A Design for Alternative Fund Raising of the NEADB: Equity Financing through the Private Capital Market

Jai Woong Lee

The original capital formation of the proposed Northeast Asian Development Bank (NEADB) seems to follow the Asian Development Bank (ADB) formula, which is scheduled to acquire 50% in the form of cash payments over a period of 5 years and to obtain 50% on a safety-net basis. Regional stockholders would be the People's Republic of China (PRC), Japan, Korea, Mongolia, Russia, and Taiwan. Stockholders from outside the region might be the United States, European Union countries, Australia, New Zealand, and so on. If I understand the mechanism correctly, the original design is based on the multinational public (or diplomatic) development bank. Therefore, the key point of the fund-raising method is that seed capital formation would be made by the governments of Japan, the PRC, and the Republic of Korea—US$1 billion over a period of 5 years. The remainder of the capital would accrue through external-payment guarantees.

However, the fundamental approach of the Bush administration in the United States seems to be neo-Monroe-ism and international vertical integration of North and South America "first-ism," which was clarified by the second presidential press conference by stating "American-interest-first-ism." Under these circumstances, a major role by the U.S. and its function in establishing the NEADB are somewhat doubtful. A smooth diplomatic solution of government-to-government fund raising among nations, both within and outside the Northeast Asian region, seems to be difficult for the time being. There is thus a *raison d'être* for an alternative, auxiliary approach through private financing channels. For example, the Japan Fund was established in 1964, and 20 years later, the Korea Fund was successfully listed on New York Stock Exchange as a Maryland State Juridical Entity.

As a rule, one-fourth of authorized capital is paid-in capital, and a stock holding company can be set up. If the joint lead managers were selected on a regional basis, the leading brokerage firms of Japan, the PRC (Hong Kong), and Korea could combine with major US and EU investment bankers to set up a syndication group. In case of global base fund-raising, leading underwriters in New York, London, Zurich, Tokyo, Hong Kong, and Sydney should participate. The key questions are: Who should be the lead manager of that syndication? Where should the headquarters be located? And who will be the governor (or CEO) and directors? If we intend to "go public," a prospectus should be prepared and presented to the global financial markets. This is the way to "start small and grow larger" on a purely commercial basis, while most of the financial institutions of the Northeast Asian region are premature.

Original Capital Formation in the ADB Formula

Establishment Process and Objectives of the ADB

The design of ADB was presented at the nineteenth meeting of ECAFE (United Nations Economic Commission for Asia and the Far East) in March 1963. In October 1964, the General Secretariat released a report on the Specialists Group on the ADB.

The twenty-first ECAFE general meeting decided to establish the Advisory Committee on the ADB, composed of nine country delegations. This committee conferred with 35 member country representatives and submitted a special report with a draft of the Articles of Agreement of the ADB, which finally passed the second cabinet meeting of Asian Economic Cooperation. On 22 August 1966 these articles were ratified by 15 countries. The general meeting for the establishment of the new bank was held in Tokyo in November, with 32 country delegates participating, and the ADB finally opened for business on 19 December 1966.

During the establishment process, the most heated debates among member delegates were concerned with the choice between Tokyo and Manila as the site of the new bank's headquarters. In a final compromise, Manila was chosen for the site, and the Governor of the ADB would be Japanese. This will be a worthy lesson for establishing the NEADB in the future (see Lee 2000a: 171–4).

The main objectives of the ADB are to promote economic growth and cooperation in Asia and the Pacific region. ADB's functions can be summarized as follows:

- promoting public and private capital investment for development purposes
- supporting capital to the developing countries within the region for balanced economic development
- assisting the adjustment of member countries' development policies and plans, in order to promote trade within the region
- extending technical assistance for development planning and implementation
- cooperating with international development organizations.

Member Countries and Voting Rights

Participation in the ADB is restricted to members of the Economic and Social Commission for Asia and the Pacific (ESCAP) and to UN or UN-related organizations. Members from outside the region are limited to developed countries. The admission of a new member requires two-thirds of the effective votes representing three-fourths of the voting rights at the general meeting of the ADB.

