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Review of the region's progress in the four areas of regional economic cooperation and integration, keeping in view the 2030 Agenda for Sustainable Development: enhancing regional financial cooperation

Enhancing Regional Financial Cooperation in Asia and the Pacific

Note by the secretariat

Summary

According to the agenda for regional economic cooperation and integration set in the Bangkok Declaration on Regional Economic Cooperation and Integration in Asia and the Pacific of December 2013, regional financial cooperation in Asia and the Pacific focuses on three issues: (a) to equip countries with tools to cope with financial volatility and ensure financial stability through cooperative arrangements; (b) to strengthen national financial markets and link them across countries; and (c) to promote an effective mobilization of resources across and within countries. The present document includes a discussion on recent developments in regional financial cooperation and suggestions to deepen it. In line with the regional road map for implementing the 2030 Agenda for Sustainable Development in Asia and the Pacific, special emphasis is placed on domestic resource mobilization, infrastructure financing and financial inclusion.

The Ministerial Conference may wish to consider the recommendations contained in this document and provide guidance on how to enhance financial cooperation in the region and to the secretariat to support these efforts.

I. Introduction

1. The first Ministerial Conference on Regional Economic Cooperation and Integration in Asia and the Pacific, held in Bangkok from 17 to 20 December 2013, adopted the Bangkok Declaration on Regional Economic Cooperation and Integration in Asia and the Pacific. In the Declaration, an agenda for the regional economic cooperation and integration in the Asia-Pacific region was set. It consists of four elements: (a) moving towards the formation of an integrated market; (b) development of seamless connectivity in the region; (c) enhancing financial cooperation; and (d) increasing economic cooperation to address shared vulnerabilities and risks. On regional financial

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cooperation, the following areas are considered in the Declaration: (a) equipping countries with tools to cope with financial volatility and ensure financial stability through, among other things, cooperative arrangements for the provision of liquidity support; (b) strengthening national financial markets and establishing linkages among them; and (c) to promote an effective mobilization of resources across and within countries.

2. Finance is a critical means of implementation of the 2030 Agenda for Sustainable Development, with Goal 17 emphasizing the need to strengthen domestic resource mobilization and to mobilize additional financial resources for developing countries from multiple sources. The 2030 Agenda also accords significant importance to promoting financial inclusion, including through enhancing access to financial services by micro, small and medium-sized enterprises. The Addis Ababa Action Agenda of the Third International Conference on Financing for Development, held in Addis Ababa from 13 to 16 July 2015, complements the 2030 Agenda as it contains further details on priority areas for regional financial cooperation, including to support financial stability.

3. The Economic and Social Commission for Asia and the Pacific (ESCAP) in its resolution 73/9 endorsed a regional road map for implementing the 2030 Agenda in Asia and the Pacific. In the area of finance, the following opportunities for cooperation are highlighted in the road map: (a) continue to undertake research, analysis and consensus-building initiatives in the area of financing for development to enhance regional knowledge of infrastructure financing, including public-private partnerships; (b) provide capacity-building to mainstream financing for development issues in areas such as domestic resource mobilization; (c) enhance the capacity for domestic and international resource mobilization; (d) strengthen partnerships for effective development cooperation; and (e) promote financial inclusion.[1]

4. The present document contains a discussion on the recent developments in the priority areas for regional financial cooperation considered in the Bangkok Declaration and the regional road map for implementing the 2030 Agenda in Asia and the Pacific, and suggestions for deepening cooperation in those areas. The discussion draws upon analyses and recommendations of the Working Group on Regional Financial Cooperation, which met in Bangkok in November 2014 and March 2015, and also considers the outcomes of the deliberations at the following events: the seventy-second session of the Commission, held in May 2016; the High-level Dialogue on Regional Economic Cooperation and Integration for Enhancing Sustainable Development in Asia and the Pacific, held in in Bangkok in April 2017; and a ministerial panel discussion on regional economic cooperation and integration in support of the 2030 Agenda, held in May 2017 during the seventy-third session of the Commission.

