Implementing the

MONTERREY CONSENSUS

in Asia and the Pacific

Issues, challenges and action

UNITED NATIONS
ESCAP
Economic and Social Commission for Asia and the Pacific

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FOREWORD

The international and the Asia-Pacific landscape has changed in profound ways since the Monterrey Consensus of the International Conference on Financing for Development was adopted in 2002 to address the challenges of financing for development in support of eradicating poverty, achieving sustained economic growth and promoting inclusive and sustainable development. While the Asia-Pacific region has made significant advances in resource mobilization, international trade and financial systems, hefty recent rises in food and energy prices and financial instability as well as the consequences of climate change have the potential to undermine the progress that has been made, including the ability of many countries to achieve the Millennium Development Goals. This presents a timely opportunity to address these challenges in a more comprehensive way than ever before in order to deliver a coordinated and comprehensive global and regional response aimed at building and sustaining economic, social and environmental resilience.

In accordance with General Assembly resolution 62/187 on the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus, the Economic and Social Commission for Asia and the Pacific (ESCAP) at its sixty-fourth session (24-30 April 2008) held ministerial-level consultations on financing for development. Subsequently, experts in development and finance and representatives of civil society entities participated in the Regional Policy Dialogue on Financing for Development, held in Bangkok on 18 and 19 June 2008.

This publication presents the outcome of those regional consultations, which underscored the substantial progress made in financing for development in the Asia-Pacific region. They also emphasized the urgent need for action in several key areas, such as financing infrastructural gaps and in social and environmental sectors to ensure the momentum of growth, reduce poverty and improve social welfare.

The present global financial crisis, in particular, highlights the critical need to maintain resilient financial systems with stronger regulatory and supervisory mechanisms within a new financial architecture to ensure financial stability in the Asia-Pacific region. The hard-earned gains of several decades in both the economic and social spheres could be quickly lost, as the Asian financial crisis showed, if decisive action is not taken to overcome these challenges.

To advance further on the goals of the Monterrey Consensus, the Asia-Pacific region should aim at reducing inequalities within and among countries and promoting inclusive and sustainable development. The region has both the resources and the development experience to strengthen South-South cooperation in order to achieve these objectives. At the same time, this will also influence the region's place in a new global economic order and the reshaping of the multilateral development agenda. The outcome of regional consultations highlights some critical issues that need special attention from policymakers.

It is my hope that this publication will serve as a useful guide for our member States to participate effectively in the global review and to take a common stand in the future implementation of the Monterrey Consensus in the Asia-Pacific region.

Noeleen Heyzer
Under-Secretary-General
of the United Nations and Executive Secretary of ESCAP

ACKNOWLEDGEMENTS

This report, *Implementing the Monterrey Consensus in Asia and the Pacific*, was prepared by Aynul Hasan and Amarakoon Bandara under the direction of Noeleen Heyzer, Executive Secretary of ESCAP, and the guidance of Shigeru Mochida, Deputy Executive Secretary and Officer-in-Charge of the Macroeconomic Policy and Development Division. It is based mainly on a report submitted to the Commission at its sixty-fourth (Bangkok, 28-30 April 2008) session and the ministerial-level deliberations of member States during that session, as well as the report of the Regional Policy Dialogue on Financing for Development, which was held in Bangkok on 18 and 19 June 2008. The latter was attended by Adrianus Mooy (Indonesia), Govindarajulu Naidu and Lim Mah Hui (Malaysia), Mohammad Arif (Pakistan), Nagesh Kumar (India), Pichit Patrawimolpon and Poramatee Vimolsiri (Thailand), Roberto Estrada De Vera (Philippines), Sridhar Srinivasan (India), S. Vithanage Lakshman (Sri Lanka), Tilak Rawal (Nepal), Vo Tri Thanh (Viet Nam), Xia Zuzhang (China), Zukhra Abisheva (Kyrgyzstan), Jomo Kwame Sundaram (Department of Economic and Social Affairs) and Biswa Nath Bhattacharyay (ADBI). Inputs were also provided by H.K. Pradhan. The report benefited from the inputs of the following staff members of the ESCAP secretariat: Dong-Woo Ha, Hiren Sarkar, Marinus W. Sikkel, Mia Mikic, Nobuko Kajiura, Raj Kumar, Ravi Ratnayake, San Yuenwah and Yap Kioe Sheng. Research assistance was provided by Kiatkanid Pongpanich. The report was edited by Orestes Plasencia.

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EXPLANATORY NOTES

References to dollars ($) are to United States dollars, unless otherwise stated.
A solidus (/) between dates (e.g. 1980/81) indicates a financial year, a crop year or an academic year.
Use of a hyphen between dates (e.g. 1980-1985) indicates the full period involved, including the beginning and end years.
A space is used to distinguish thousands and millions.
Totals may not add precisely because of rounding.

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ABBREVIATIONS

ABF	Asian Bond Fund
ABI	Asian Bond Market Initiative
ADB	Asian Development Bank
AMF	Asian Monetary Fund
ASEAN	Association of Southeast Asian Nations
ASEAN+3	ASEAN members plus China, Japan and the Republic of Korea
ASP	ASEAN surveillance process
BIS	Bank for International Settlements
BIT	bilateral investment treaty
BSA	bilateral swap agreement
BTA	bilateral trade agreement
CMI	Chiang Mai Initiative
EMEAP	Executives' Meeting of East Asia and Pacific Central Banks Group
FDI	foreign direct investment
FTA	free trade agreement
GDP	gross domestic product
GST	general sales tax
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IMF	International Monetary Fund
MNE	multinational enterprise
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
RTA	regional trading arrangement
SDRM	Sovereign Debt Restructuring Mechanism
SME	small and medium-sized enterprise
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

EXECUTIVE SUMMARY

The Asia-Pacific region has made substantial progress in confronting the challenges of financing for development since the adoption of the Monterrey Consensus in 2002, but challenges remain, especially in the context of the changing economic and financial landscape. The region's growing dynamism continues to attract external resources, particularly in the form of foreign direct investment, but only to a limited number of countries. International trade is growing more rapidly, with the Asia-Pacific region's global share of total exports rising from 29.5 per cent in 2000 to 32.3 per cent in 2007, though this is expected to fall as economic conditions worsen. Despite still being developing countries, several countries of the region have become donors, strengthening South-South cooperation. The growing domestic resources along with a strategic shift away from external financing have also helped the region to reduce its dependency on external debt from 33 per cent of GDP in 2000 to 18 per cent in 2006. Learning lessons from the Asian financial crisis, the region has also put in place several mechanisms, such as the Chiang Mai Initiative and the Manila Framework, to address systemic issues in East and South-East Asia. The banking systems in the region are fundamentally better placed than they were a decade ago. Initiatives such as the Asian Bond Fund are helping to develop the capital market.

These substantial gains at the regional level mask significant divergence in the progress in financing for development at both the subregional and country levels. There are many countries in the region where macroeconomic fundamentals are weak and financial systems fragile. These are reflected in saving rates as low as 10 to 15 per cent of GDP, which lock them in a poverty trap. It is a continuous struggle for these economies to raise development finance domestically, and they are unable to attract adequate external resources for their development.

Foreign direct investment is concentrated in a handful of countries with limited resource flow to the most needy. Geographical location as well as limited opportunities to access markets prevents them from benefiting from international trade—one of the most important potential sources of development finance. Moreover, despite the sharp drop in the region's external debt, several countries are suffering from a severe debt burden. The recent rises in food and fuel prices are exerting further pressure on the debt burden. Afghanistan, Kyrgyzstan and Nepal are now seeking refuge under the Heavily Indebted Poor Countries (HIPC) Debt Initiative. Meanwhile, many least developed countries are still heavily dependent on external assistance for meeting their development goals. The vast disparities are indicative of an urgent need for collective action at both the regional and global levels. Such collective action could strengthen national efforts in bridging these gaps.

At the national level, maintaining a sound macroeconomic policy environment along with efficient institutions would be critical in order to address issues related to financing for development. The financial and capital markets need to be developed, and the regulatory and supervisory mechanisms strengthened. Government revenue needs to be strengthened by, among other things, improving the quality of tax administration. Expenditure policies need to be streamlined and well targeted. Governments could play an important role in improving the investment climate by taking such steps as removing bureaucratic red tape and improving governance in order to reduce the cost of doing business. Such actions could help attract not only domestic private investment but also foreign direct investment. Sectors such as SMEs and microfinancing, which are vital for inclusive development, need to be assisted to ensure that the credit needs of the poor, particularly women, are provided for.

The financial strength of many developing countries in the Asia-Pacific region provides ample opportunities for strengthening South-South cooperation in financing for development. A regional mechanism could be established to mobilize the resources of the region for its own development, in particular the financing of infrastructure gaps, and sovereign wealth funds could play an important role in that regard. Promoting public-private-partnerships at the national and regional levels could be another option, and the development of the regional bond market is another area on which the region needs to focus. Expansion of the Asian Bond Fund could be the starting point.

A successful conclusion of the Doha Round of trade negotiations will benefit all—rich and poor. In the meantime, trade liberalization and facilitation at the regional level could benefit countries with limited markets. South-South and triangular cooperation could provide opportunities, particularly for the least developed countries, to benefit from trade, technology transfer and finance.

While external borrowing provides financial resources for development, excessive borrowing could hamper development in the future. Effective debt management, including the efficient utilization of such borrowed money, could be essential in maximizing returns. In this regard, building strong institutional arrangements in debt management and human resource development would play a key role. Monitoring private external borrowing should be considered in developing countries with weak financial systems to minimize exposure to financial crises. Regional initiatives, such as the Chiang Mai Initiative to cope with disruptive capital flows and the Manila Framework to improve early warning, should be strengthened in both scope and coverage to make them fully fledged regional mechanisms. Coordination of monetary policy at the regional level could help maintain financial stability in the region.

The current financial turmoil underscores the need for a coordinated effort in addressing systemic issues. In a globally integrated financial system, a crisis in one country could easily have a serious impact on the entire world. Creating a new financial architecture with a greater focus on financial and economic governance in a multi-polar economic order would therefore be a timely endeavour aimed at reshaping the multilateral financial system to ensure financial stability.

IMPLEMENTING THE MONTERREY CONSENSUS IN ASIA AND THE PACIFIC: ISSUES, CHALLENGES AND ACTION

The Asia-Pacific region has experienced a high rate of economic growth rates over the past two decades, with the average per capita income of the developing economies increasing nearly threefold from $733 in 1990 to $2,421 in 2007, and income poverty declining from over a billion persons in extreme poverty to 641 million during the same period. Nevertheless, the region still faces various development challenges: about 97 million children are underweight; 4 million children die before reaching the age of 5; 400 million people in urban areas have no access to basic sanitation, and a further 566 million people living in rural areas lack access to clean water. Moreover, the extent of disparities among and within countries is significant. Many of these development challenges are associated with a lack of financial resources. How can the countries of the Asia-Pacific region respond to these challenges? The Monterrey Consensus of the International Conference on Financing for Development[1] provides a framework for addressing these challenges at the global, regional and national levels.

