reforms had on reducing preferential access to finance of large, politically connected industries by the extent to which smaller firms, the traditional losers of financial repression,⁹⁴ benefited from reforms. Interest rates for SMEs averaged below 5 percent from 1998 to 2005; as a result, their share of total corporate lending increased from 27 percent in 1998 to 40 percent in 2009 (OECD 2013).

Finally, under the Financial Sector Master Plan, the Malaysian government is gradually opening the domestic banking sector to increased foreign competition. In 2003, the government ended its requirement that foreign firms raise 50 percent of their locally-required credit from local banks. As table 6.6 indicates, Malaysia has recently pursued a number of reforms aimed to increase the operational freedom of incumbent foreign banks. In 2006, BNM announced foreign incumbent banks would be eligible for up to four new licenses. In addition to relaxation of foreign equity requirements in Islamic banking, the government also began to issue new foreign bank licenses in 2009. The lifting of foreign bank ATM restrictions in 2011 removed a major barrier to foreign banks trying to compete for retail customers (OECD 2013).

Post Crisis Banking Sectors Compared

As detailed above, Indonesia and Malaysia pursued different crisis response strategies in the wake of the Asian financial crisis and these strategies affected banking sector structure and

⁹³ See Rosser (2004), Pepinsky (2013a).

⁹⁴ See Rajan and Zingales (2003) and Abiad & Mody (2005) for further discussion of why small firms are disadvantaged by financial sector repression.

competition. Table 6.3 reports key banking sector indicators in Indonesia and Malaysia from 1990 to 2010. We see how key measures of banking sector performance have diverged post-crisis. For example, both countries experienced a decline in the percentage of bank assets that are state owned, but in Indonesia the state owns more than half of all banking assets while the Government of Malaysia owns less than one percent of all banking assets in its country. Data on net interest margin, a common indicator of profitability, is not available pre-crisis, however we see that Indonesia has an average net interest margin twice as large as Malaysia; this indicates the Malaysian banking sector is more competitive than is Indonesia. Furthermore, net interest margin in Malaysia is comparable to averages in advanced industrial countries with more highly developed financial sectors.

Table 6.3 Indonesia and Malaysia Banking Sector Indicators 1990-2010

Indonesia	1990	1995	1997	1998	2000	2005	2010
Bank Credit to Deposits ¹	131	121.6	118.2	95.9	40.4	65.8	75.9
Bank Deposits to GDP ¹	30	39.2	46	48.9	44.7	35.6	31.9
% Bank Assets State Owned ²	55		72.8		55.1		45.2
% Bank Assets Foreign ³	4		9		31	32	46
Concentration ¹		72.8	43.4	40.2	64.3	42.9	44.8
Net Interest Margin ¹				-3.86	2.47	5.81	6.64
Return on Equity ¹				408.3	5.59	16.3	20.2
Malaysia							
Bank Credit to Deposits ¹	126.5	120.2	140.5	134	112.3	97.36	89.1
Bank Deposits to GDP ¹	80.6	94.99	102.1	113.1	107.6	105.9	119
% Bank Assets State Owned ²			13.05			0.45	
% Bank Assets Foreign ³	24	18	18	18	18	17	18
Concentration ¹			43.95	41.26	50.27	49.56	54.2
Net Interest Margin ¹				3.17	3.37	3.5	2.99
Return on Equity ¹				0.16	12.29	18.77	15.7

1) IMF Financial Development and Structure Dataset

2) 2 Cornett, Guo, Khaksari, and Tehranian (2009); IMF (2012); State-owned defined as at least 20% stake

3) Claessens and Van Horen (2012); Foreign-owned defined as at least 50% stake

The indicators in Table 6.3 as a whole suggest the financial sector in Indonesia, though it became less concentrated after 1997, retains several key characteristics of repression. The state directs a large share of credit allocation decisions due its ownership of close to half of all bank assets. Banks are relatively well protected from competition, as indicated by high net interest margin and return on equity. Financial development remains weak, as denoted by a bank credit to deposit ratio around 76 percent and a bank deposit to GDP ratio close to 30 percent.

In contrast, Malaysia's banking sector, as a result of its restructuring post-crisis, displays the hallmarks of financial sector development and liberalization. While bank credit to deposits is lower than its 1997 peak of 140 percent, it is close to 90 percent and bank deposits to GDP reached a peak in 2010 at 119 percent. While the percentage of bank assets owned by foreigners has remained steady at 18 percent, the state has largely divested its control of bank assets. While bank concentration has increased since 1997, this has not been through nationalization. As a result of these liberalizing measures, banks in Malaysia face similar levels of competition as do their counterparts in advanced industrial economies. This is illustrated by Malaysian banks' relatively low net interest margin and return on equity averages post-crisis.

Disparate crisis-response policies, therefore, resulted in quite different banking sector structures in Indonesia and Malaysia. The fundamentals of the Indonesian financial sector indicate a repressed system with credit rationing in which large and politically powerful firms receive preferential lending terms, banks are insulated from competition, and smaller and less politically connected firms are denied debt financing. Malaysia, in contrast, has continued to develop and deepen its financial sector by privatizing and liberalizing the sector. As we will see below, these developments have implications for societal support for liberal FDI policy. The Indonesian government is still able to leverage its financial system to provide preferential credit

to key supporters. Access to subsidized debt financing has encouraged the most important business groups in Indonesia to actively lobby to increase foreign equity restrictions; this has substantially stalled and even reversed FDI policy reforms. Debt finance in Malaysia is no longer driven by state preferences and bureaucratic favors. The decoupling of the state and the banking sector has led to increased competition among banks, increased access to debt finance for smaller and less politically powerful firms, and the decline of subsidized credit to politically important corporations and industries. As a result, business groups in Malaysia have substantially changed their lobbying strategy over FDI policy from one of advocating regulatory exclusion to one that champions liberalization. This strategic shift has motivated the Malaysian government to gradually reduce barriers to FDI even in the face of opposition from *bumiputera* workers who may not be well organized, but who form an important base of support for the ruling UMNO.

Investment Policy Politics

In this section I outline the politics of investment policy in Indonesia and Malaysia from 1997 to 2013, paying particular attention to lobbying efforts of business groups. As described below, Indonesia underwent immediate but partial FDI reform following 1997. After IMF pressure to liberalize foreign equity restriction subsided, however, reform efforts stalled and then backtracked significantly starting in 2009. These policy developments reflect the policy preferences of politically important business groups that have consistently lobbied to protect domestic firms from foreign entrants. Indonesian business interests have largely relied on state-led credit allocation to finance investment and industrial expansion while eschewing FDI except in specific circumstances. Malaysia's approach to FDI liberalization has been more gradual but consistent. Following a substantial change to the banking sector following the 1997 financial crisis, business leaders increasingly looked to foreign firms as sources of investment equity.

Malaysia's long history of consulting closely with business groups has led to substantial opening of the economy to foreign entrants, and with increasingly less oversight.