In June 1998 there were 41 member countries within the region and 16 countries outside the region, for a total of 57 members. Member countries have "basic voting rights" evenly distributed as 20% of voting rights, and "proportionate voting rights" (1 voting right per 1 stock equal to 10,000 SDR) in accordance with Article 33-1.

Capital and Borrowings

Capital

The financial sources of ADB are mainly capital and borrowings (see Lee 2000a: 182–5). The capital can be classified as paid-in capital and callable capital.

Payments of paid-in capital are partially in convertible currency and partially in member-country currencies. In practice, on the occasion of the fourth general increase in capital, convertible currency accounted for 40% of paid-in capital.

Member-country currency can be paid in the form of a promissory note or debenture issued by a designated deposit institution of the member country or its government. The promissory note or debenture should be non-transferable and a non-interest-bearing note of certificate, which must be paid upon the request of the ADB.

On the other hand, callable capital cannot be used as a source of a loan, but the payment obligation arises when ADB requests payment. Therefore, the callable capital can be utilized as collateral for borrowing from the international financial market. In this concept, the callable capital contributes to borrowing from the international financial market in an indirect way (Cho 2001: 9–10). Payment of callable capital is supposed to be made in gold, convertible currency, or domestic money which causes the callable capital to be called (DSM). But up to the present, ADB has not requested payment of callable capital.

The question of increasing the ADB's capital is reviewed every five years and is decided by two-thirds of the members present, representing three-fourths of voting rights.

Since the ADB adopted an authorized capital system, in cases where the total capital exceeds the authorized capital, the ADB is obliged to take measures to increase the authorized capital. When the ADB was established, the authorized capital was 1.10 billion SDR. Through successive general and special capital increases, the authorized capital reached 34.91 billion SDR (see Table 1).

The most noteworthy fact of capital formation of ADB is the composition of its capital, which is distinctively differentiated from that of a private financial institution. At the end of 1997, the paid-in capital accounted for only 2%, whereas callable capital accounted for the remaining 98%. In addition, of the 2% share of paid-in capital, convertible currency accounted for only 0.8%, whereas member-country currencies accounted for the remaining 1.2% (see Table 2). This is a typical public, international financial organization capital composition, which is very different from that of a private international organization.

Table 1. ADB authorized capital increases, 1966–97 (million SDR)

Classification	Fiscal Year	Amount of Increase	Cumulative Amount
Capital on establishment	1966	–	1,100
First general increase	1971	1,650	2,750
Special increase	1973–75	323	3,073
Second general increase	1976	4,148	7,221
Third general increase	1983	7,547	14,768
Special increase	1985	235	15,003
Special increase	1986	1,200	16,203
Special increase	1988	622	16,825
Special increase	1991	64	16,890
Special increase	1993	315	17,205
Fourth general increase	1994	17,705	34,910[a]

a. As of December 1997.

Table 2. ADB capital composition, 1966–97 (%)

Classification	Paid-in Capital	Convertible Currency	Member-Country Currency	Callable Capital
Capital on establishment 1966	50.0	25.0	25.0	50.0
First general increase	20.0	8.0	12.0	80.0
Special increase 1973	32.0	14.8	17.0	68.0
Second general increase	10.0	4.0	6.0	90.0
Third general increase	5.0	2.0	3.0	95.0
Special increase 1985	12.0	5.2	6.8	88.0
Fourth general increase	2.0	0.8	1.2	98.0[a]

a. As of December 1997.

Borrowings

The ADB refurnishes the sources of funds by borrowings from member governments or international financial markets. There is no clear definition of a limit on borrowing in the articles of agreement. Usually, the board of directors makes it a rule to limit borrowings to the 95% member-country capital amount.

At the end of 1997, the outstanding borrowings of ADB amounted to $17.5 billion, of which long-term borrowing accounted for $14.2 billion and short-term borrowing accounted for $3.3 billion (see Table 3).

Table 3. ADB borrowings on an annual basis, 1994–97 (US$ million)

Category	1994	1995	1996	1997	Cumulative
Borrowing	1,335	1,715	584	5,588	25,305[a]
Outstanding	3,717	14,636	13,697	17,542	–

a. As of 1996–7.