This study, based on a report submitted to the Commission at its sixty-fourth session and the ministerial-level deliberations of member States during that session, held in Bangkok (28-30 April 2008) and the report of the Regional Policy Dialogue on Financing for Development, also held in Bangkok (18-19 June 2008), evaluates the progress made, identifies issues and challenges and proposes action on each of the six action areas under the Monterrey Consensus for the consideration of the countries of Asia and the Pacific.

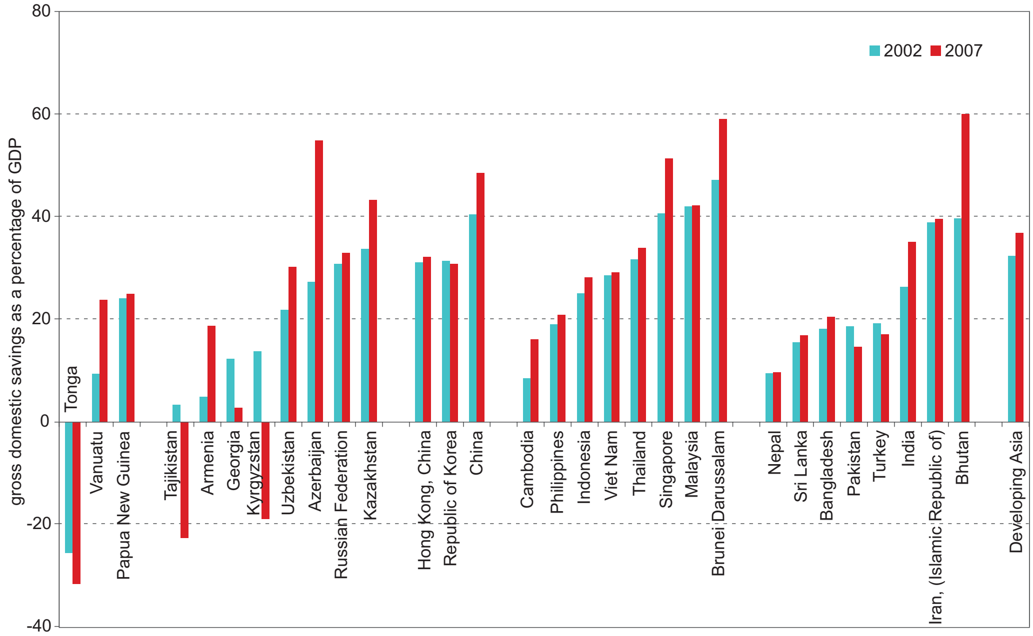
I. Mobilizing domestic financial resources for development

Progress, issues and challenges

Domestic financial resources, providing the bulk of finance for investment and social provision, play a critical role in the development process in all developing economies. Mobilization of adequate financial resources domestically as well as making their productive deployment therefore assumes priority within the framework of the Monterrey Consensus.

1 *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

Figure 1. Savings rates in selected countries and areas of the Asia-Pacific region



Source: World Bank, *World Development Indicators online* (Washington, D.C., 2008) with updates from ADB, *Key Indicators for Asia and the Pacific* (Manila, 2008).

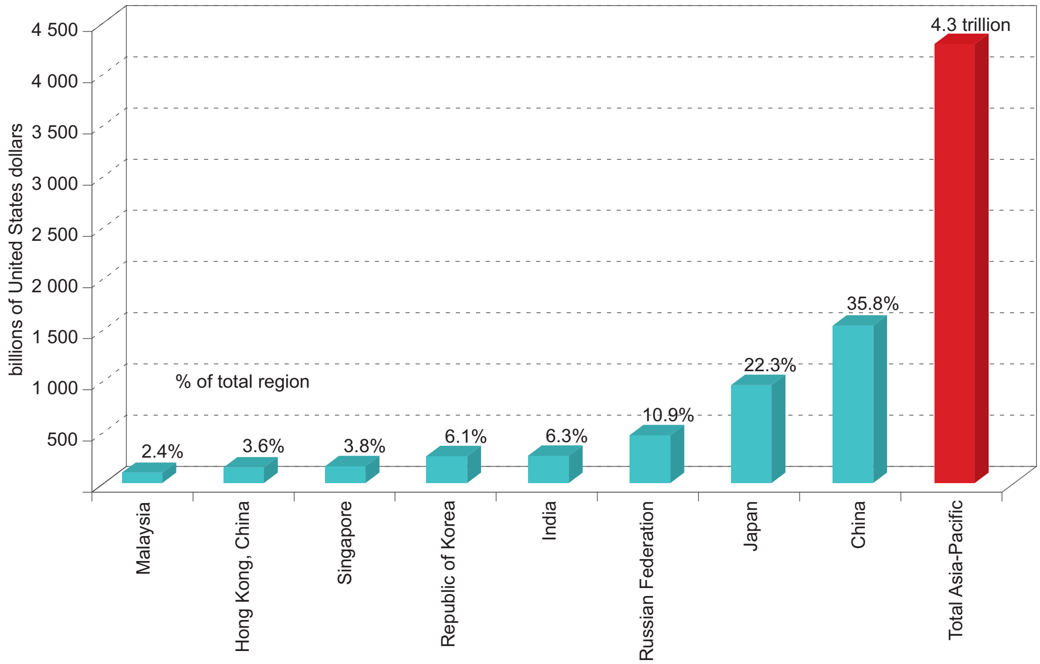
Notes: Calculations for Developing Asia are based on countries listed in the table.

> *"The region has made substantial progress in domestic resources mobilization but with huge disparities"*

The Asia-Pacific region has made substantial progress in domestic resource mobilization. The average savings rate in Asian developing countries increased from 32.4 per cent of GDP in 2002 to 36.8 per cent in 2007. In some countries, the savings rates are as high as 50 per cent (figure 1). Meanwhile, the region has also accumulated foreign exchange reserves in excess of $4 trillion (figure 2).

However, the savings rate in several South and South-West Asian countries, the Central Asian republics and the Pacific island nations remained low due to their low income levels and underdeveloped domestic financial markets and instruments. These economies depended to a large extent on external financial assistance for their development expenditure.

Figure 2. Foreign exchange reserves in selected economies in the Asia-Pacific region, 2007



Source: IMF, *International Financial Statistics*, July 2008 (Washington, D.C.).

In the period following the 1997 crisis, Asian financial systems have responded well and a few countries have gradually shifted away from what was primarily a bank-based to a broad-based financial system, developing markets in government and corporate bonds as well as strengthening stock markets. The shift has been significant in such countries and areas as Hong Kong, China; India; Malaysia; the Republic of Korea; Singapore and Thailand, with a greater pace of financial market reforms, diversified corporate ownership structures and better governance as well as a fiscal policy stance that is supportive of financial market development.

The potential for domestic financial resource mobilization in the Asia-Pacific region is very high. The region's financial resources are not fully utilized for its own development due to a lack of available mechanisms and instruments, and underdeveloped capital markets to mobilize the resources. As a result, a large part (60-70 per cent) of the region's savings are invested outside the region, particularly in Europe and North America, despite a large unmet demand for investment (approximately $220 billion per year) in infrastructure within the region. Instead, the region's investment is financed (at a higher cost) by financial flows from outside the region, thus making a net loss for the region.

In order to mobilize domestic finance for development, an efficient banking system is crucial. Countries in the region have taken significant steps to restructure their ailing banks, adopting a policy of bank recapitalization and entering into legally binding agreements with debtors in asset transfers and sales. Governments have set up asset management companies to take over the distressed debt of ailing corporations and facilitate the settlement process (which understood to have taken on large amount of debt, ranging from 10 to 35 per cent of GDP in some of the East Asian countries, such as Indonesia and the Republic of Korea).

However, the banking systems in a number of countries in the region, particularly least developed countries, are fragile as Governments continue to intervene and crowd out resources, with ineffective supervision and a low capital base. There have been inordinate delays in bankruptcy proceedings in many countries due to political pressures and cumbersome regulatory regimes. Delays have propelled banks and firms in some countries into out-of-court restructuring and settlements lacking transparency. The restructuring of distressed private banks and corporations was constrained by the ineffectiveness of formal reorganization procedures, such as bankruptcy and renegotiations in a few cases, undermining judicial efficacy. Resolving problems with non-performing assets and the restructuring of distressed corporations in the post-crisis period has been one of the most difficult challenges faced by Asian policymakers.

> *“ Domestic bond markets have made a significant contribution to resource mobilization in some countries ”*

In such countries and areas as India, Indonesia, the Philippines, the Republic of Korea, Singapore and Hong Kong, China, domestic bond markets have made significant progress in financing for development, supporting the resource mobilization efforts of Governments as well as corporate issuers. Using domestic currency debt reduces vulnerability to fluctuations in interest and exchange rates. However, many countries in the region lack a vibrant domestic debt market with appropriate instruments. Factors affecting the slow development of bond markets include poor trading and settlement infrastructure, a lack of benchmark bonds, fragmented capital markets, and inadequate investor protection.

Small and medium-sized enterprises (SMEs) are the backbone of many developing economies in the Asia-Pacific region, providing a major source of non-agricultural employment, contributing significantly to economic growth, and promoting entrepreneurship and innovation. However, SMEs in general are found to face more financial constraints in the form of high interest rates, lack of access to long-term credit, large collateral requirements for bank loans, relatively high bank charges and fees, paperwork and patronage. The Asian financial crisis displayed how a currency and banking crisis can hit SMEs hard, restricting credit flows to this sector. Since the existing financial infrastructure in most developing countries is predominantly built around the conventional banking system, improving SME access to bank finance could make a significant contribution to financing for development.

Although financial liberalization in the region is expected to contribute towards improved efficiency, it might have adversely affected the flow of credit to the SME sector due to the relaxation of policies that had set specific targets for bank lending and the provision of higher risk weights on SME loan portfolios. Specialized banking facilities need to be developed to provide a package of services to address problems specific to SMEs. Considering the banking system's inadequacy to meet the growing demand for credit to SMEs, there is a need to create specialized development finance institutions for financing medium to long-term lending (along the lines of the Bank Rakyat Indonesia, the Industrial Bank of Korea, the Small Industries Development Bank of India, and the Development Bank of the Philippines).