Indonesia

As figure 6.1 indicates, Indonesia experienced a rather immediate but partial FDI liberalization following the 1997 crisis, mostly at the instance of the IMF. Afterward, however, reform stalled. A new investment law was passed in 2007, but did not result in substantial openness; Indonesia's performance on the OECD FDI restrictiveness index did not change as a result of the new law. Moreover, in recent years Indonesia has seen an increase in FDI restriction, especially with respect to mining, agriculture, and processing these raw materials. The Indonesian Chamber of Commerce and Industry (KADIN) has used its influence in BKPM and PEPI to spearhead this protectionist push. As a result, in 2013, Indonesia had an FDI policy climate that was more liberal than it was in 1997, but substantially more restrictive than most countries for which the OECD monitors investment climate.

Initial post-crisis FDI reform was driven by a decision to liberalize the banking sector to recapitalize failing domestic banks and IMF conditionality that demanded decreased foreign equity restrictions in several key sub-sectors including retail and wholesale trade and palm oil plantations.⁹⁵ The IMF also initially demanded a revision of Indonesia's negative list, which was originally scheduled to be completed by 30 June 1998. However, this condition was subsequently dropped in the 19 October Letter of Intent (LOI). The decision to eliminate this requirement and focus conditionality on bank restructuring and fiscal discipline was in part due to the more immediate needs of crisis response, but also reflected targeted push back by Soeharto with respect to FDI liberalization. According to J. Soedradjad Djiwandono, former Governor of

⁹⁵ IMF – Indonesia 10 April 1998 Letter of Intent Appendix, pg. 15

the Bank of Indonesia, Soeharto explicitly stated in a 21 January 1998 cabinet meeting that he was unprepared to comply with the LOI's condition of eliminating foreign equity restrictions stating "the national development that was based on the development trilogy as stated in the state guidelines has been securely ingrained in our society" (Djiwandono 2005, 163).

Unlike foreign equity restrictions in the banking sector, which were quickly eliminated after Soeharto's departure from power, FDI policy toward the real sector was not fundamentally altered following regime change. Instead, the government of Indonesia has continued to pursue an FDI policy that is fundamentally targeted and conditional in nature, meaning it uses an array of fiscal and legal incentives to attract FDI into sectors it wishes to promote while maintaining high levels of restrictions on FDI in sectors it wishes to protect for indigenous firms. This guiding policy framework has been implemented through the 2007 Law on Investment, which mostly clarified rather than liberalized FDI policy, and increased efforts to implement targeted investment incentives. Investment policy has become more restrictive since 2009, with the passage of a protectionist mining law and a series of investment regulatory decisions that are widely seen as illiberal.

Table 6.4 FDI liberalization in Indonesia 1997-2010

1997	Presidential Decree removes 49% foreign equity limit on purchases of listed shares
1998	Full foreign ownership allowed in banking
1999	BKPM no longer requires Presidential signature for approvals
	Local content program for motor vehicles phased out
	Fully foreign ownership of holding companies allowed, including through acquisitions
	Several sectors opened further to FDI, including retail, general importing, palm oil plantations, broadcasting and downstream operation in the oil sector.
2007	Investment Law does away with general divestiture requirements
	New Negative List opens some sectors to greater foreign participation
2009	Mining Law allows foreign ownership of concessions

	Electricity Law allows for private operators in areas not served by PLN
2010	New Negative List opens some sectors to greater foreign participation

Source: OECD 2010, 45

As table 6.4 indicates, Indonesia made no major alterations to its FDI law between 1999 and 2007. In 1999, to comply with IMF loan conditions, several sectors were opened to FDI by presidential decree. The next notable change to investment law came in 2007 with the passage of the 2007 Law on Investment, which replaced the 1967 law and unified the investment code for foreign and domestic investors. The government engaged in extensive consultation with business groups as it prepared the law. BKPM held multiple advisory meetings with chambers of commerce and investor groups, both foreign and domestic in origin. But, as the primary lobbying group for domestic investors, KADIN was the most influential business group in pre-legislative discussions (OECD 2010). The law was applauded mainly for clarifying regulations and procedures that had previously been confusing. In particular, it provided guidance on investment licensing procedures and on restricted sectors. At the same time, it failed to reform land ownership restrictions and has been accused of fostering the impression that foreign equity restrictions are arbitrary and subject to capricious manipulation by bureaucrats.

First, the 2007 Investment Law clarified and, in some ways, simplified investment licensing procedures. The BKPM is in charge of investment licensing; administering licenses now comprises 70 percent of its operating budget (OECD 2010, 90). Unlike in earlier years, the BKPM's screening authority is limited to ensuring investment proposals comply with current laws, especially foreign equity restrictions. BKPM is not endowed with the power to reject investment applications for any other reason, including vague considerations of the "national interest." Importantly, the 2007 law provides investors the right to sue if their proposals are rejected on grounds not stipulated in law. However, the investment licensing process is much

more complex than the 2007 reform suggests due to the 1999 Regional Autonomy Law (RAL). The RAL granted broad licensing authority to subnational governments, which has led to a fragmented and overlapping licensing and permitting environment.

Investment approval from BKPM is just the start of a complex set of licenses and approvals investors must obtain from a variety of central and regional government agencies. Companies are required to obtain several different kinds of onerous permits before participating in government tenders or applying for bank loans. Local governments' regulatory authority means BKPM cannot mandate streamlining of regulatory procedures nor require provinces to set up "one-stop-shops" for obtaining business licenses. As a result, there is a large regional disparity in ease of doing business; the Jakarta Special Capital Region is generally held as an example of a foreign investor-friendly regulatory environment while many more rural provinces rich in natural resources tend to have much more complex and onerous licensing requirements (OECD 2010). Foreign investors have repeatedly voiced their frustration with decentralization of business licenses and approval, arguing such policies create legal uncertainty and expose firms to the whims of local leaders.⁹⁶ However, KADIN and its affiliates actively lobbied for decentralized licensing and permitting procedures because they view their local political ties as a comparative advantage vis-à-vis foreign firms (IBC 2007). Moreover, since domestic investors only require local approval, foreign firms complain the national level BKMP screening is discriminatory against FDI (U.S. State Department, 2013).

In addition to a complex screening process that discriminates against foreign investment and was promoted by local business interests, the 2007 Investment Law also included a new and

⁹⁶ Shoeb Kagda, "Jakarta Needs to Engage Provinces; It Must Work with Provinces in Reforming Cumbersome Regulations Imposed by Regional Governments," *The Business Times Singapore*, 15 February, 2005.

expanded negative list of subsectors in which foreign investors face equity ceilings. The revised negative list included 338 subsectors subject to foreign investment limits, which was a large increase for the 83 subsectors included on the previous negative list.⁹⁷ Energy, plantation agriculture, and mobile and fixed-line telecommunications all experienced increased restrictions; fixed-line telecom saw the most substantial closure from a 95 percent foreign equity cap to a required minority position (49 percent). Mari Pangestu, the Trade Minister at the time, maintained the new list was formulated to protect “national interests,” while regional news analysts argued the restrictive list reflected the government’s need to bolster support among indigenous business groups in the run up to the 2009 elections.⁹⁸ The composition of the negative list reflects the government’s long-standing policy of protecting small and medium sized indigenous firms from foreign competition, and the 2007 investment reforms also included extensive state-led credit programs aimed at financing local companies (OECD 2010). Importantly, the 2007 Investment Law places authority over the negative list with the executive and does not require parliamentary approval.