II. The financial landscape in Asia and the Pacific

5. The financial landscape in the Asia-Pacific region is characterized by a significant degree of diversity. National financial systems range from a few large and diversified financial hubs that are thriving, well-regulated and globally integrated to a larger number of middle-sized emerging markets. However, financial markets in most economies are relatively underdeveloped in terms of size, liquidity and maturity, which impedes the channelling of long-term savings to long-term investments. Furthermore, financial intermediation

[1] See E/ESCAP/73/31, annex II.

is predominantly bank-based in most countries, and financial innovation, including venture capital, plays only a limited role in corporate financing in most economies.

6. Banks tend to focus on traditional bank businesses of deposit taking and consumer lending to households and larger companies. In many countries, banks play a role in financing economic development, export promotion and public investment projects, and in some of the region's largest countries, including China and India, more than half of the banking assets are State-owned. While direct government ownership and explicit and implicit guarantees have played a useful developmental role, they have supported unprofitable businesses. In all, the region's banks still need to realize their full potential to contribute to the development of competitive and efficient financial systems to enable them to cater more efficiently to the requirements of the 2030 Agenda.

7. Despite the dominant role of banks in the region's financial systems, capital markets have expanded significantly over the last two decades. The region's equity market capitalization amounted to $22.8 trillion in 2016, or 35 per cent of the capitalization of the global market.[2] The capitalization of the region's developing countries equity market increased significantly over the last decade, from $5.8 trillion in 2006 to $16.5 trillion in 2016. However, the development of equity markets has been highly concentrated in a few economies, with China; India; the Republic of Korea; and Hong Kong, China representing 81 per cent of the total. This suggests that the full potential of stock markets in developing countries still needs to be exploited. Regarding the development of local currency bond markets, considerable progress has been made among the emerging East Asian countries between December 2006 and December 2016, with the size of the market increasing from $2.7 trillion to $10.2 trillion over that time frame.[3] However, this market remains dominated by government bonds, which accounted for 64.6 per cent of the total.

8. A look at the financial market depth index developed by the International Monetary Fund (IMF), which captures the importance of stock and bond markets as a share of gross domestic product (GDP), supports this point. For instance, in East and North-East Asia, the index has more than tripled from 0.22 in 1995 to 0.70 in 2014. For South-East Asia, growth in the depth of the financial markets was even higher, though it started from a lower base of 0.05 in 1995 to 0.25 in 2014. The North and Central Asia subregion also progressed in this regard; the index started from an even lower starting point, 0.02 in 1995, and reached 0.09 in 2014.[4]

9. In contrast, progress in increasing the depth of the region's financial institutions has been more subdued. The financial institutions index, which captures the importance of bank credit, pension fund assets, mutual fund assets and insurance premiums, increased from 0.52 in 1995 to only 0.60 in 2014 in East and North-East Asia, while it decreased from 0.20 to 0.13 during the same period in South-East Asia. This decrease is attributed to a marked

[2] World Bank, Market capitalization of listed domestic companies, World Development Indicators. Available from http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS (accessed 18 August 2017).

[3] See https://asianbondsonline.adb.org/. The East Asian emerging markets are China; Indonesia; Malaysia; Philippines; Republic of Korea; Singapore, Thailand; Viet Nam; and Hong Kong, China.

[4] The figures are normalized so that a value of 1 represents the value of the index for the United States of America in each year.

disintermediation process resulting from the Asian financial crisis. As with the financial markets depth index, North-Central Asia experienced robust growth, albeit starting from a low base (from 0.03 in 1995 to 0.13 in 2014).

10. The lack of depth and breadth in the financial markets of many Asia-Pacific developing countries is accompanied by an insufficient degree of financial market diversification. Despite advancements in macroprudential regulatory frameworks, tendencies to manage businesses through high sector exposures remains an issue. This business model needs to change if financial markets are to support the implementation of the 2030 Agenda. There is considerable room to enhance financial inclusion, channel credit to underserved sectors and to small and medium-sized enterprises, strengthen financing for the development of sustainable infrastructure, and promote climate financing.

III. Current arrangements to support financial stability

11. Recognizing that national policy decisions can have systemic and far-ranging effects well beyond national borders, the Addis Ababa Action Agenda is committed to fostering cooperation to prevent and reduce the risk and impact of financial crises.[5] Fostering financial stability is also one of the goals of regional financial cooperation stipulated in the Bangkok Declaration. For that purpose, two important policy instruments are: effective economic surveillance and monitoring, and provision of short-term liquidity support in case of emergencies. Asia and the Pacific has made progress in those two areas, although the level of progress varies across its subregions.