In recent years, there have been extensive innovations in the design of financial products, one of which has been the unbundling of several forms of risks and cash flow characteristics of SME borrowers. Broadly classified as structured finance, these innovative instruments have taken the form of securitization, leasing and factoring, which had traditionally found extensive applications in corporate lending. Depending on the legal and institutional background of the private credit markets and the credit information available, these structured lending products carry potential for SME lending. Other forms of innovative financing practices in the region that have facilitated SME financing include credit guarantee schemes, provision of venture capital for start-up companies and private equity. The SME finance framework must incorporate new products as well as better risk unbundling approaches, providing banks and other financial institutions with sufficient incentives to enhance their stake in this important sector.

“Improving the investment climate to facilitate the growth of small enterprises is vital to maximize development outcomes”

The success of SMEs depends on the existence of a business environment that is favourable to them. This would require improving the overall investment climate, facilitating the growth of small enterprises, providing supportive business development services and reducing business transaction costs. Although the investment regimes faced by small and informal sector firms are similar to those for larger firms in many economies, the financing constraints on smaller firms are found to be magnified, and their severity more acute in poorer economies. An effective way to enhance the capacity of SMEs and access finance is to address constraints arising from market failures (such as imperfect information, and externalities). Another important factor in helping SMEs is the development of the insurance sector, which could address the problem of market risks.

> *"Financial systems should be inclusive so that they meet the credit needs of the poor, particularly women"*

Development practitioners, external donors and Governments have all recognized the increasing role played by microfinance institutions in financing asset-poor households and microentrepreneurs. Financial systems should be inclusive so that they meet the credit needs of the poor, particularly women. Poverty is being considered an outcome of market failure, as financial market imperfections often prevent asset-poor households from borrowing against their current assets and future earnings. Microfinance schemes have successfully provided credit to these households, which are invisible to the formal banking system. Microfinance success stories in several parts of Asia and the Pacific have demonstrated that even the poor can graduate from the informal money market into organized banking and begin generating sustainable livelihoods. Accordingly, donors have been motivated to scale up microfinance schemes.

It should also be recognized that the poor need much more than mere credit. The slum population is increasing due to rapid urbanization. Housing finance has benefited high-income groups rather than low-income groups. Scaling up these sources of finance has been seen to reduce poverty significantly, thereby helping to achieve the Millennium Development Goals. If the causes of financial market failure, particularly asymmetric information and high transaction costs of microlending, are appropriately addressed, it is possible for microfinance institutions to improve the access of the poor to formal finance. Microfinance also has the potential to finance all types of financial needs, including consumption, which the formal banking system is unable to do.

It has been argued that financing for development not only depends on the efficiency of the financial system but also on the business environment within which firms operate. Improvements in the investment climate generate incentives for private sector firms to invest productively. Policies that promote, for example, efficient registration systems, the removal of regulatory impediments in the form of entry and exit barriers, protection of creditor rights as well as transparent credit information flows between lenders and borrowers are also important determinants of the growth of firms. The establishment of a credit reporting system strengthens the accuracy and reliability of decision-making tools, such as credit scoring, and facilitates better credit analysis by lenders. Therefore, the provision of finance has to be linked to a wider strategy of creating a favourable business environment. Inappropriate policies, an inadequate regulatory framework and poor macroeconomic management constitute perhaps the most formidable constraints to private sector development in the region.

Different groups of countries in the region face different challenges to financing development and mobilizing domestic financial resources. Weaker financial systems and capital markets are more often vulnerable to external shocks, thus needing special policy attention.

Proposed action

- Improve macroeconomic conditions; in particular, provide a positive real interest rate on savings to induce people to save.
- Provide income-generating employment opportunities. Increase the efficiency of methods for generating tax revenues by formalizing the informal sector, adopting appropriate tax rates and improving the quality of tax administration.
- Promote pension reforms in the direction of funded schemes, in particular, to relieve fiscal pressures arising from demographic transitions.
- Develop domestic capital markets, in particular bond markets, to facilitate the mobilization of domestic resources.
- Consider allowing multilateral development banks with a “AAA” rating to issue local currency bonds (as is being done by the Asian Development Bank in a few countries) as a means of avoiding currency and maturity mismatches and exchange risks.
- Develop instruments for SMEs and microfinance and strengthen financing for the poor through microcredit schemes. Design an inclusive financial system that meets the credit needs of the poor and the microentrepreneur, and scale up microfinance.
- Overcome the “non-bankability” of SMEs and increase microfinance for SMEs by enabling innovative debt and equity financing through factoring, asset securitization, credit guarantees (by institutions as well as associations) and competency-based collateral loans.
- Consider the feasibility of a specialized bank capable of providing a package of services, such
- as finance and business development services, to address SME issues.
- Support insurance schemes that could address market fluctuations in prices.
- Help improve financing for low-income groups by, among other things, improving legal/regulatory frameworks, enforcing property rights, embarking on land/slum development programmes, providing affordable financing and improving technology to build low-income housing.
- Place emphasis on improving the overall investment climate, facilitating enterprise growth, providing supportive business development services and reducing business transaction costs.

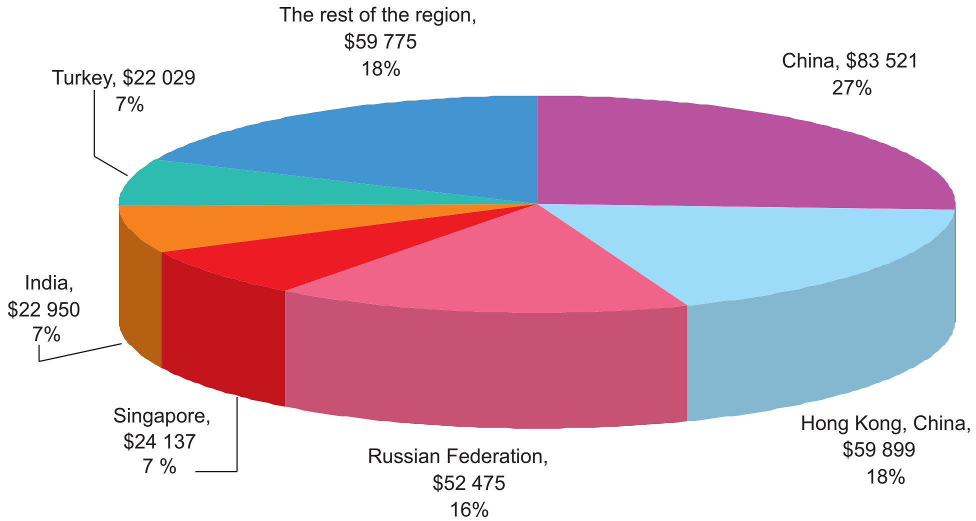
II. Mobilizing international resources for development: foreign direct investment and other private flows

Progress, issues and challenges

The Asia-Pacific region continues to attract a significant share of private capital, particularly foreign direct investment (FDI), from global financial markets. In 2007, developing countries in the Asia-Pacific region attracted $325 billion, more than triple the inflows of 2002. However, as reflected in figure 3, the progress in attracting FDI across developing countries in the region is uneven. For example, four countries and one territory (China, India, Russian Federation, Singapore and Hong Kong, China) accounted for 75 per cent of total FDI inflows to the Asia-Pacific region. FDI flows have been directed more into brown fields, such as mergers and acquisitions, than green fields with limited positive externalities.

Figure 3. FDI flows to Asia-Pacific countries in 2007

(Millions of United States dollars)



Source: UNCTAD, *World Investment Report, 2008* (Geneva).

There are many reasons for the considerable divergence in international capital flows. China attracts over a quarter of the total flows to the region influenced by market size and high growth. Countries and areas such as India, Malaysia, the Republic of Korea, Singapore, Thailand and Hong Kong, China, have established a good track record of private capital market access in the form of bank loans and global bond placements. They have improved their saving-investment scenario considerably in recent years and have been able to foster a better investment climate, thereby witnessing a surge in non-debt creating capital inflows. Financial flows to these economies are nevertheless highly sensitive to the general conditions in regional and global capital markets, as well as domestic macroeconomic and political developments. On the other hand, most of the countries of South and South-West Asia, the Central Asian republics, and the Pacific Islands lack access to global capital markets due to weak macroeconomic fundamentals and fragile financial markets. These countries therefore depend to a large extent on financial assistance from bilateral and multilateral donors, mainly in the form of concessional financing.

“The region has become not only a major destination for FDI inflows but also a source of outflows”

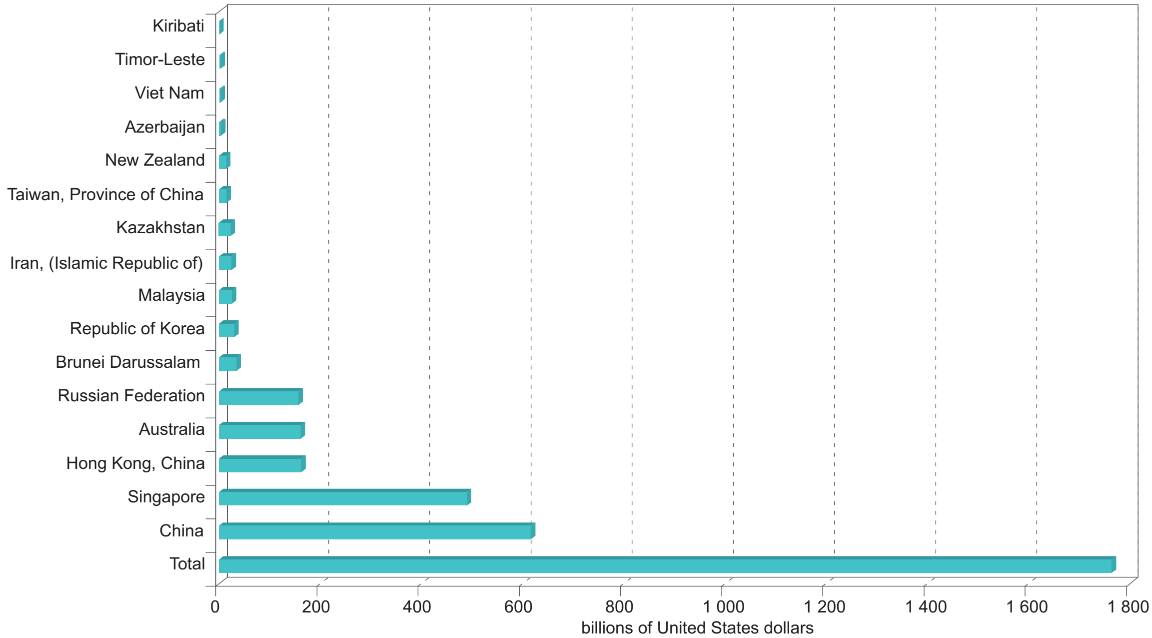
The region has become not only a major destination for FDI inflows but also a source of outflows. In 2006, the region accounted for $196 billion in FDI outflows or about 16 per cent of the world total.