In tandem with the new investment law, the government of Indonesia also introduced a new incentive program. Foreign investment incentives have been contentious in Indonesia. Incentives were first introduced in 1967, canceled in 1984, reinstated in 1996, and again canceled in 2000. The 2007 re-introduction of incentives had several key features including an expanded role for BKPM. Under the new law, foreign investors wishing to qualify for incentives must apply to the BKPM, which evaluates applications based on a range of factors including: employment creation potential, whether the proposed investment would contribute to

⁹⁷ Bill Guerin, “Indonesia Blacklists FDI,” *Asia Times Online*, 10 July, 2007.

⁹⁸ Bill Guerin, “Indonesia Blacklists FDI,” *Asia Times Online*, 10 July, 2007.

infrastructure construction or technology transfer, whether the proposed investment is a priority activity or a pioneer industry, whether the project would be located in a depressed area or promote environmental sustainability, and whether the project will contribute to local business development through research and development, local partnership, or by using local content. If BKPM thinks the project deserves fiscal incentives, it forwards a recommendation to the Ministry of Finance. If the Ministry of Finance concurs, it publishes individual decrees to authority incentives for specific projects.

The framework of incentives and conditions for eligibility are controlled by the National Team on Export and Investment Promotion (PEPI), which was formed in 2003, is chaired by the president, and includes extensive involvement of BKPM and KADIN officials. The targeted nature of these incentives, combined with individual project eligibility screening requirements, further indicate the extent to which Indonesian FDI policy remains fundamentally conditionally open in construction. A 1999 review of ASEAN FDI policy review is particularly negative toward such screening boards:

The screening agency serves a political purpose as well as an economic one. It demonstrates to a local population, which may be hostile to, or suspicious of, foreign investment, that such investments are actively monitored by the government. The principal aim of such an agency, however, is to further the development strategies of the host government. The agency will favour certain sectors on a priority list or those investors that fulfill pre-established criteria, usually related to exports. (Thomsen 1999, 19)

KADIN's influence in BKPM, especially since the two signed a memorandum of understanding in 2009, further ensures FDI incentives target projects that benefit local partners (OECD 2010, 89).

Despite tentative movements toward openness described above, Indonesia has experienced backtracking with respect to FDI policy since 2009. The 2009 Mining Law is a

prime example of such protectionism. Mining investments had previously been regulated through a 1967 law that had been widely seen as stable and transparent, but had become increasingly difficult to sustain after the 1999 RAL. The 2009 Law stipulates several conditions that discriminate against foreign investors. For example, foreign operators must transfer 20 percent of project equity to local private or public investors within nine years of the initial investment. Regional powers have created more uncertainty over foreign ownership, sometimes canceling mining licenses without warning or clear cause.⁹⁹ Additionally, the law places restrictions on foreign-owned mining services companies, requiring all refining and processing to occur locally and phasing out foreign-owned service companies as local firms develop greater technical capabilities. KADIN officials stated publically in 2012 they were actively campaigning to further restrict foreign investment in mining through the elimination of profit-sharing and long-term mineral rights to foreign entities.¹⁰⁰

The backsliding in foreign mining rights is indicative of a broader pattern of policy slippages in Indonesia due to consistently positive economic performance. KADIN officials have argued Indonesia's strong growth indicates, "it may be time to complete Sukarno's 1958 revolution, [and] kick out the foreigners."¹⁰¹ This anti-FDI sentiment reflected in Bank Indonesia's blockage of a domestic bank's acquisition by a Singaporean holding company in April 2012, an announcement of new foreign equity restrictions in banking in the same month,

⁹⁹ Eric Bellman, "Regional Powers Sting Firms in Indonesia," *The Wall Street Journal*, 8 October, 2013.

¹⁰⁰ John Berthelsen, "Indonesia Makes Tracks for Economic Nationalism," *The Nation*, 12 June, 2012.

¹⁰¹ John Berthelsen, "Indonesia Makes Tracks for Economic Nationalism," *The Nation*, 12 June, 2012.

and a series new regulations since October 2011 aimed at protecting the local palm oil refining industry.¹⁰² KADIN has been particularly vocal about increasing FDI restrictions in anticipation of the scheduled 2013 revision to the negative list, which had not been announce as of January 2014. KADIN had successfully lobbied for further protection of domestic retail businesses in previous negative list revisions, and petitioned hard for restrictions in the wholesale distribution industry. A KADIN spokesman Fernando Hutahaeen argued for a 30 percent equity cap on foreign investors in the subsector arguing, “The wholesale distribution business does not need huge capital or high-end technology to be developed. National players already have the skills. Foreign investment should be directed to a sector in which we lack capability.”¹⁰³ This statement reflects a general sense among KADIN officials that the government of Indonesia should emulate China’s FDI policies that limit FDI to priority sectors and then guide domestic acquisition of foreign holdings after sufficient technology transfer has occurred.¹⁰⁴

Indeed, a close look at Indonesia FDI policy indicates the government’s focus on finding foreign equity partners to finance major infrastructure projects through public-private partnerships (PPPs).¹⁰⁵ Local business leaders support such moves because inadequate roads, electricity, telephony, and internet connectivity are some of the largest impediments to growth in

¹⁰² John Berthelsen, “Indonesia Makes Tracks for Economic Nationalism,” *The Nation*, 12 June, 2012.

¹⁰³ “Indonesia Commerce Body Urges Government to Restrict Foreign Investment,” *BBC Monitoring Asia Pacific*, 25 October, 2013.

¹⁰⁴ “Indonesian Economists Discuss Chamber of Commerce’s Economic Road Map,” *BBC Monitoring Asia Pacific*, 9 November 2009.

¹⁰⁵ “Larger Share of Foreign Ownership in Indonesia’s Infrastructure Projects,” *Indonesia Investments*, 27 December 2013.

the country.¹⁰⁶ Lack of infrastructure has become even more problematic in the aftermath of the 2004 tsunami and technological and financing constraints make many of these projects untenable through purely domestic input. Most liberalizing revisions to the negative list have been in infrastructure to accommodate this pressing need, but many in the domestic and foreign business communities view equity limits in these areas to be unstable and that the government will place increasing foreign equity restrictions on infrastructure once a sufficient number of high-priority projects are complete (OECD 2010, 135).

As a result of these policy changes, Indonesia's investment climate is best characterized as protectionist and unstable. An Asian Development Bank survey of firms in 2003 found 70 percent of firm indicated policy uncertainty was a major obstacle to business (ADB 2005). The 2007 Investment Law clarified equity restrictions, but also increased investor perception that the negative list is unstable and arbitrary.¹⁰⁷ Moreover, the OECD measure of FDI restrictiveness finds protectionist backsliding since 2010. The restrictive stance of Indonesia's FDI policy seems strange given severe long-term credit rationing. KADIN has identified long-term credit expansion as a primary need of the local business community.¹⁰⁸ According to a 2009 World Bank Enterprise Survey, 47.9 percent of Indonesian firms identify access to finance as the most important constraint on business development (World Bank 2009). The same survey of 1044 businesses found financing constraints were most severe for small and medium firms with 99

¹⁰⁶ "Taking a Closer Look into Kadin's Economic Road Map," *The Jakarta Post*, 7 November, 2009.