CHANGING INTERNATIONAL ENVIRONMENT AFTER THE INAUGURATION OF THE BUSH ADMINISTRATION

Financial System: Global (IMF, IBRD) versus Regional (ADB) and Sub-Regional (NEADB)

After World War II, the United States launched itself into global management by five key organizations: the United Nations Security Council, the International Monetary Fund (IMF), GATT, UNESCO, and the International Court of Justice. In his *Rise and Fall of the Roman Empire*, Gibon wrote that "Rome conquered the world three times: first by arms, second by law, and third by culture." The five postwar pillars are Gibon's expanded tools for world management.

As far as the global financial system is concerned, the IMF and its affiliates, the IBRD group, and regional financial institutions such as the ADB, the AfDB, and the European Bank for Reconstruction and Development (EBRD) took the role and functions of global and regional finance (see Table 4). As global financial institutions, the IMF specialized in balance of payment loans for the international equilibrium of currencies, on the basis of the US dollar as a key currency; the IBRD specialized in project and program loans; the IDA specialized in lower-income country loans; the IFC specialized in capital market formation; the MIGA specialized in private investment guarantees; and finally the ICSID specialized in solutions to investment disputes.

As regional financial institutions, the Inter-American Development Bank (IDB) concentrated its activities in North, Central, and South America; the EBRD concentrated on the European continent, including system-changing counties; the

AfDB concentrated on the African continent; and finally the ADB concentrated on Asia and Oceania (Cho 2001: 9–10).

Table 4. Global and regional financial institutions: functions and type of lending

Function	Global Financial Institution	Regional Financial Institution	Sub-Regional Financial Institution
BOP loan	IMF	ADB (Asia in general)	NEADB (Northeast Asia)
Project loan	IBRD	AfDB and AfDF (Africa)	–
Lower income country	IDA	EBRD (Europe)	–
Capital market oriented	IFC	IDB (Americas)	–
Investment guarantee	MIGA	–	–
Disputes solution	ICSID	–	–

Under the present system of specialized global and regional financial institutions, the proposed NEADB might be classified as a sub-regional financial institution within the territorial domain of the ADB, unless the NEADB aims at a differentiated identity, separate from the ADB's territorial role and functions.

***Raison d'être* for the NEADB under the Bush Administration's Neo-Monroe-ism**

The Bush administration was born out of a somewhat complicated federal and state presidential election process. But the heavier burden of the Bush administration seems to be how to recover from an economic downturn that is already a recession. The Bush administration had three policy tools: lowering interest rates, a tax-cut of $1.3 billion, and a weak-dollar policy to drive exports. But except for the low interest policy, a tax-cut of $1.3 billion for ten years will have little or no effect, while a weak dollar policy will turn into a strong dollar policy, because of Japan's weak yen policy.

Policy planners of the Bush administration, therefore, are switching somewhat similarly to neo-Monroe-ism. Even President Bush proclaimed his "America's interests first" policy at his second press conference. In line with this norm, the national defense policy is under evaluation, and the so-called NMD plan is being set up from the national security point of view. In the international economic field, weight is being placed on the vertical integration of North, Central, and South America, rather than on the horizontal integration of Europe, Asia, and the Pacific. The idea seems to be a unification of NAFTA and the Latin American Common Market, MERCOSUR, together with reinforcing the Inter-American Development Bank. In order to utilize limited resources effectively, international financial planners of the Bush camp are already standing by with a draft of the Meltzer Commission Report, a Republican oriented international organization reform plan. The basic ideas of the Meltzer Report are, first, to limit IMF functions to short-term loans of less than 120 days and, second, to transform the IBRD into a World Development Agency like the IDA (Blecker 2000: 192–204), extending loans only to lower income countries.

Under these changing circumstances, it is probably not easy to expect positive support from the Bush administration for the establishment of the NEADB.

Comparison of IDB and ADB

From the viewpoint of the United States, the differences between the IDB and the ADB are not only territorial coverage (the American continents versus Asia) but also the history and process by which they were established: long and short, regional and out of region.