A good investment climate tends to attract FDI. A series of studies on “doing business” commissioned by the World Bank provide evidence that barriers to industrial dynamism have much to do with an investment climate produced by a system of complicated laws, regulations and registration processes, high tax rates, high cost of and limited access to finance and overly complex or stringent labour regulations, among other things. Constraining regulations as well as inadequate infrastructure act as perverse incentives for business. In order to promote FDI and other private flows for investments, it is necessary to design government policies in such a way as to foster an investment climate that facilitates private sector growth. A better investment climate provides opportunities and incentives for both multinational and local enterprises to invest productively, which, in turn, creates employment and reduces poverty, as may be seen from the experience of China and India with rising levels of private investment.

In recent years, many countries in the region have amassed large volumes of international reserves. While a surge in non-debt-creating flows has provided favourable conditions, it was their desire to insulate themselves from financial market volatility that induced them to accumulate excess reserves. The build-up of excessive foreign exchange reserves and fiscal surpluses has led to the emergence of sovereign wealth funds in the region, with a current market size of about $1.8 trillion (figure 4). Sovereign wealth funds are government-promoted investment vehicles usually controlled by the country’s ministry of finance and operationally managed by the central bank or a statutory management agency. Sovereign wealth funds typically invest in a broad range of asset classes, such as United States or European government bonds, agency and asset-backed securities, equities and real estate. This is a new phenomenon wherein the Government acts as an investor, and this practice is expected to have a significant impact on a country’s public finance and monetary conditions.

Figure 4. Major sovereign wealth funds in the Asia-Pacific region, 2007

(Assets under management in billions of United States dollars)



Source: UNCTAD, *World Investment Report* (Geneva, 2008).

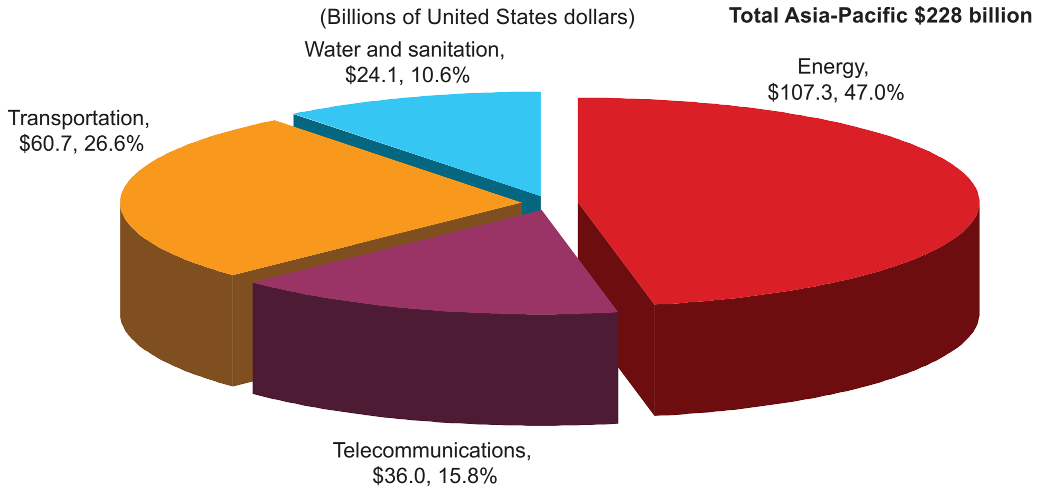
Considering the size of the outward investment flows from the region, sovereign wealth funds emanating from the region could be used as an effective instrument for financing development projects in the Asia-Pacific region, particularly in social infrastructure. Improving financial systems, in particular promoting integrated bond and equity markets in the region, would be vital in order to induce investments from sovereign wealth funds. Such investments, however, have to take into account considerations of political economy to avoid the apprehension of receiving countries and may therefore require a code of conduct on sovereign wealth funds to address transparency concerns. The resources of sovereign wealth funds have to be utilized prudently. However, the target should be a socially acceptable rate of return rather than purely commercial ventures.

> *“The region’s infrastructure financing gap—estimated at $220 billion per year—remains a critical challenge”*

Maintaining growth momentum depends heavily on the ability of the region to upgrade infrastructure and bridge the huge infrastructure investment gap. Infrastructure development in Asia lags behind economic growth, leaving an infrastructure funding gap of more than $220 billion per year (figure 5), but this is not due to a lack of funds in most cases; rather, it is mainly a reflection of the lack of bankable projects, good governance and political will. Among the challenges in addressing infrastructure financing are the provision of an enabling environment for such investment (legal, policy, institutional capacity, customs, governance), coordination among multiple stakeholders (public and private sector, central and local governments), the development of "bankable" projects (design, cost estimate, technical preparation, risks pricing), and the promotion of innovative financial instruments.

Figure 5. Estimates of average annual infrastructure financing needs for Asia and the Pacific during the period 2006-2010

(Billions of United States dollars)



Source: *Enhancing Regional Cooperation in Infrastructure Development Including that Related to Disaster Management* (United Nations publication, Sales No. E.06.II.F.13).

In Asia, commercialization and private sector participation in infrastructure have progressed significantly, attracting large foreign investments and improving basic infrastructure delivery in such sectors as power, telecommunications, roads and ports. Governments need to explore the possibilities for creating public-private partnerships with suitable regulatory frameworks as well as policy environments that accommodate private players and commercialization in various forms, such as management contracts, lease contracts and build-own-operate and build-operate-lease-transfer contracts. Support from Governments in the form of equity participation, concessions on land or water supply, dedicated revenue streams for loan repayment, and a transparent regulatory framework has been encouraging. Many provincial governments in the region have been successful in urban infrastructure development by creating special purpose vehicles, often with equity contribution from governments or project sponsors. Political drive and policy continuity are key requirements.

Multilateral development banks can play a larger role in infrastructure development and financing by co-financing, providing guarantees, arranging currency swaps and raising long-term local currency bonds. To facilitate better decentralization outcomes, it is also necessary to make arrangements for multilateral development banks to work with local governments and the private sector. Technical assistance from multilateral development banks will be crucial for the pre-investment phase in order to make projects bankable, together with mechanisms to provide insurance against political and commercial risks.

> *“Private remittances have become a major source of development finance in countries of the Asia-Pacific region”*

In recent years, there has been a remarkable increase in the share of private remittances in international financial flows, and it is particularly more prominent in the Asia-Pacific region. This component of foreign exchange earnings has eased the pressure on current accounts considerably and has acted as a source of financing for development in several economies in the region. In several South Asian countries (Bangladesh, India, Nepal, Pakistan and Sri Lanka), the inflows of private remittances have risen rapidly in recent years, representing a major source of hard currency and significantly offsetting the deficits on trade. Net inflows attributable to workers’ remittances in South Asia were estimated at $43.8 billion in 2007, as compared with $30.6 billion in foreign direct investment in 2007. There is evidence that a substantial portion of such remittances are repatriated using informal channels, apparently due to the high costs associated with transferring funds through formal channels. Governments could facilitate these flows by introducing systems to transfer funds at low cost through formal banking channels. Countries of origin and destination could facilitate migration through a collaborative approach, thereby working towards regulatory and enforcement mechanisms to protect the rights and safety of workers, and ensuring decent working conditions and wages for migrants.

High capital mobility and volatility arising from liberalized financial markets have created a number of new issues for policymakers in the region. In today’s globally integrated world economy, with fewer countries dismantling formal exchange control regimes, the distinction between domestic and external sources of capital is becoming blurred. While resources for development may be obtained from domestic or foreign sources, there is a common policy space that is likely to influence their overall volume and composition and the cost of finance. Thus, such prerequisites as sound fiscal and monetary policies, standards of governance and disclosure, effective legal enforcement of settlement procedures, sufficient capitalization of the banking system, and liquidity provision are becoming increasingly important.

Proposed action

- Improve the domestic business environment and macroeconomic conditions to attract FDI.
- Promote South-South cooperation to enhance FDI flows within the region.
- Introduce systems to transfer funds, in particular private remittances, at low cost through formal channels.
- Establish a regional mechanism for financing infrastructure development. Strengthen the existing process to develop regional bond markets in Asia, including the expansion of the Asian Bond Fund to cover more countries.
- Create integrated equity and bond markets throughout the Asia-Pacific region.
- Make arrangements for multilateral development banks to work with local governments and the private sector in the provision of pro-poor infrastructure, such as water supply, sanitation and sewerage, and take higher but calculated risks in developing such projects.
- Make non-bankable projects bankable by addressing issues relating to the pre-investment phase.
- Channel technical assistance from multilateral development banks, which is crucial for the pre-investment phase, together with mechanisms to provide insurance against political as well as commercial risks.
- Encourage public-private partnerships for developing infrastructure as an attractive solution in which both the private and public sectors could share risks and rewards.
- Encourage multilateral development banks to play a larger role in infrastructure development and financing by co-financing, providing guarantees, arranging currency swaps and developing bond markets.

III. International trade as an engine for development

Progress, issues and challenges

International trade is an important source of development finance, as an export-oriented strategy not only enables financing of essential imports but increases productivity and growth. Although the Monterrey Consensus focuses on a country's domestic resources as the major source of financing for development, it strongly emphasizes the role of external sources, such as international trade and capital inflows, as important drivers of a nation's growth.