12. With respect to subregional economic surveillance, the Association of Southeast Asian Nations (ASEAN) Surveillance Process has been the first formal institutional mechanism established in the region. Introduced in 1998, it provides a peer review of economic surveillance and monitoring in the annual ASEAN Surveillance Report. This serves as the main input for annual policy discussions involving ASEAN finance ministers.

13. The Economic Review and Policy Dialogue, introduced in May 2000, is the regional economic surveillance forum of the ASEAN+3 finance ministers and central bank governors.[6] It encompasses a review of global, regional and national economic conditions, monitoring of regional capital flows and currency markets, and identification of macroeconomic and financial risks and policies to reduce such risks. It also aims to strengthen banking and financial system conditions and provides an Asian voice in the effort to reform the international financial system. In April 2011, the ASEAN+3 authorities established the ASEAN+3 Macroeconomic Research Office, a unit entrusted with regional economic surveillance.

14. In the Pacific, the Association of Financial Supervisors of Pacific Countries, established in 2002, meets regularly to discuss supervisory and surveillance-related developments. In North and Central Asia, the Eurasian Economic Community, which was replaced by the Eurasian Economic Union on 1 January 2015, launched the Anti-Crisis Fund in 2009 as a regional financial arrangement to help member countries cope with the global financial crisis. In 2015, the fund was transformed into the Eurasian Fund for

[5] General Assembly resolution 69/313, annex, para. 105.

[6] The dialogue process, which brings together ASEAN, China, Japan and the Republic of Korea, has aimed at strengthening policy dialogue, coordination and collaboration on common financial, monetary and fiscal issues.

Stabilization and Development, which supports members' adjustment programmes while overseeing surveillance mechanisms.

15. Regarding short-term liquidity support, ASEAN established the ASEAN Swap Arrangement in 1997 to deal with balance of payment difficulties. Over the years, the total amount available for swap transactions has been raised from $100 million to $2 billion. Subsequently, the Chiang Mai Initiative was established in 2000 as a network of bilateral swap agreements, combining the ASEAN Swap Arrangement with many of the bilateral swap agreements between different ASEAN+3 member countries. In 2010, the Chiang Mai Initiative Multilateralization was set up to pool this network of bilateral swap agreements into a single reserve pooling arrangement of $240 billion. Crisis-affected members are eligible for short-term liquidity support from the Chiang Mai Initiative Multilateralization up to 30 per cent of their quota. To access the remaining 70 per cent of their quota, they need to be under an IMF arrangement. Access to funds through the Chiang Mai Initiative Multilateralization is linked to an IMF arrangement because of countries' limited capacity to formulate and enforce effective adjustment programmes during crises.

16. Examples of other sizeable swap arrangements in the region are the $2-billion Framework on Currency Swap Arrangements for South Asian Association for Regional Cooperation Members, established in 2012 by the Reserve Bank of India; the China-led $230-billion bilateral swap agreement for more than thirty countries, which became effective in 2009; and, as mentioned above, the Eurasian Economic Community-led Eurasian Fund for Stabilization and Development, of about $8.5 billion, which offers financial credits and investment loans.

IV. Status of cooperation on capital market development

17. As a valuable tool for the mobilization of financial resources, the development of capital markets can contribute to the attainment of target 17.3 of the 2030 Agenda.[7] To advance cooperation among countries to expand the capital market, several initiatives have been undertaken in Asia and the Pacific. Among the most notable ones are the Asian Bond Fund Initiative, introduced in June 2003 by the Executives' Meeting of East Asia and Pacific Central Banks and the Asian Bond Markets Initiative, launched by ASEAN+3 in August 2003. The Asian Bond Fund 1 called for purchases by central banks of sovereign and quasi-sovereign United States dollar-denominated bonds issued by 8 of the 11 members of the Executives' Meeting of East Asia and Pacific Central Banks using their foreign exchange reserves.[8,9] To facilitate investments by public and private sector entities, Asian Bond Fund 2 was set up for purchases of $2 billion in local currency-denominated sovereign and quasi-sovereign bonds and the listing of local currency exchange-traded bond

[7] Mobilize additional financial resources for developing countries from multiple sources.