The idea of an American regional bank originated all the way back in 1890, when an inter-American conference was held, more than half a century ahead of the global financial organization of the IMF and the IBRD. After the establishment of the IMF and the IBRD in 1947, Mexico and Peru raised strong proposals for an inter-American bank. In 1954 Colombia and Chile proposed the idea again at a meeting of the Organization of American States (OAS), but it was rejected by the United States on the grounds that the role and functions would overlap with those of the IMF and the IBRD. However, the United States had gradually been shifting from its former position toward the vertical integration of the American continents at the Economic and Social Special Committee in August 1958, since Cuba had become a socialist country and since "liberation theology" had prevailed after Che Guevara's appearance.

In October 1958, a draft plan for establishing the IDB was initiated. It was finalized in April 1959 and became effective on 30 December 1959, when 85% of the member countries had ratified it. In February 1960, a general meeting for the establishment of the IDB was held in Washington, and the IDB opened for business on 1 October 1960.

Besides this long historical background, it should be noted that the United States has 34.66% of the voting rights, Canada has 4.38%, the region's developing countries have 53.7%, and countries outside the region have only 7.20%. One noteworthy fact is that Australia is the only Asia-Pacific member and has a mere 0.08% of the voting rights.

Japan contributed $100 million for the "Japan Special Fund" within the IDB but is not a member. The Republic of Korea made an application for participation in August 1979, and proposed a special contribution in June 1981, but has still not yet received any response; it attends the annual meetings only as an observer.

The other feature is the establishment of the Inter-American Investment Corporation, specifically investing in small and medium-size private industries in Latin American countries, under a separate legal entity outside the IDB. Recently, the United States has been particularly concerned with the IDA, because signs of domino-type economic crises began in Argentina and spread to Brazil and other Latin American countries. As a result, the MERCOSUR meeting was cancelled at the end of March 2001. In the face of the FTAA at the end of April 2001, Chile and Uruguay began bilateral negotiations with the United States.

As far as the ADB is concerned, the establishment process, objectives, member countries, voting rights, capital, and borrowing are all reviewed above, so the author would like to refrain from overlapping explanations. From the long history leading to the establishment of the IDB, we should learn several lessons. Among other things, the United States historically has shown strong reluctance about the overlapping territorial role and function between global and regional financial institutions This characteristic would be much stronger and more positive in the case of regional and sub-regional division of financial organization structure.

Therefore, an effective solution for getting through this red tape seems to be the establishment of a special fund such as an Asian Development Fund or more precisely a Northeast Asian Special Fund, like the African Development Fund or the special funds in the European Bank for Reconstruction and Development (EBRD), such as the Russian Small Business Investment Special Fund. Otherwise, we can refer to the EBRD's "special support program" for nations undergoing system changes, particularly in the areas of privatization, finance, and the energy industry. Such funds seem to be loopholes for an alternative, even within the present framework of the global and regional financial system in Asia, by keeping in line with international public law and order.

ALTERNATIVE FUND RAISING THROUGH THE PRIVATE CAPITAL MARKET

The Korea Fund Formula

The Japan Fund was set up in 1964, the same year as the Tokyo Olympics and Japan's participation in the OECD. The Japan Fund and the Korea Fund are both close-ended country funds listed on the New York Stock Exchange and are managed by US investment management companies with great success. Since both funds are almost the same in structure and character, except for the timing of their establishment, the latest issue of the Korea Fund of 1984 will be cited as a case study.

The following description appeared in the *Prospectus* of the Korea Fund (see also Table 5):

> The Korea Fund, Inc. is a diversified, closed-end investment company. Its investment objective is long-term capital appreciation through investment in securities, primarily equity securities, of Korean companies. It is expected that normally at least 80% of the Fund's assets will be invested in securities listed on the Korean Stock Exchange. No assurance can be given that the Fund's investment objective will be realized. Investment in Korea involves certain consideration, such as fluctuations of currency exchange rates, restrictions on foreign investment and repatriation of capital, and political and economic risks, which are not normally involved in the investment in the United States.

Table 5. Summary of Korea Fund Prospectus

Item	Summary
Fund character	The Fund is a diversified, closed-end investment company designed for US and other country investors by investing in stocks listed on the Korean Stock Exchange.
Investment objectives and policies	Long-term capital appreciation through equity investment in Korean securities, primarily equity securities, listed on the Korean Stock Exchange
Underwriters	The common stock is being offered by a group of underwriters led by the First Boston Corp., Shearson Lehman/American Express Inc., International Finance Corporation, Daewoo Securities Co. Ltd., and Korea Associated Securities, Inc.
Advisers and sub-advisers	Scudder, Stevens, and Clark (listed SEC); Daewoo Research Institute (listed SEC)
Amount	$60,000,000 (price to public per share: US$12.00)

Source: Korea Fund Prospectus (J. W. Lee).