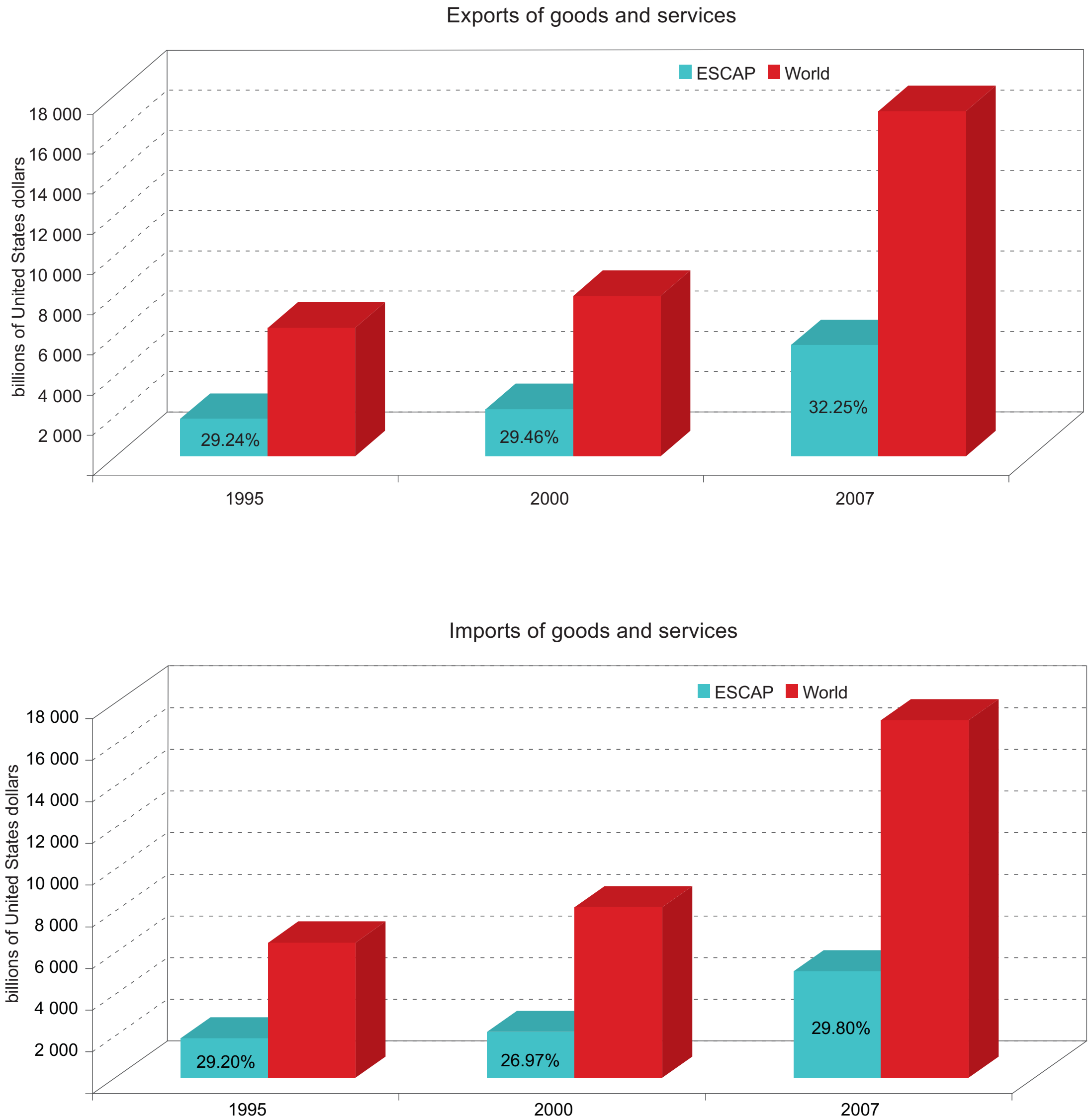
> *"Soaring current account surpluses indicate the immense gains from trade"*

According to the latest estimates, the share of developing economies in world exports increased from 30.1 per cent in 2000 to 35.2 per cent in 2007. The Asia-Pacific region's share of world exports increased steadily, from 29.5 per cent to 32.3 per cent, during the period 2000-2007 (figure 6). The value of exports of developing countries in the region has grown, on average, by 15.5 per cent annually during this period. Annual growth was very significant in Central Asian countries (23 per cent), East Asia (16.6 per cent) and South Asia (15.1 per cent). In South-East Asia, exports doubled during this period. This remarkable growth in exports has been driven by increased production capacity, favourable terms of trade for developing commodity exporters (oil, metals and agricultural) and strong demand for exports in the United States and the European Union. The region's share in imports has also grown, from 27 per cent in 2000 to 30 per cent in 2006.

The current account surplus of the developing Asian countries increased from $56.3 billion in 2000 to $413.2 billion in 2007, reflecting the increasing surplus from international trade (figure 7). International trade has grown much more rapidly in a few countries, which has also created opportunities for intraregional trade within the region. Over two-thirds of the increased share of trade of all developing and transition economies in Asia and the Pacific in 2007 can be attributed to China.

Trade restrictions, mostly in the form of non-tariff barriers, on access to developed country markets and some emerging markets are hurting many developing countries in the region, particularly the least developed countries. The existing comparative advantage in agriculture cannot be utilized due to agricultural trade restrictions, including denial of access to developed country markets and distortional agricultural subsidies. Granting duty-free and quota-free market access to industrial and agricultural products from least developed countries could relieve some of the financial pressures that those countries face.

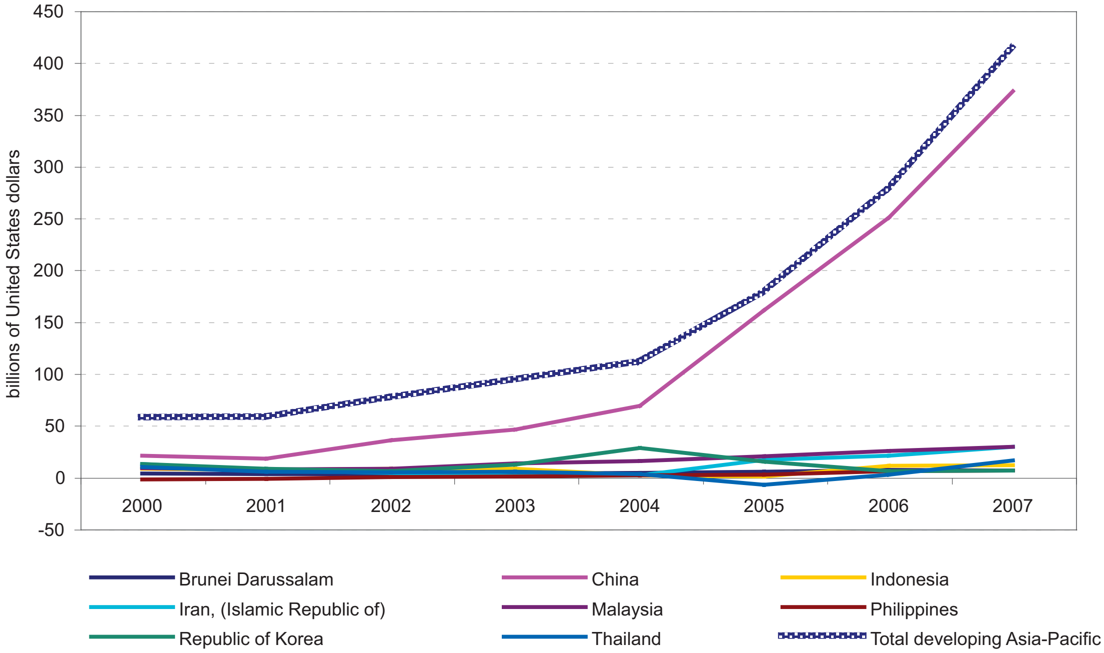
Figure 6. Share of the ESCAP region in world trade



Source: Calculated from data downloaded from UNCTAD (2008). *Handbook of Statistics* online database, accessed on 27 October 2008 from http://stats.unctad.org/Handbook/ReportFolders/ReportFolders.aspx.

Note: Percentage figures represents share of ESCAP region to world total.

Figure 7. Current account balance of selected developing countries in the Asia-Pacific region, 2000-2007



Source: International Monetary Fund, *World Economic Outlook Database*, October 2008.

International trade has flourished because of improvements in transport technologies. However, the escalating cost of fuel has so increased freight costs that, in the case of some commodities, the cost of freight is higher than that of the commodity itself. This could severely impede trade if the supply chain is not shortened. Improvements in trade facilitation, such as switching to paperless transactions, as in the ASEAN single window initiative, could help save considerable time and money. Other internal bottlenecks to trade facilitation would include the quality and availability of raw material, labour shortages, cumbersome rules, regulations and customs procedures, all of which prevent countries from benefiting fully from the new trade regime.

The region as well as the rest of the world could benefit immensely from an effective conclusion of the Doha round of multilateral trade negotiations. Many countries, including many in Asia and the Pacific, have been actively promoting bilateral trade agreements with other nations, reflecting their frustration at the slow progress of the Doha round negotiations. It should be noted, however, that investment protection provisions in bilateral trade agreements (BTAs) are much stronger than those under WTO and that, in BTAs, developing countries have much weaker leverage when facing trading giants, as compared with the scenario of a multilateral setting within the framework of WTO.

> *“ Trade barriers are hurting many developing countries, particularly least developed countries ”*

The sixth Ministerial Conference of WTO, held in Hong Kong, China, in 2005, reached an agreement on “aid for trade”, particularly for least developed countries and other developing countries with supply-side constraints. The aid for trade initiatives are expected to encourage countries to participate effectively in trade negotiations and successfully implement trade agreements. The least developed countries can benefit from the market access opportunities if their capacity is developed on the supply side and national competitiveness constraints are relieved. Nevertheless, aid for trade should be regarded as an additional source of finance, and not a substitute for ODA. Progress in aid for trade has been rather slow in Asian and Pacific developing countries, which received a very small proportion of overall trade-related assistance. Rather than being linked to new conditionalities, aid for trade should aim at compensating for lost revenue, increasing the capacity for production and facilitating trade negotiation, among others.

Proposed action

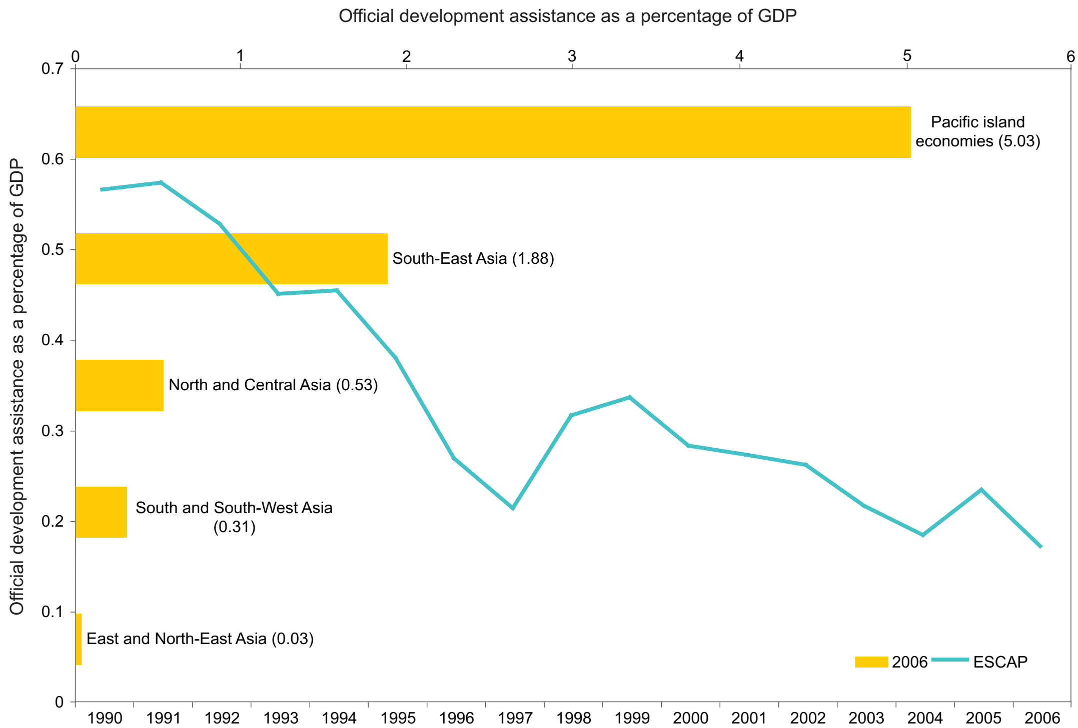
- Press for a successful and speedy conclusion of the Doha Round negotiations, while continuing to liberalize and facilitate trade within the Asia-Pacific region by deepening and strengthening existing regional and bilateral arrangements (for example, Asia-Pacific Trade Agreement [APTA], ASEAN plus agreements and similar South-South agreements).
- Facilitate financial flows associated with trade and trade-creating FDI.
- Promote aid-for-trade at bilateral and regional levels and improve its effectiveness. Improve supply capacity by addressing such issues as low quality and non-availability of raw materials, skilled labour shortage, and trade facilitation through the targeted removal of cumbersome rules and regulations and the improvement of customs procedures.
- Improve policy-oriented trade research.
- Combine trade policy with domestic reforms to ensure coherent economic and social policies.
- Promote and facilitate connection of producers and exporters from low-income and the least developed countries with regional and global supply and production chains.
- Support the reform of the decision-making process associated with the formulation of trade policy at the national, regional and global levels, which would include setting the negotiation agenda and advancing the negotiation process at WTO, to enable developing countries to play a more effective role in the global trading system.