¹⁰⁷ Laurel Teo, "Indonesia's New Investment Rules add to Confusion; Chambers say Many Grey Areas in Caps on Foreign Stakes," *The Business Times Singapore*, 13 July, 2007.

¹⁰⁸ "Taking a Closer Look into Kadin's Economic Road Map," *The Jakarta Post*, 7 November, 2009.

employees or less; large firms were more worried about the regulatory environment and inadequate infrastructure (World Bank 2009, 4).

This divide between large and small firms is unsurprising; in a repressed financial system, smaller firms experience credit rationing while large and politically powerful firms receive preferential access to credit instruments. However, given the state's dominance in the banking sector, with a 50 percent market share, lobbying efforts from the business community have focused on state-led credit expansion programs rather than further banking sector and FDI liberalization.¹⁰⁹ The government has even pursued increasing equity restrictions in the banking sector in recent years. While the lack of sufficient long-term credit and an increasingly hostile policy environment toward FDI seems counter-intuitive, this dynamic is explained well by the overarching theory of this dissertation. When credit allocation decisions are largely driven by the state rather than by the market, the most politically connected firms will receive subsidized credit while their competitors are left out. Under these conditions, these politically connected firms will prefer to prevent foreign entry in order to capitalize on a larger slice of a smaller pie.

Malaysia

Unlike Indonesia, Malaysia's statutory restrictions on FDI did not change immediately following the financial crisis. This is largely due to the fact that Malaysia was not subject to IMF conditionality and it did not stabilize the banking sector through foreign acquisitions. However, the tenor of FDI policy did change substantially, if gradually, in the decade following the crisis with no major policy reversals; Table 6.6 outlines these changes. Before the crisis, Malaysia's investment policy stance reflected partial openness to foreign investment that encouraged export-

¹⁰⁹ "Taking a Closer Look into Kadin's Economic Road Map," *The Jakarta Post*, 7 November, 2009.

oriented investment under very specific conditions while greatly restricting domestic market-oriented foreign investment activities. The government responded ad hoc to crisis by temporarily lifting equity restrictions in the manufacturing sector in 1998.¹¹⁰

Table 6.5: Malaysia FDI Liberalization, 1998-2012

1998	Temporary relaxation of foreign ownership and export requirements for manufacturing companies not directly competing with local producers (with certain sectoral exceptions).
	Foreign equity allowed in wholesale and retail companies raised from 30% to 51%
	Foreign equity allowed in telecommunications companies raised from 30% to 49% (61% on a case-by-case basis in mobile telephony), provided that the investor reduces the share to 30% within five years.
2003	Removal of requirement that foreign-controlled companies obtain 50% of their local credit from Malaysian banks.
	Insurers with FDI > 51% have greater operational flexibility to open up to two branch offices in one year.
	Relaxation of guidelines for foreign equity participation in local firms which previously stipulated a 30% limit on foreign equity.
	Indefinite extension of policy permitting 100% foreign ownership in new investment and expansion of existing investment in manufacturing and removal of sectoral exceptions.
	New guidelines on employment of expatriates in manufacturing: companies with paid-up capital of at least USD 2 million receive automatic approval for up to 10 expatriate posts.
	Three new Islamic banking licenses offered to foreign players, with foreign equity participation up to 100%.
	Four new Islamic insurance (<i>takaful</i>) licenses offered, with foreign participation up to 49%
2005	Foreign equity participation in Islamic subsidiaries of domestic banks raised from 30% to 49%.
	Foreign equity participation in investment banks and <i>takaful</i> operators raised from 30% to 49%.

¹¹⁰ Because these equity restrictions were at first only temporarily repealed, the OECD measure of FDI Restrictions does not measure a change until 2003 when the ability of foreign firms to establish wholly owned subsidiaries in the manufacturing sector became permanent (OECD 2013).

	March licenses for 5 foreign stock brokerage firms and 5 global fund management firms to operate in Malaysia. Venture capital firms can be 100% foreign-owned.
	Foreign-controlled companies no longer face domestic borrowing requirement or require BNM approval for any amount of ringgit credits.
2006	Locally-incorporated foreign banks are to be allowed to open up a 4 additional branches based on a distribution ratio of 1 (market center), 2 (semi-urban), and 1 (non-urban).
	Foreign equity participation in insurance sector raised from 30% to 49% for new foreign shareholders and up to 51% for the original foreign shareholders of locally incorporated insurance companies.
	New licenses offered for international Islamic banks and international <i>takaful</i> operators. Foreign equity participation permitted up to 100% and both branches and subsidiaries allowed.
	Government announces intention to allow spouses of foreign expatriates to work.
2008	A further foreign stockbroking licenses announced.
2009	Two new Islamic banking licenses offered, with a minimum paid-up capital of USD 1 billion and with foreign equity participation for these new licenses permitted up to 100%.
	Two new family <i>takaful</i> licenses offered, with foreign equity participation permitted up to 70%. Foreign equity participation increased from 49% to 70% for investment banks, insurance companies and <i>takaful</i> operators and from 70% to 100% for fund management companies providing wholesale services. A foreign equity limit above 70% for general insurance companies to be considered on a case-by-case basis to facilitate consolidation and rationalization of the general insurance industry.
	Flexibility to increase foreign equity participation from 49% to 70% for existing domestic Islamic banks wishing to scale up operations by entering into strategic partnerships with foreign players, and maintaining a paid-up capital of at least USD1 billion.
	Locally-incorporated foreign insurance companies and <i>takaful</i> operators allowed to establish branches nationwide, and to enter into <i>bancassurance/ bancatakaful</i> arrangements with banks, without restriction.
	Locally-incorporated foreign banks allowed to establish up to four new branches in 2010 based on a distribution ratio of 1 (market center): 2 (semi-urban): 1 (non-urban) (additional to the four allowed in 2006 and up to ten microfinance branches).
	Five new commercial banking licenses offered to foreign players bringing in specialized expertise and world-class banks offering significant value propositions.

	Elimination with immediate effect of foreign equity restrictions in 27 service sub-sectors (incl. health and social services, tourism, transport, business and computer services).
	Some relaxation of rules on foreign property ownership: property transactions over RM 500 000 for commercial, industrial and agricultural land no longer require FIC approval.
	100% foreign equity allowed in some maritime services.
	Deregulation of FIC guidelines: the FIC no longer processes any acquisitions, mergers or takeovers nor imposes equity conditions.
	Foreign equity guidelines in air transport to be set by regulator and no longer fixed at 30%.
2011	Flexibility from complying with the distribution ratio requirement for locally-incorporated foreign banks that have fewer than eight branches and have yet to establish new branches.
	Announcement that another 17 service sub-sectors would be liberalized in 2012.
	Equity in stockbroking companies fully liberalized.