The rough character of the Korea Fund is self-explanatory in this summary. The *Prospectus*, dated 26 June 1984, further prescribed that the Korea Fund would comprise 5 million shares of $0.01 par value common stock but that the price to public would be $12.00 (or a total of $60 million) and that the shares would be offered by underwriters such as the First Boston Corporation, Lehman Brothers (Shearson Lehman/American Express, Inc.), and the International Finance Corporation (IFC) when, as, and if issued by the Fund, and delivered to and accepted by the underwriters, and subject to their right to reject orders in whole or in part. It is noteworthy that IFC was included among the underwriters. Besides these three underwriters, the joint lead managers, there were about 50 co-lead managers and managers, from among the world's leading securities, investment trusts, and pension fund organizations (see Figure 1).

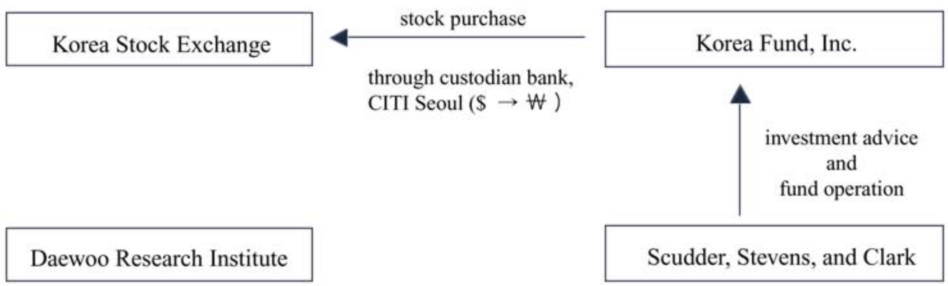

Figure 1. Flowchart of Korea Fund operations

Briefly, the contents of the *Prospectus* included: an explanation of the fund's investment objectives and policies; the offering; the expected listing (NYSE); the expected symbol (KF); special considerations; the investment advisers (Scudder, Stevens and Clark); the Korean adviser (Daewoo Research Institute); advisory fees; the custodian (Brown Brothers Harriman and Co.); the sub-custodian (Seoul Branch of CITI Bank, N.A.); and the underwriters (First Boston Corporation, Shearson Lehman/American Express, Inc., and International Finance Corporation). The prospectus also contained more than 11 pages about the Korean securities market and 18 pages of general information about the Republic of Korea (First Boston et al. 1984: 14–25 and 27–47).

Establishing a Regional Fund: The NEAD Fund Approach

Territorial Coverage

According to Cho's (2001: 1) article on the design of the proposed Northeast Asian Development Bank, the territorial coverage is defined as the northeast of the PRC, Mongolia, the Korean peninsula, the Russian Far East, and Japan.

Regional and Out-of-Region Stockholders (Investors)

The expected investors (stockholders) within the region are assumed to be the PRC (including Hong Kong and Macau), Japan, the Republic of Korea, Russia, and hopefully Taiwan. Among the expected investors (stockholders) outside the region are the United States, the European Union, Australia, and New Zealand.

Composition of the Capital of the NEADB

According to Cho's (2001: 6–7) article, the initial proposed capital is $20 billion; 50% of this amount would be paid-in cash payments, through a rights offering over a 5-year period. The remaining 50% would be in the form of callable capital, for which there is no obligation of payment on the part of stockholders (investors). The regional stockholders' share would be $12 billion, representing 60% of the total capital. The remaining 40% would be raised by investors from outside the region.

Citing the ADB model, 93% of the capital would be callable capital, and only 7% would be paid-in capital ($3.3 billion). On the basis of this $3.3 billion, $87 billion can be obtained in the form of callable capital. Still following the ADB formula, Cho's (2001: 7–8) article estimates the contributions from individual countries: $0.5 billion from Japan, $0.25 billion from the Republic of Korea, and $0.2 billion from the PRC, over a period of 5 years. Thus the NEADB would obtain about $190 million per year, on an annual cash flow basis.