IV. Increasing international financial and technical cooperation for development

Progress, issues and challenges

Official development assistance (ODA) acts as a major source of development financing, particularly in least developed countries, landlocked developing countries and small island developing States, which have the smallest capability to attract foreign private capital flows. Targeted ODA can be a crucial instrument for supporting investments in the social sector, such as education, health, public utilities, agriculture and rural development, and for enhancing food security. The Monterrey Consensus considers ODA to be critical for achieving the Millennium Development Goals and other internationally agreed targets.

Figure 8. Official development assistance to ESCAP subregions, 2006
(Percentage of GDP)



Source: Development Assistance Committee of the Organisation for Economic Co-operation and Development, and International Monetary Fund, *World Economic Database, October* (Washington, D.C., 2008).

According to OECD, the share of ODA stands at 0.28 per cent of the donors' gross national income in 2007, which is lower than the 2005 share of 0.33, per cent and below the agreed goal of 0.7 per cent. After adjusting for debt relief (for the years 2005 and 2006, mainly for Iraq and Nigeria), ODA actually fell during the period 2005 to 2007. For the Asia-Pacific region, ODA has declined from 0.6 per cent of GDP in 1990 to only 0.2 per cent of GDP in 2006 (figure 8). As a subregion, Pacific island economies received the most ODA (5 per cent of GDP) in 2006, followed distantly by South-East Asia (1.9 per cent) and North and Central Asia (0.5 per cent). Significant increases in ODA flows have been recorded in countries such as Afghanistan, Georgia, Kyrgyzstan, Tajikistan, Timor-Leste and Viet Nam, many of them experiencing a political economy transition.

“Least developed countries still depend heavily on ODA”

A substantial share of ODA goes to middle-income countries, which usually have alternative options for funding, when the least developed countries are in dire need of greater aid, especially grants, in order to finance budget deficits. Nearly 70 per cent of total ODA is bilateral, which seems to be concentrated on a small number of recipients countries. The *World Economic and Social Survey 2005*[2] noted that the top 20 recipients received more than half of net bilateral ODA and less than 50 per cent of aid recipients received 90 per cent of all aid from Development Assistance Committee donors. The achievement of the Millennium Development Goals, particularly by least developed countries as outlined at the 2000 Millennium Summit, will remain uncertain unless additional ODA is provided.

Multilateral aid has remained relatively small and more constrained than in the past. Technical assistance obtained from multilateral development banks is crucial for the pre-investment phase of infrastructure projects. Moreover, aid flows have become less responsive to short-term or cyclical phenomena.

The Paris Declaration,[3] adopted in March 2005, and the Accra Agenda for Action[4] attempted to resolve the concerns regarding aid effectiveness, improving its quality and quantity, capacity development

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[2] United Nations publication, Sales No. E.05.II.C.1

[3] Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results and Mutual Accountability, adopted at the High-level Forum on the question of “Joint Progress towards Enhanced Aid Effectiveness: Harmonization, Alignment, Results”, held in Paris from 28 February to 2 March 2005 (see http://www1.worldbank.org/harmonization/PARIS/FINALPARISDECLARATION.pdf).

[4] Adopted at the High-level Forum on Aid Effectiveness, held in Accra from 2 to 4 September 2008.

and the predictability of aid. It has been argued that a donor-driven aid programme may give donors a greater sense of control but diminishes the accountability of recipient Governments. Aid programmes are well utilized if Governments and donors work together to monitor the implementation of a country's development strategy and the national budget. In this context, the need for an international aid monitoring system has been recognized, which would ensure that donors and recipients can hold each other accountable in aid programmes.

Aid dependency has continued in a number of least developed and low-income countries of the region, whose current accounts have remained structurally in deficit, despite commodity price boom, essentially due to a very narrow export base and non-compressible import items. ODA provides a significant portion of budget support in these economies, with over 25 per cent of central government expenditure accommodating for the provision of public goods in support of growth and development. If the commitments under the Millennium Development Goals have to be met, the rationale for ODA should be shifted from the narrow focus of aid effectiveness, as determined by the policy environment, to the attainment of social, human and environmental objectives.

> *“Several developing countries in Asia have become donors, strengthening South-South cooperation”*

One positive development to note is the emergence of some countries in the region as donors: these countries provide zero tariffs, ODA and FDI to neighbouring countries as well as countries in other regions, including Africa. The challenges faced by developing countries could be met by calling for greater aid disbursement, particularly to least developed countries, strengthening existing partnerships and exploring new ones. South-South cooperation should be promoted to enlarge the pool of aid resources. Developed countries can join developing countries in extending help to countries in need of aid. This triangular cooperation can enhance the impact of aid.

Not only the donor countries but also the recipient countries have a role to play. Countries receiving ODA have to improve its utilization. Good governance and better policies are critical in this regard. Moreover, investment is needed to enhance the aid absorption capacities of the recipient countries. In a scenario of declining ODA, it is critical to address the need for greater aid effectiveness by building absorptive capacity, strengthening country ownership of programmes and improving the quality of country development strategies. Aid effectiveness needs to be strengthened in order to increase the development impact of ODA. National Governments could improve the country conditions to ensure a stable policy environment, improved transparency, and accountability, particularly in bidding and contracting.

Improving the predictability of aid is also crucial in order to enable countries to produce sound medium-term budgets. The practice of aid-tying, whereby donors provide aid only to purchase goods and services from their own country, substantially reduces the value of the aid provided for the recipient country, as the goods and services often do not conform to the needs of the recipient country. Although there has been considerable progress in untying aid, efforts need to continue, and donors must harmonize aid processes by adopting common practices. The donor and the partner country must have a shared responsibility for development results, ensuring mutual accountability.

Proposed action

- Call for greater aid disbursement, particularly to least developed countries by strengthening existing partnerships and exploring new ones (particularly under South-South and triangular cooperation).
- Address the need for greater aid effectiveness in a scenario of declining ODA by building absorptive capacity, strengthening country ownership of programmes, improving the quality of country development strategies and addressing governance issues.
- Improve technical and financial cooperation within the region through, among other things, the development of local and regional bond markets, the provision of guarantees (acting as a mono line) on bond issues by multilateral development banks to local issuers to make them attractive and pass on technology and expertise to local banks and help them design bankable projects.
- Promote South-South cooperation to help all parties, particularly in tapping the huge energy resources in the region.

V. External debt

Progress, issues and challenges

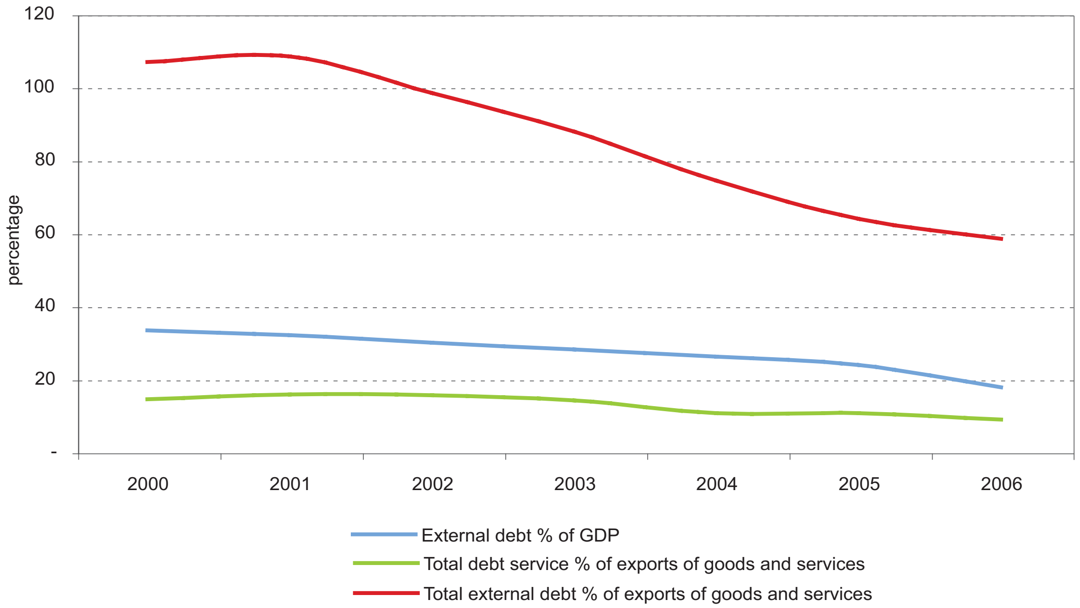
The Monterrey Consensus called for concerted efforts, by both multilateral institutions and national Governments, to reduce the burden of debt of heavily indebted poor countries to sustainable levels and strongly endorsed international initiatives to support and strengthen the resolution of the debt crisis. Significant global efforts have been made since the Monterrey Consensus to enable debt to be a positive source of financing for development. Countries that managed debt properly could use it as a critical source of financing for development. However, in some countries, the level of debt has risen to such a high level that it has become an obstacle to development.

Several new elements of the debt problems have also surfaced in recent years, including rising levels of corporate debt, the linkage between domestic and external debt, the level of contingent liabilities and the nature of debt instruments, such as bonds that do not come under the purview of traditional Paris Club/London Club arrangements for restructuring. The evolving environment therefore requires newer approaches to dealing with the debt problems of developing countries.