Source: OECD 2013, pgs. 58-59

Over the next decade, a long process of consultation with local business developed a coalition that supported major liberalizing reforms. These reforms were guided by the New Economic Model, which identified investment as most important component of Malaysia's strategy to become an OECD country by 2020, and the Industrial Master Plan of 2006-2020, which focused its attention on attracting more FDI to the manufacturing and service industries (OECD 2013). A series of partial liberalizations of the financial sector starting in 2003 relaxed, but did not eliminate, equity caps on foreign equity in local banks and insurance firms. Issuance of additional traditional and *takaful*¹¹¹ banking licenses followed. In 2009, the government made a major and permanent change to investment policy when it removed Foreign Investment Committee (FIC) screening for all foreign mergers and acquisitions excepting some large real estate transactions. In addition, the FIC was no longer authorized to place equity conditions on M&A activity. The same year, the government opened 27 service sub-sectors to up to 100

¹¹¹ Islamic banking.

percent foreign ownership. In 2011, the government announced a further round of investment liberalizations in 17 service sub-sectors and a further opening of the financial sector.

The political process of FDI liberalization demonstrates a marked shift in the policy preferences of both government bureaucrats and industrial capitalists. Prior to the Asian financial crisis, the main policy objective of the government and supportive industrial capitalists was to maintain a regulatory approach of incentivizing targeted export-oriented manufacturing FDI while preventing foreign investors from meaningfully competing in the domestic market. This approach included a combination of equity restrictions on foreign participation in local business as well as strong centralized investment screening bureaucracy, the FIC, which was chaired by the Prime Minister. The FIC reviewed all applications for foreign acquisitions and approve or denied projects based on a set of criteria that emphasized contribution to the national interest and “more balanced” distribution of wealth, meaning distributing benefits to *bumiputera*.

Before the financial crisis, local chambers of commerce universally supported this strategy of partial openness. In 1992, the Malaysian government scrapped a proposed liberalization measure due to local firm opposition.¹¹² At that time, local business owners were particularly resistant to efforts to increase joint ventures between local and foreign firms.¹¹³ As late as November 1995, a coalition of Malaysian chambers of commerce including Malaysian Retailers’ Association, National Chamber of Commerce, Industry Malaysia, and International Chamber of Commerce, successfully lobbied the Domestic Trade and Consumer Affairs Ministry to implement new regulations that required wholesale and retail companies with foreign equity to

¹¹² “Industries Seek More Investment from Abroad,” *The Nikkei Weekly*, 26 September, 1992.

¹¹³ “Industries Seek More Investment from Abroad,” *The Nikkei Weekly*, 26 September, 1992.

incorporate locally and comply with more onerous performance requirements.¹¹⁴ These new laws were widely seen as implemented to protect local business owners from foreign competition.¹¹⁵ In early 1997, MITI head Datuk Seri Rafidah Aziz further clarified the government's prevailing policy of investment dualism in an address at the Malaysia-US Business Council Roundtable meeting, "We want to make sure that while welcoming foreign investors, we set a target on where exactly they can come in."¹¹⁶

In the aftermath of the crisis, local business groups along with key bureaucrats began to see investment screening, equity restrictions, and performance requirements as problematic barriers to foreign investors that needed to be removed in order to promote healthy economic growth. Reforming the FIC quickly became a focal point of negotiations around changes to foreign investment laws. The Federation of Malaysian Manufacturers (FMM) began to publically lobby the Minister of Finance to review and limit the role of the investment screening body as early as July 1998.¹¹⁷ In a memorandum prepared for dialogues with the Finance Ministry over the 1999 Budget, the most prominent chamber of commerce for local manufacturers emphasized the need to push through a number of measures designed to improve access to credit including liberalizing reinvestment allowances and extending limits on foreign currency accounts.¹¹⁸ The FMM pointed to a need to finance expansion of production capacity, particularly since the

¹¹⁴ Ester Tan, "New Rules for Wholesale, Retail Trade," *New Straits Times*, 1 November, 1995.

¹¹⁵ Ester Tan, "New Rules for Wholesale, Retail Trade," *New Straits Times*, 1 November, 1995.

¹¹⁶ "Focus on Do-Able Investment Policies," *New Straits Times*, 12 March, 1997.

¹¹⁷ "FMM Appeals for Better Export Financing Incentives," *New Straits Times*, 8 July, 1998.

¹¹⁸ "FMM Appeals for Better Export Financing Incentives," *New Straits Times*, 8 July, 1998.

depreciation of the ringgit provided an opportunity to capitalize on cheaper production costs.¹¹⁹ Foreign affiliates brought with them access to offshore sources of finance, which was crucial to overcoming credit rationing in the aftermath of the banking crisis (UNCTAD 1998).¹²⁰ To facilitate the manufacturing sector's financing needs, the FMM proposed reducing the investment screening role of the FIC, preferring that it only monitor foreign acquisitions in sectors deemed to be in the national interest, which it defined as utilities such as power generation and distribution, telecommunications, and water treatment; defense; air and seaports; and banking and financial institutions.¹²¹

The government initially responded to the FMM's demands by temporarily lifting equity restrictions in the manufacturing sector. But, this policy concession was not sufficient for local businesses, who saw FDI liberalization, particularly with respect to foreign mergers and acquisitions, as a solution to a financing gap. Chambers of commerce used the Ministry of International Trade and Industry's (MITI) annual dialogues with the business community to lobby jointly for liberalizing changes. In 2002, the Malaysian International Chamber of Commerce and Industry (MICCI), the oldest trade association in the country, and the FMM renewed their repeated calls for eliminating foreign ownership restrictions in both manufacturing

¹¹⁹ "FMM Appeals for Better Export Financing Incentives," *New Straits Times*, 8 July, 1998.

¹²⁰ A 1998 survey of electronic manufacturing foreign affiliates in Malaysia found that the majority financed operations through primarily offshore sources while less than a sixth operated through self-financing.

¹²¹ Rupa Damodaran, "Lower Energy Cost Tops Manufacturers' Wish List," *New Straits Times*, 12 June, 2009.

and services, limiting the power of the FIC, and reforming immigration rules to allow more skilled workers permanent residency in the country.¹²²

Increased support of FDI liberalization was clearly linked to the governments' decision to recapitalize the banks without allowing foreign bank takeovers. As one authority on Malaysia's crisis response puts its:

[State intervention] focused on narrowing the NEP in the real economy and deepening it in the banking sector through state-guided consolidation. The Malaysian state used this crisis to discipline the Malaysian economy in some sectors while protecting the NEP and its limits on competition in others (Cook 2008, pg. 86).

In other words, the governments' decision to preserve foreign equity limitations on banks made continued equity ceilings in other sectors untenable. This is because constrained credit made industry look to alternatives over bank-based finance. Government appeals for banks to lend were ineffective as banks worked to clean their balance sheets.¹²³ Raising foreign equity through stock offerings was unattractive due to both temporary restrictions on the capital account and because portfolio investment flows were considered a major contributor to the asset bubble and collapse in the first place. Unlike Indonesia, the Malaysian government did not directly control any local banks and therefore was unable to directly influence credit allocation decisions because they did not offer banks a soft financing constraint. The result of the government-guided banking sector restructuring actually reduced the government's concentration of equity holdings in any

¹²² Eddie Toh, "Businessmen Urge Malaysia to Ease Foreign Equity Cap in Key Sectors; They Also Seek to Mothball Foreign Investment Panel," *The Business Times Singapore*, 9 April, 2002.