Design of the NEAD Fund

In accordance with the discounted cash flow analysis of the afore-mentioned $190 million, the scheme of the Northeast Asian Development (NEAD) Fund would be around $150 million. The allocation of fund-raising, in principle, should follow the proposed proportion of the NEADB's regional and out-of-region member countries, in accordance with the article by Cho.

The underwriters should be market makers and have international name value. One regional underwriter could be selected from each major investor: Japan, the PRC (including Hong Kong), and the Republic of Korea. One out-of-region underwriter could be chosen from each major investor: the United States, the European Union, Australia, and New Zealand. The three regional underwriters should act as joint lead managers; out-of-region underwriters might become co-lead managers; and the rest would be managers. But, it is strongly recommended that the IFC or the AFIC (Asia Finance and Investment Corporation) or both should be elected as joint-lead managers.

The joint-lead managers could select the regional listing, preferably Tokyo, Hong Kong (or Shanghai B share), and Seoul. Co-lead managers could select, with the consent of joint-lead managers, the listing outside the region: New York or London or both.

The joint-lead managers in Japan, the PRC, and the Republic of Korea would set up an investment management company, and the joint-lead-managers' home countries would each set up sub-investment advisers.

A custodian bank (or company) should be set up in one of joint-lead managers' home countries, namely a bank located in Hong Kong or Tokyo or Seoul, which would also become a sub-custodian if not selected as custodian.

In other miscellaneous matters, the practices of the Japan Fund or the Korea Fund could be followed, in accordance with the bona fide agreement of member countries' delegations.

CONCLUSION

The design of the NEADB would be desirably concluded as follows. The first priority is to set up the NEADB as prescribed in line with Dr. Lee-Jay Cho's (2001) paper with some minor modifications, such as possibly omitting the somewhat overlapping territorial and scope-of-operation areas in the existing ADB. Also, patient diplomatic or international political-economic endeavors should be made to set up a Northeast Asian cabinet meeting, together with out-of-region countries, through lessons learned from the Inter-American Conference and the Organization of American States during the birth of the Inter-American Development Bank.

The second alternative is to set up a "Special Fund" covering the Northeast Asian area within the framework of the ADB, on the grounds that, out of the ADB's total outstanding loans from the Asian Development Fund ($20.9 billion), Mongolia is the only member in the NEADB target area to benefit, and its loan is a mere $377.5 million, or 1.8% of ADF loans (see Table 6).

Table 6. Asian Development Fund (ADF) loans approved by country

Country	Loans approved (US$ million)	Share of total (%)
Pakistan	5,473.1	26.2
Bangladesh	5,331.9	25.5
Sri Lanka	1,969.8	9.4
Nepal	1,558.8	7.5
Vietnam	1,337.8	6.4
Philippines	1,108.7	5.3
….	….	….
Mongolia	377.5	1.8
Total	20,919.6	100.0

Source: Lee 2000a: 198.

The third alternative is to set up a "Special Facility for Sub-Northeast Asia" in the IDA. It would be similar to the "Special Facility for Sub-Saharan Africa" donated by 18 developed nations, through a direct-support fund ($1.2 billion) and a special mutual-financing fund ($0.79 billion, see Lee 2000a: 133).

The fourth alternative is to design an alternative Northeast Asian Development (NEAD) Fund, raised through the private capital market. The reasons for citing this as the last method of fund raising are: (1) it includes no privilege of callable capital (unlike a public international financial institution such as the ADB); (2) the member countries are at different levels of capital market development and have different political ideologies and systems; and

(3) the member countries have no formal standing cabinet meeting such as the Inter-American Conference and the Organization of American States. The only loose organizational conference that can be cited is APEC, which is too wide to be a cohesive and binding organization.

In this respect, in choosing any alternative, the concerned Northeast Asian countries and the out-of-region countries should set up a cabinet level organization, through which regional financial cooperation, such as the proposed NEADB or NEAD Fund, could come into existence. We have a long way to go, but as the Asian proverb says, "A journey of 10,000 miles starts with the first step." I think all of us at present are on the right track along that road, with a spirit of cooperation.

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