> *"Significant progress in reducing the external debt burden in the region, but in several countries external debt is still a critical issue"*

On the whole, the Asia-Pacific region has done well in maintaining external debt at sustainable levels. Total external debt outstanding for the Asia-Pacific region as a percentage of GDP declined from 33.14 per cent in 2000 to 17.58 per cent in 2006 (figure 9). As a percentage of goods and services exported, total external debt has also declined, from 106.67 per cent to 58.27 per cent during the same period, indicating its strong debt-servicing capacity. Several factors have contributed to the reduced level of external debt in the wake of the Asian financial crisis. The development of domestic bond markets in several countries (for example, India, Indonesia, Malaysia, the Republic of Korea and Turkey), a shift towards domestic borrowings by Governments, and increased issuance of domestic debt instruments by the corporate sector are mainly behind this reduction.

Figure 9. Debt indicators for the Asia-Pacific region



Sources: World Bank, *World Development Indicators 2007* CD-ROM and *World Development Indicators* online database accessed on 22 October 2008 (Washington, D.C.).

Some of the economies that have witnessed current account surpluses and rising capital inflows have made prepayments on some of the external loans. The debt repayments are also motivated by improved terms and conditions in global capital markets, mainly due to a lower credit risk assessment by lenders. Debt situations are somewhat critical, however, in several low-income countries, such as Indonesia, Kazakhstan, Kyrgyzstan, the Lao People's Democratic Republic, Myanmar, Pakistan, Papua New Guinea, the Philippines, Samoa and Tajikistan.

A few countries have also undertaken debt restructuring exercises. Indonesia entered rescheduling agreements with the Paris Club in April 2002 and with the London Club in June 2002. The Lao People's Democratic Republic reached an agreement to reschedule with the Russian Federation in June 2003. Kyrgyzstan rescheduled with the Paris Club in March 2002. Although there are a number of initiatives in the area of official debt restructuring, there appears to be no common approach to orderly work-outs for commercial debt, and there is no operational mechanism to reduce debt vulnerability and make provisions for adequate liquidity in countries facing serious debt-servicing difficulties.

Even though some of the low-income developing countries of the Asia Pacific region could be considered severely or moderately indebted, and, with the exception of Afghanistan, Kyrgyzstan and Nepal, they are not on the list of specific categories, such as HIPC, that would allow them to avail themselves of debt reduction under the multilateral initiatives. These countries are experiencing significant shortages of new funds, curtailing essential imports and accentuating poverty. They lack access to private capital markets and therefore depend to a large extent on assistance from bilateral and multilateral donors, primarily in the form of concessional financing. The external debt situation of this group of countries therefore continues to depend to a large extent on the policies and practices of the donors. Resolving debt issues along with an orderly flow of financial resources assumes importance for this group of low-income developing countries, thereby supporting their integration into the global financial system.

“ The rising short-term debt
is becoming a concern ”

The East Asian financial crisis was caused by mismatches in the composition of debt between the private and public sectors, and its maturity, the high level of contingent liabilities, and inconsistency between macroeconomic policy and external sector objectives. The structure of debt has undergone significant changes to date, with an increase in domestic debt in total public debt, decline in the proportion of short-term external debt, and higher build-up of reserves in relation to external debt. However, rising short-term debt in recent years is also exposing the region to vulnerability. For example, the region has witnessed a 30 per cent increase in short-term debt during the period 2000 to 2006 and an increasing shift from official borrowing to borrowing from private sources. A significant portion of the external liabilities of some countries of the region are denominated in Japanese yen (China, Indonesia, Malaysia and the Philippines), and the appreciation of the yen has led to an increase in exchange risk.

There is a need to have a comprehensive measure of total public debt, including both public and private sector non-guaranteed debt. The increasing role of the private sector in the development process has been an emerging feature, complemented by the changing composition of capital flows (for example, the increased importance of portfolio investment flows and the raising of bonds and loans from commercial sources). These have created new dimensions of the debt problems, such as corporate debt problems, exchange rate debt linkages, domestic-external debt linkages, contingent liabilities. It is necessary to monitor the level of private sector debt, which will include corporate debt as well as debt by financial intermediaries.

The level of debt must be sustainable over the medium run, and it is necessary to assess several debt indicators simultaneously in a forward-looking framework to address the issues related to sustainability. There are constraints in establishing frameworks for assessing debt sustainability in developing countries, especially in least developed countries and economies in transition. The general approach to debt sustainability as outlined in the IMF "Guidelines for Public Debt Management"[5] considers the situation in which the Government could continue to service its obligations without an "unrealistically large" future correction to the balance of income and expenditure. The Monterrey Consensus takes a different stand, recognizing the debt sustainability thresholds after considering the social and developmental imperatives of a Government's expenditure and revenue-raising capacity, thus the servicing of debt without affecting the development goals.

> *" Special attention requires monitoring contingent liabilities "*

The analysis of debt sustainability typically focuses on the officially reported claims on the Government, and this often fails to detect the possible future increases in payments obligations that may emerge from explicit or implicit government guarantees. In post-crisis Asia, such government guarantees to the domestic banking sector represented over 20 per cent of GDP in the Republic of Korea, 30 per cent in Thailand and about 50 per cent in the case of Indonesia. Contingent liabilities are often not measured in many countries and are therefore not covered in the debt statistics. The extent of such liabilities can also be widened in the presence of poor governance and regulatory regimes. These liabilities carry significant fiscal risks, which constrain the ability of Governments to undertake policy reforms in times of crisis. Countries in the region should measure and limit the use of contingent liabilities, making it transparent, and disseminate such information to the public.

Foreign currency debts are exposed to risks in various forms, such as currency and interest rate risks. Commodity price fluctuations add further risk by affecting the ability to service the debt. An integrated framework of managing debt with costs and risk trade-off, with the necessary skills and capacity to undertake such strategies, could minimize such risks. Currency and interest rate risks should be managed through the development of integrated risk management policies and the establishment of appropriate benchmarks, well tested with the debt data. It is necessary to explore the process of integration of the foreign exchange reserves and external debt within the asset-liability framework. While a passive

[5] https://www.imf.org/external/np/mfd/pdebt/2003/eng/am/120903.pdf.

approach to debt management is desirable under normal circumstances, analytical studies must be undertaken before any active debt management is pursued. Debt managers should continuously explore opportunities to reduce the burden of expensive debt, via early retirement (prepayment) and refinancing of existing high-cost debt that can be retired without additional costs, such as penalties, provided that this does not adversely affect the maturity profile.

Proposed action

- Promote effective debt management, including balancing between private and public debt, its maturity, the level of contingent liabilities and reserve management. Use foreign debt efficiently for development purposes, ensuring effective utilization and minimizing the cost of borrowed capital.
- Reduce dependency on external borrowing and secure long-term financing from domestic sources.
- Develop the financial system, including the domestic bond markets, in particular, the government bond market, by creating an environment conducive to the promotion of long- term investments.
- Consider a regional mechanism to monitor private debt and to mitigate the destabilizing effects on financial markets in times of crisis.
- Build strong institutional arrangements for debt management, with emphasis on the debt management office and human resource capacity with good debt management skills.
- Relax the conditions attached to benefiting from the HIPC initiative by low-income countries.
- Implement appropriate frameworks, including early warning systems and debt sustainability analyses, on a regular basis to ensure that the debt burden remains at sustainable levels.
- Maintain macroeconomic stability on a sustainable basis with due attention to monetary, fiscal and exchange rate policy coherence and consistency. In particular, pay careful attention to the growing fiscal deficits of the public sector.

VI. Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development

Progress, issues and challenges

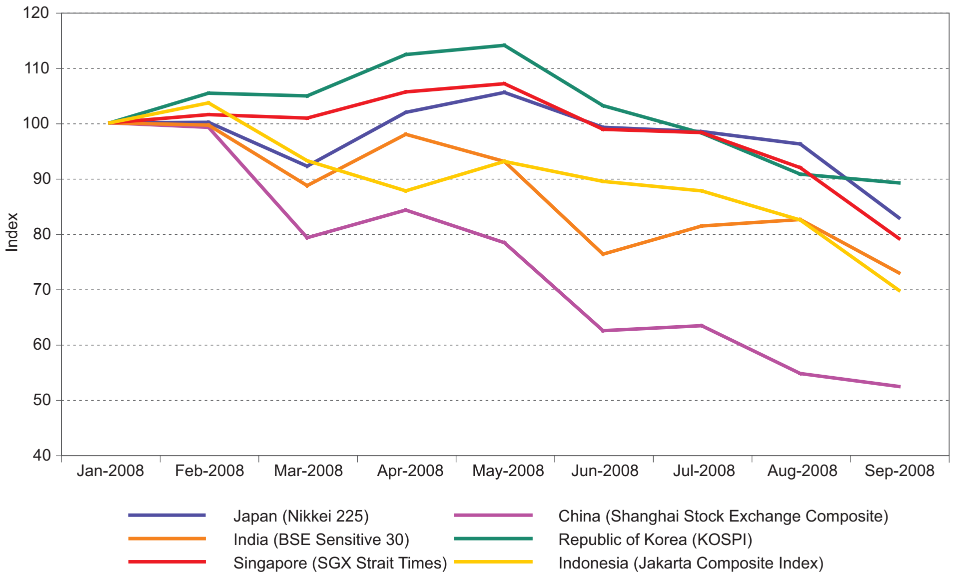
The Asian financial crisis and the current global financial turmoil underscore the importance of addressing systemic issues at both the regional and global levels. The Monterrey Consensus envisaged the urgency of enhancing the coherence and consistency of the international monetary, financial and trading systems in order that the benefits of global integration might be achieved with minimal repercussions. To a significant extent, achieving coherence and consistency depended on the sustained reform of the international financial architecture. The current financial turmoil only indicates that the developed countries in particular have failed to address the very issues identified in the Monterrey Consensus as key for financial market stability. The speculative capital flows that continue to remain significant in the region's financial flows and add complexities to market liquidity and monetary policy operations are a potential threat to the region's financial stability (figures 10 and 11). In particular, the current global financial turmoil poses a serious threat to the economic and social development of the Asia-Pacific region if the crisis lingers on and the global economy enters into a recession. The region needs to act now and undertake preventive measures so that it can withstand both the present crisis as well as the downstream effects on its economies.

Although the region has been criticized for accumulating excessive foreign exchange reserves, those reserves have proven to be handy in the current crisis. Financial and economic strength enabled several countries in the region to be proactive in introducing financial safeguards and stimulus packages. For example, in October 2008, Japan announced a $400 billion stimulus package while the Republic of Korea introduced a financial package to guarantee inter-bank lending, underwriting $100 billion worth of foreign debt. Malaysia injected RM 5 billion into the market for the benefit of undervalued companies. China announced, in November 2008, a stimulus package of $586 billion to boost investments in infrastructure and social welfare. However, a region-wide coordinated approach could have been more efficient in providing liquidity to the market.