¹²³ Kasmiah Mustapha, "Daim Repeats Call to Banks: Lend to Productive Sectors," *New Straits Times*, 9 July, 1999.

given bank.¹²⁴ Under these conditions, FDI emerged as an attractive financing option for the largest and most powerful industry groups.

As business support coalesced around liberalizing FDI and particularly merger and acquisition activity, the government of Malaysia announced its intention to remove the FIC approval requirement starting in August 2004.¹²⁵ The news was met with substantial approval from local and international chambers of commerce including the MICCI,¹²⁶ the FMM,¹²⁷ the American Malaysian Chamber of Commerce,¹²⁸ the British Malaysian Chamber of Commerce, and the European Union-Malaysia Chamber of Commerce.¹²⁹ However, support was not universal, with local real estate moguls arguing FIC oversight over land sales was important to prevent foreigners from acquiring excessive amounts of real property.¹³⁰

Despite the strong support from the business community, the FIC screening requirement was not removed until 2009. The delay reflected an interrelated bureaucratic power struggle between the Prime Minister and the Executive Cabinet and the political economy of *bumiputera* redistributive policy. As a result of business sector feedback from annual MITI consultations,

¹²⁴ The Abiad et al. (2008) Financial Sector Liberalization dataset codes Malaysia as shifting from a “largely liberalized” to a “fully liberalized” score for the bank privatization component of the index in 1999.

¹²⁵ “MICC Welcomes New Investment Regulations,” *New Straits Times*, 27 June, 2004.

¹²⁶ “MICC Welcomes New Investment Regulations,” *New Straits Times*, 27 June, 2004.

¹²⁷ G. Umakanthan. “FIC Still Useful,” *New Straits Times*, 1 May 2004.

¹²⁸ G. Umakanthan, “Easing Guidelines for Foreign Investment,” *New Straits Times Malaysia*, 24 July, 2004.

¹²⁹ G. Umakanthan. “FIC Still Useful,” *New Straits Times*, 1 May 2004.

¹³⁰ G. Umakanthan. “FIC Still Useful,” *New Straits Times*, 1 May 2004.

Prime Minister Tun Abdullah Ahmad Badawi tried multiple times to overhaul the FIC, an action requiring Cabinet approval. The Cabinet twice rejected this proposal, both due to concerns dismantling the screening power of the FIC would be politically unpopular with *bumiputera* groups and because the senior civil servants comprising the committee were reluctant to relinquish their bureaucratic power.¹³¹ In a December 2007 business awards ceremony, Abdullah told industry groups that stalls to reforms were temporary and a reflection of the political business cycle, saying, “Whatever you hear, it’s because the elections are coming. I believe we will come back after the elections with a two-thirds majority.”¹³² The subtext was clear: *bumiputera* riots combined with an obstructionist cabinet were temporary obstacles reflective of pre-election politicking. Changes in the cabinet membership post-election would provide political space for reform.

Indeed, the precise timing of the government’s major foreign investment policy overhaul corresponds with key political developments. The 2008 election was the most closely contested race since 1969. The BN lost its two-thirds majority in Parliament, and had a particularly poor showing in traditional wealthy urban strongholds including Kuala Lumpur and Penang. The main opposition parties, the Democratic Action Party (DAP), the Parti Keadilan Rakyat (PKR), and the Pan-Malaysian Islamic Party (PAS), all campaigned on platforms to limit preferential treatment of *bumiputeras*. The poor electoral showing weakened Prime Minister Abdullah; he eventually announced in July of 2008 that he would relinquish his leadership position the following year.

¹³¹ “Sweeping Changes to FIC, Toll Cut on the Cards,” *The Malaysian Insider*, 29 June, 2009.

¹³² Deborah Loh, “Rules Eased to Woo Foreigners Yet Help Bumis,” *New Straits Times*, 5 December, 2007.

Abdullah formally handed power to his Deputy Prime Minister Najib Razak on 2 April 2009. The same month, Razak announced the liberalization of foreign equity restrictions in 27 service sub-sectors.¹³³ On 30 June in the same year, Razak announced the overhaul of the FIC on the same day he reduced the percentage of equity publically listed stock reserves for *bumiputera* from 30 percent to 12.5 percent.¹³⁴ The timing of these changes reflects changes within the executive cabinet associated with Razak's ascension to Prime Minister. Razak appointed a smaller cabinet, with 39 fewer members than Abdullah's second cabinet. Additionally, investment reformers like Deputy Prime Minister Muhyiddin Yassin, who had formerly served as the head of MITI, were given more prominent positions in the cabinet and therefore were better positioned to successfully lobby for reform. Pressure from the unified opposition also motivated BN leaders to overcome strong *bumiputera* opposition to reform since no viable opposition parties lobbied to continue the affirmative action program unchanged and since failure to reform would only increase opposition support among those prominent in the business community. Even without a strong challenge from a *bumiputera*-focused opposition party, the BN was careful to announce a new *bumiputera* equity holding company program in conjunction with reformation of the FIC in order to counter indigenous complaints that such policies favored foreign investors over small local firms.¹³⁵

The Malaysian reform experience, therefore, illustrates three key points. First, business groups were quick to change their policy preferences over FDI policy post crisis. While

¹³³ Pauline Ng, "Najib Expected to Trim Investment Panel's Role; Review of FIC Aimed at Boosting Foreign Investment Flows into Country," *The Business Times Singapore*, 17 June, 2009.

¹³⁴ Hazlin Hassan, "KL Scraps 30% Equity Share for Bumis," *The Strait Times*, 1 July, 2009.

¹³⁵ "Sweeping changes to FIC, toll cut on the cards," *The Malaysian Insider*, 29 June, 2009.

supporting a heavily-regulated, partially liberal investment policy was beneficial when debt finance and portfolio investment were readily available, the Malaysian government's response to its banking crisis led to large changes in credit allocation decisions in which large powerful firms found it increasingly difficult to obtain sweetheart deals for their financing needs. In the absence of subsidized credit, business groups began to lobby for liberalization of FDI policy. These policy demands were not immediately acceded to, however, because the ruling coalition needed to appease *bumiputera* interests, which were traditional sources of electoral support. A history of racially motivated riots in response to policy actions perceived as antithetical to the spirit of the NEP made BN leaders particularly keen to avoid public confrontation that might create negative perceptions of Malaysia's political climate among potential investors.

It is important to note that while increased political contestation within Malaysia's competitive authoritarian electoral system did indeed motivate eventual reforms, interest groups in the country had different policy preference structures than theories that place democratization at the center of FDI liberalization processes assume. *Bumiputera* laborers were among the domestic groups most opposed to liberalization while domestic business interests continually lobbied for liberalization in order to reap the benefits of easier access to foreign equity participation. The success of opposition parties in the 2008 help catalyze change because these groups gained support among urban capitalists. A labor-driven theory of FDI liberalization is not supported by this case.