“The current global financial turmoil poses a serious threat to the financial stability and economic and social development”

Figure 10. Stock markets in selected economies of the ESCAP region, 2008

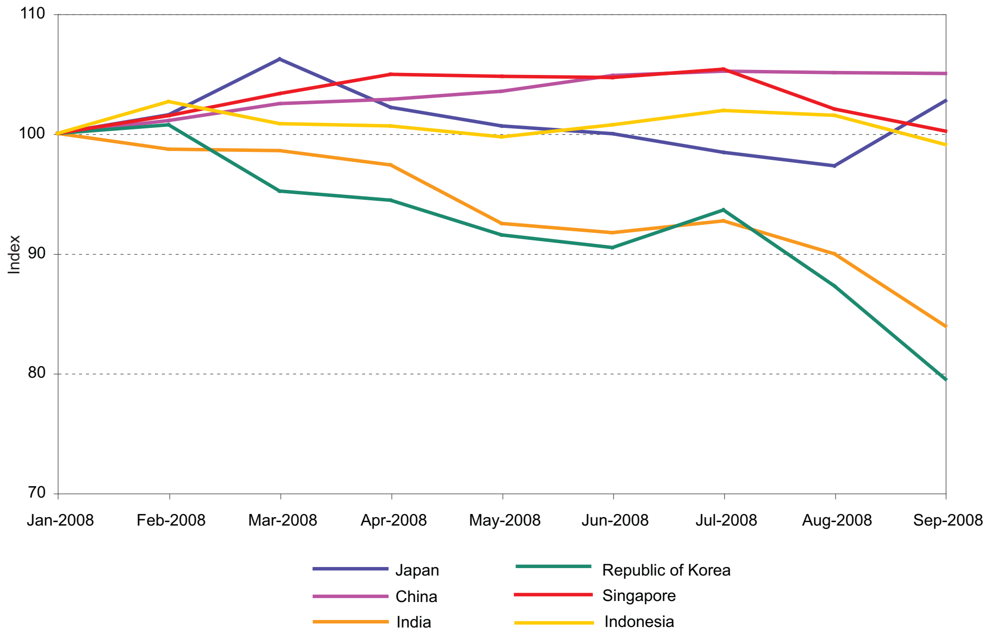
(January 2008 = 100)



Source: CEIC Data Company Ltd. (www.ceicdata.com).

Figure 11. Exchange rate movement of selected economies in the ESCAP region, 2008

(January 2008 = 100)



Source: CEIC Data Company Ltd. (www.ceicdata.com).

The Asia-Pacific region has built up reserves as insurance against currency attacks. It has enforced prudential regulations in the banking system and discouraged short-term external borrowing. Some countries in the region have also applied quantitative capital controls on a temporary basis. These have been primarily aimed at minimizing the disruptive impact of volatile capital flows. However, the ever-changing landscape has confronted the region with new challenges, such as increased cross-border mergers and acquisitions, the build-up of excessive liquidity and the emergence of sovereign wealth funds, the implications of high food and energy prices, the financial implications of climate change and related natural disasters, and the increased vulnerability of the financial sector to global shocks. The financial systems must adapt to such irreversible trends in the internationalization of firms and markets and remain prepared with contingency policy frameworks to deal with the eventualities of a larger outflow of capital. The economic events of the past year have validated some of these concerns.

> *“The current global financial turmoil calls for a more responsive financial architecture”*

The perils of financial innovation have led to excessive risk-taking by institutions such as hedge funds and private equity funds. The recent turmoil has proved that the present multilateral trading and financial systems are extremely vulnerable and insufficient, and that the global economy needs a more responsive architecture. There is a need for stronger institutional arrangements that discourage excessive speculation in the financial markets, promote stable macroeconomic policy and encourage productive investment in the real economy. The multilateral framework involving trade, exchange and investment regulations should have maximum space for Governments to pursue policies that are in the national interest in order to mitigate the volatility of financial flows. The national policy framework should also minimize the potential moral hazard of the private sector that is inevitable in any policy of guarantees.

The growth of cross-border capital flows continues to pose significant challenges in post-crisis Asia. From 1997 to 2007, total capital inflows have more than quadrupled, far exceeding the total current account, posing challenges for the conduct of monetary and exchange rate policies. Total private capital inflows in 2007 to developing Asia and the newly industrialized Asian economies was $823.1 billion and the outflow was in the order of $660.7 billion (thus a net inflow of $163.0 billion). While many developing countries have benefited from such capital, financial globalization has exacerbated market volatility and contributed to the emergence of new sources of systemic instability.

Leveraged "buyouts" and private equity fuelled by cheap credit and excess liquidity can cause further instability. Vigilance and control of excess liquidity in the financial system and prudential norms are important in addressing financial crises. The regularity of financial crises and the cost of cleaning them up (privatization of gains and socialization of risks) imply that capital is not allocated efficiently as it produces the highest rate of return for holders without considering the adverse effects on the rest.

The need for a major overhaul of the financial system is felt now more than ever before, with a soundly managed and adequately capitalized banking system that can safely and efficiently intermediate between savers and investors. Many countries in the region have embarked on improving the regulatory and supervisory mechanisms, as well as adopting minimum standards for capital adequacy as outlined in the "Core Principles for Effective Banking Supervision"[6] under the New Basel Capital Accord (also known as Basel II).[7] Basel II includes improved capital adequacy framework, which is intended to foster a strong emphasis on risk management and to encourage improvements in the internal risk assessment capabilities of banks. The experience in general with Basel II preparedness in the Asia-Pacific region is widely diverse, and the majority of countries are in the early implementation stages of their compliance programme.

Governments and central banks should also foster greater depositor confidence in the banking system by ensuring timely liquidity provisions, discouraging excessive risk-taking by banks and addressing the problem of moral hazard. The capital adequacy ratio has to be constructed in the light of the individual circumstances of countries' banking systems and their asset characteristics. Bank regulators also have to take additional measures to improve the measurement of risks relating to structured instruments, off balance-sheet items and contingent liquidity risks.

"A well-functioning financial system and a stronger regulatory oversight are critical for mitigating the contagion effects of financial crises"

Given the inescapable trends in financial globalization and market integration, the framework for macroeconomic policy has to be more resilient and adaptable, recognizing the two-way link between macroeconomic management and financial sector development. Coherence in monetary, fiscal and

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[6] http://www.bis.org/publ/bcbs30a.pdf.

[7] http://www.bis.org/publ/bcbsca03.pdf.

debt management policies should constitute the foundation for an efficient financial market. At the same time, a well-functioning financial system with stronger regulatory oversight is crucial for macroeconomic stability, and to weather the effects of market volatility and contagion in times of crisis.

The region has pioneered its own initiatives to address systemic issues. For example, the Chiang Mai Initiative (CMI), agreed in May 2000 by the finance ministers of ASEAN+3 countries, provided emergency liquidity by creating a network of bilateral swap agreements (BSAs) and repurchase agreement facilities among the member countries. The ASEAN+3 bilateral swap arrangements somewhat resemble an international "lender of last resort" facility, which provides a short-term facility for liquidity assistance in the form of swaps of dollars for the domestic currencies of the 13 participating countries of ASEAN+3. As of 2007, 16 BSAs among 8 countries have been concluded with a combined total size of almost $83.0 billion. CMI marked a significant step in Asian regional monetary cooperation aimed at enhancing financial stability. The members should work towards strengthening this initiative making liquidity support and an effective line of defence against speculative attacks in the region.. The initiative received a fresh impetus with the injection of an additional $80 billion after the current crisis to assist member countries with emergency needs.

"Existing mechanisms, such as CMI and the Manila Framework, need to be expanded both in scope and coverage to have a greater impact on the way systematic issues are addressed"

The proposal of Thailand to establish an Asian bond fund through a voluntary contribution of 1 per cent of foreign reserves held by the Governments of the region culminated in an agreement that took the form of a declaration at the second ministerial meeting of the Asia Cooperation Dialogue, which was held in Chiang Mai, Thailand, in June 2003. It was endorsed by ASEAN + 3 in August 2003. The Asian Bond Fund was launched (with the initial round, Asian Bond Fund I, valued at about $1 billion and the second round, Asian Bond Fund II, valued at about $2 billion) under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) Group, comprising the central banks of 11 economies and managed by the Switzerland-based Bank for International Settlements (BIS). For the time being, ABF is set to invest in United States dollar-denominated bonds issued by Asian Governments and quasi-governments in EMEAP economies other than Japan, Australia and New Zealand, although the ultimate goal is to move away from excessive dependence on the United States dollar. At their 11th meeting, held in Madrid in May 2008, ASEAN+3 ministers took steps to develop the related infrastructure.

The global financial crisis that has unfolded recently emphasizes the fact that reforming the international financial architecture is too important to be left to either the major central banks or investors or multinational corporations. There is a need for dialogue at both the global and regional levels, and it would augur well if such efforts were made at the national level, involving even the private sector. The voices, particularly from civil society, for a new global architecture should be reckoned with.

Given the present global turmoil, regional cooperation will play a vital role in the financial stability of the region. Some of the important areas where regional cooperation is needed would include the monitoring of the financial market volatility, provision of international liquidity, and progressing towards a regional financial architecture. Coordination in macroeconomic policy and the strengthening of surveillance mechanisms are also important. The fast-changing global environment calls for enhancing the ongoing mechanism for dialogue in order to build consensus on policy coordination. There is a need to promote capacity-building activities at the regional level in the financial sector, including regulators and financial institutions involved in implementing international norms.

Proposed action

- Build credibility by pursuing a sound macroeconomic policy, enforcing prudential regulations, and discouraging short-term external borrowings through price-based or quantitative capital controls.
- Establish effective international mechanisms to make available adequate liquidity in times of crisis and provide contingency financing for countries in difficulties.
- Improve the institutional framework by ensuring transparency in the provision of information to financial markets, adopting common minimum standards in prudential regulations.
- Address flaws in the existing surveillance system and the need for effective regionwide surveillance and early warning to prevent future financial crises, given the growing financial flows. One option could be to expand the scope and coverage of existing initiatives, such as the Chiang Mai Initiative, to cope with disruptive capital flows, and the Manila Framework to improve early warning under a full-fledged regional surveillance mechanism.
- Exercise vigilance over and control excess liquidity in the financial system and adhere to prudential norms in addressing financial crises.
- Strengthen monetary and financial integration in the region
- Encourage regional cooperation in monetary policy to play a vital role in the financial stability of the region.
- Convene an Asian stability forum to monitor currency and maturity mismatches.
- Reform the international financial architecture to reflect the voices of developing countries and ensure economic and financial governance in a multi-polar economic order.

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