A final key point is that policy change lagged shifting policy strategies of industrial capitalists, as found in news reporting and chamber of commerce statements, by a decade. A large reason for this delay was due to pressures from *bumiputera* groups to maintain equity restrictions and government screening authority over foreign acquisitions. Another significant

factor, however, was the intransience of elites on the FIC who were reluctant to cede their power. Successful reform of the screening authority was only achieved after a change in leadership of the ruling coalition and a subsequent cabinet reshuffle. Thus, it is important to note that while domestic business groups shifted their policy preferences over FDI policy after the government instituted important reforms to the banking sector post-1997 crisis, these changes are best understood as creating a set of conditions conducive to, but not necessarily sufficient for, reform.

Conclusion

This chapter outlined the co-evolution of banking and FDI policy in Malaysia and Indonesia from 1997 to 2013, with an emphasis on how disparate policy responses to the Asian financial crisis of 1997 affected credit allocation practices and therefore business groups' preferences over openness to FDI. Starting from a similar level of openness to FDI in 1997, the countries have diverged widely in their investment restrictiveness. While Indonesia experienced some investment liberalization directly following the crisis due to IMF conditionality, Malaysia has seen much more substantial and sustained policy liberalization. In 2012, Malaysia's investment policy environment was at the average level of openness for a panel of 52 advanced and emerging economies. Indonesia, in contrast, was one standard deviation above the average level of restrictiveness in this same sample. Additionally, Indonesia has seen significant policy backtracking since 2010 when domestic business groups began a sustained lobbying effort to pursue additional restrictions on FDI.

I argue the divergent experiences with FDI policy in Indonesia and Malaysia post-crisis can be explained by development in each country's bank sector that altered elite strategic assessment of FDI openness. Indonesia's banking sector has become more state-dominated since 1997 while Malaysia privatized its state-owned banks in the aftermath of the crisis and pursued

substantial prudential regulatory reform. Indonesian banking regulatory reform has not been as extensive as has Malaysia's and credit allocation in the country has never fully recovered since the crisis. At the same time, Indonesian banks benefit greatly from repressive policies that push the cost of credit higher and that create strong incentives for the government to use preferential credit as a tool of coalition-building. As a result, the most politically important Indonesian firms received preferential access to credit while remaining firms are largely credit starved.

Documentation of prominent domestic business groups' lobbying efforts over FDI policy indicate Malaysian firms experienced a sharp change in policy preferences over FDI in the wake of the crisis when preferential credit was non-existent and financing constraints were perceived as the largest impediments to business growth. Indonesian firms, however, became increasingly hostile to foreign direct equity, particularly after the banking sector re-stabilized post-crisis with a more prominent state-owned banking system. As a result, Indonesian FDI policy reform efforts have stagnated and even reversed after an initial round of IMF-instigated liberalizations.

Comparing these two cases offers several interesting conclusions about the process of FDI reform. First, policy reform is most likely to occur when elite policy preferences over foreign investment change. The Malaysian experience has been that elites have driven the process of FDI reform while the Indonesian experience indicates elites are powerful blocking mechanisms when they are opposed to foreign equity entry. This finding is counter to existing arguments about FDI liberalization that places great weight on the role of labor in a democratizing state at pushing reforms. Indeed, the UMNO, under the BN umbrella, has been able to maintain hegemonic party control in Malaysia while also gradually but substantially liberalizing the investment climate. Indonesia, on the other hand, has undergone a democratic transition, but anti-FDI elites have successfully impeded FDI policy reform.

Second, other explanations for FDI liberalization place great emphasis on the capacity of the IMF to be an agent of change. Indeed, we see that Indonesia initially experienced movements toward openness under IMF conditionality. However, without elite support, reform efforts quickly stalled and eventually were partially reversed. Conversely, Malaysia underwent more gradual but sustained and substantial reform without the external pressure of IMF conditionality. Because elite interests undergird regulatory policies toward FDI, substantial policy liberalization cannot be forced through by external groups. For liberalization to take hold, business groups must believe policy openness will be in their interest.

Thus, the comparison of Malaysian and Indonesian FDI policy reforms post 1997 crisis corroborate the central argument of this dissertation that banking sector reform leads to FDI policy reform. These cases more closely evaluate elite lobbying efforts over FDI policy as domestic credit allocation processes change, and indicate firms are more likely to view FDI positively when the state is less involved in the lending process. In conjunction with the previous chapter, these cases also show that FDI policy liberalization can experience reversal and that changes in the domestic credit allocation process can explain both *levels* of and *changes* to openness to FDI.

CHAPTER 7: CONCLUSION

This dissertation argued policies toward FDI are best understood as the product of domestic political coalitions that are conditioned on the local financing environment. Local capitalists would most prefer to protect themselves against foreign direct entrants who create competition in local labor and product markets, force productivity gains that eat away at rents, and fracture lucrative political coalitions between business elite and governments. However, local firms also need access to capital in order to survive and grow. When the state pursues policies of financial repression, politically influential firms are able to capitalize on subsidized lending. When the domestic banking sector undergoes substantial reforms, local elites no longer have access to subsidized credit through political connections. The need to obtain finance outweighs firms' preferences to exclude foreign direct investors. Under such conditions, industrial elites will support increasingly liberal FDI policy environments.

Summary of Findings

My analysis found evidence broadly consistent with this theory. Using statistical techniques that separate short and long-term effects, I find banking sector reforms lead to higher levels of FDI equity openness overtime, even when controlling for popular alternative explanations of investment policy liberalization such as regime type, IMF coercion, and diffusion effects. I also find countries that undergo banking reforms are more likely to liberalize from a closed equity policy environment and more likely to remain fully liberal. At the same time, increased access to alternative forms of investment are associated with partial reform. Short-term

capital account openness reduces a country's propensity to switch from an intermediate level of policy openness to a fully liberalized FDI environment.

While large N quantitative analysis did find policies toward equity restrictions respond in a manner consistent with my theory, there is little evidence that changes in investment screening policies follow a similar logic. This finding surprised me. It may be that decisions to abandon screening requirements are better explained by bureaucratic politics since screening imbues investment ministries with a great deal of authority that senior officials may be quite reluctant to relinquish. Since regime type was more consistently significant in screening models than in models of equity restrictions, it may also be the case that non-democracies are more likely to retain authoritative control over inward investment. Or, it may be the case that *de jure* measures of screening do a poor job identifying truly restrictive policy environments. While China's screening processes are clearly exclusionary, some countries such as Canada have retained screening authority without actually using approval processes to block foreign investment projects. Clearly, more research is needed to understand the process through which screening requirements are relaxed.

While my quantitative analysis establishes a statistical correlation between banking sector reforms and FDI liberalization, the comparative case study of Indonesia and Malaysia in Chapters 5 and 6 serve to trace the process of policy reform in two similar cases that differ in the extent to which they pursued meaningful banking sector reforms after a shared financial crisis. These case studies allow me to relax my assumption that FDI policies are typically an expression of elite interests and also provide a more direct examination of the lobbying activities of business elites with respect to FDI policy. I find that Malaysia's more extensive banking sector reforms coincide with a shift in local economic elites' attitudes toward FDI policy liberalization, and that

the pressures from these powerful interests lead to substantial investment regulatory reforms. Indonesia, in contrast, has a banking sector that continues to be largely protected and controlled by the state. Unlike industrial elite in Malaysia, Indonesia's business class has become increasingly hostile to FDI and the process of investment policy reform has stalled. Indonesia also contains interesting within case variation; the state pursued limited banking sector reforms in the 1980s and subsequently also underwent limited FDI liberalization. However, these liberalizing movements were not sustained as the state re-asserted dominances in the banking sector in the wake of the 1997 Asian financial crisis.

These case comparisons support the quantitative analysis in Chapters 3 and 4 in several ways. First, they provide qualitative support for the argument that policy reform is most likely to occur when elite policy preferences over foreign investment change. The Malaysian experience has been one of elites driving the process of FDI reform while the Indonesian experience indicates elites are powerful blocking mechanisms when they are opposed to foreign equity entry. Second, these cases provide further evidence that democratic transitions do not drive FDI policy liberalization. The hegemonic ruling party in Malaysia has carefully managed movements toward increased openness to foreign investors in the context competitive authoritarianism. If anything, popular opinion is skeptical of foreign investors. Local chambers of commerce have used their policy influence to push through investment liberalization despite the objections of workers. Indonesia, on the other hand, has undergone a democratic transition, but anti-FDI elites have successfully impeded FDI policy reform. Third, these cases question the capacity of the IMF to be a meaningful agent of change with respect to FDI policies. Indonesia did undertake more open policies in the initial phases of IMF-required adjustment. However, without elite support, reform efforts quickly stalled and eventually were partially reversed. Conversely, Malaysia underwent

more gradual but sustained and substantial reform without the external pressure of IMF conditionally. Because elite interests undergird regulatory policies toward FDI, external groups cannot force through substantial policy liberalization. For liberalization to take hold, business groups must believe policy openness will be in their interest.

Contribution

This project represents a substantial contribution to the IPE literature for several reasons. First, my theory provides way of integrating the financing environment into an understanding of FDI policy. This helps to provide a more united theory of FDI policy in developed and developing countries that can also explain reversals in openness, especially in the mid 20th century and renewed reversals today. By connecting elite strategies over FDI to the financing environment, this theory helps to overcome prevalent idea that FDI policy, once open, is irreversible. As a result, this theory can both explain moves toward openness and moves toward increasingly restrictive policy environments.

Placing the financing environment at the center of elites' strategic calculus also suggests a way forward for IPE scholars who wish to explain how patterns of financial connectedness and regulation affect actors' strategic interests, political actions, and governments' policymaking. The global financial crisis inspired scholars to re-imagine how the global financial system undergirds the real economy, affects the ability of the state to engage in public goods provision, and expands or narrows the set of policy options to redistribute wealth domestically and internationally. The fact that typical treatments of FDI policy explanations ignored the role of the financial environment in affecting local industrialists' willingness to exclude foreign investors from local establishment nicely illustrates the problem of divorcing finance from explanations of other economic behavior.

My theory also helps explain continued variation without assuming labor groups play a large role in pushing for openness. Not only do such theories have trouble explaining why some of the most visible protests against FDI occur through mass mobilization, but they also lead to the conclusion that FDI automatically redistributes gains toward workers. This is not necessarily true, especially since FDI often occurs through M&A that often leads to labor force reductions. As others have pointed out, FDI may also reduce the collective bargaining strength of labor since multinationals have greater threat of exit than do local firms. If FDI policy liberalization is driven by changes in elites strategies toward openness rather than through the expression of workers' interests, then the question of workers' industrial and political bargaining strength in a economically integrated world again becomes relevant.

Extensions

Of course, this project leaves many questions left unanswered and therefore creates new opportunities for further research. Two possible extensions address a central weakness of the current analysis. First, I highlight how this theory can better explain historical trends and variations in domestic regulation of foreign investor entry over time. However, the data I use in my quantitative analysis start in 1973 and my qualitative cases begin analysis in the late 1960s. I expect my theory to explain not only patterns of liberalization in the last quarter of the 20th century, but also patterns of regulatory closure that occurred earlier in the century. Moreover, my theory anticipates increased restriction on FDI policies in countries whose governments responded to the more recently global financial crisis by exerting increased control over domestic financial systems. To test the applicability of this theory beyond the liberalizing trends during the late 20th century we need more data. Future research could extend measures of FDI regulation to include a longer time series in both directions.

Second, this research is best seen as a first attempt to establish the relationship between banking sector regulations and the formation, maintenance, and change in domestic coalitions advocating for protection from or openness to FDI. As such, most of the evidence I present is broadly consistent with the expectations that derive from my theory, but tested almost entirely from macro-level policy outcomes. Future work can more closely measure and test the policy positions of domestic firms and use these data to more closely test all parts of the causal chain. As the IPE literature increasingly looks toward firm-level analysis, exploring the precise ways in which local firms pressure their governments over policies related to FDI will add to a more robust understanding of the political role of business elite in different domestic contexts.

This research project also establishes a new beachhead from which to explore the implications of a financing opportunities cost theory in a more nuanced way. IPE scholars are increasingly taking seriously the assertion that firms exhibit heterogeneous preferences. While this project treated domestic industrial elites as a united group, future research could test industry-level variation in FDI regulation. Such research could provide a further test of my theory since more capital-intensive activities should be more responsive to changes in the financing environment if elite strategies over FDI policy are driven by the cost of alternative sources of capital. Perhaps more interesting than variation at the sub-sector level is studying how firm size and organizational structure informs variation in strategies over FDI. Drawing on insights from the Melitz model, domestic firm size, exporting capacity, and status as conglomerate should affect firms' interests in regulating FDI. Of course, such a research project would entail overcoming significant problems of measurement and data availability with respect to industry-specific FDI policies and the policy influence of individual firms or industries.

Another question that this current research project leaves largely unanswered is under what conditions will governments pursue policies of financial repression and financial reforms. Clearly, these policies, once established, affect the strategic environment in which firms make decisions about how to respond to global financial flows. Less understood is why powerful vested interests would allow governments to enact policies that erode their political influence. Throughout this dissertation I draw on analysis that largely sees financial reforms as the product of exogenous shocks that limit the range of options available to governments. As the comparative cases of Malaysia and Indonesia demonstrate, however, reform in the face of crisis is not a given. What makes some governments more likely to respond to crisis with substantial financial reform? To what extent does this choice depend upon the strength of industrial capitalists?

Finally, almost all IPE research related to FDI is ultimately interested in how cross border flows of direct investment change the nature of domestic political coalitions. In particular, when do foreign firms become important social interests in host states? Under what conditions do foreign firms and domestic firms become partners in their activities aimed at changing or maintaining government policies? Thinking seriously about the conditions under which local firms will view multinational entry as vital to their own bottom line further complicates the essential question of the role of foreign firms in domestic politics. Rather than asking whether mobility makes a firm powerful or indifferent, the question most relevant to integrated economies is under what conditions do the interests of foreign and domestic firms become indistinguishable.

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