[8] The members of Executives' Meeting of East Asia and Pacific Central Banks are the central banks of nine East Asian economies (China; Indonesia; Japan; Malaysia; Philippines; Republic of Korea; Singapore; Thailand; and Hong Kong, China) plus Australia and New Zealand.

[9] Sean Kidney, Diletta Giuliani and Beate Sonerud, "Public sector agenda for stimulating private market development in green securitisation in Europe", Policy Paper, February 2017 (London, Centre for Climate Change Economics and Policy, 2017). Available from www.cccep.ac.uk/publication/public-sector-agenda-for-stimulating-private-market-development-in-green-securitisation-in-europe/.

funds on stock markets, including on the exchanges in Malaysia, Singapore and Hong Kong, China.

18. The objective of the Asian Bond Markets Initiative is to help develop local currency bond markets by creating robust primary and secondary markets and improving market access to a diverse issuer and investor base. Few countries have a developed corporate bond market. ASEAN+3 is currently working on integrating regional bond markets through the ASEAN+3 Bond Market Forum by harmonizing and standardizing market practices, regulations, and clearing and settlement procedures related to cross-border bond transactions.

19. Similarly, the ASEAN Capital Market Forum, which comprises capital market regulators, is focusing on the harmonization of rules and regulations and fostering the integration of the region’s capital markets, including through capital market disclosure standards for cross-border offerings of securities. Given the differences in the size of capital markets and the pace of reforms, only a few ASEAN countries, namely Malaysia, Singapore and Thailand, have moved to adopt the cross-listing of stocks through the ASEAN Trading Link.

20. In North and Central Asia, the parties of the Eurasian Economic Union are striving to create a common financial market in the banking, insurance and securities sectors by 2025. For that purpose, the Eurasian Economic Commission Board approved in November 2016 a draft decree on the development of the conceptual framework for the creation of the common financial market of the Eurasian Economic Union.[10]

21. In South Asia, the South Asian Federation of Exchanges was established in 2000 to facilitate the exchange of information and promote cooperation among its members in their efforts to develop capital markets and common standards for listing, trading and clearing settlement for securities and providing investor protection. In the Pacific islands, capital market development is very limited. In 2000, the Suva Stock Exchange was renamed the South Pacific Stock Exchange and an electronic trading platform was launched, with a view to becoming a regional exchange.

22. Capital controls and lack of foreign exchange hedging instruments is another area that requires work as part of the process to develop financial markets in the region. Although progressive capital account liberalization has led to greater market access to foreign investors, in several countries, non-residents are not permitted to hold and trade domestic securities. For example, India has restrictions on foreign investment in rupee-denominated bonds, and in Thailand, foreign entities are only allowed to issue baht-denominated bonds on the condition that they keep the proceeds in baht and use them in the country.[11]

23. To enable larger international allocations from institutional investors, hedging instruments, such as interest and currency swaps, are needed. Initiatives for that purpose have already been launched. For example, the Reserve Bank of India has been working with the Securities and Exchange Board of India to allow non-resident institutional investors to hedge currency

[10] Eurasian Development Bank, *Eurasian Economic Integration 2017* (Saint Petersburg, 2017). Available from http://greater-europe.org/wp-content/uploads/2017/06/edb-centre_2017_report-43_eei_eng.pdf.

[11] Ila Patnaik and others, “Foreign investment in the Indian Government bond market”, NIPFP Working Paper, No. 126 (New Delhi, National Institute of Public Finance and Policy, 2013). Available from www.nipfp.org.in/publications/working-papers/1691/.

risk with exchange-traded currency futures. At the international level, the Currency Exchange Fund was created to provide hedging against currency and interest rate mismatches in frontier and less liquid emerging markets. Its services cover more than 70 currencies, including 17 in Asia. However, the price of these hedging instruments can be prohibitive, especially for illiquid and underdeveloped markets. Given the importance of hedging instruments, efforts need to be directed towards developing regional derivative markets, especially to cover the currencies of underdeveloped countries in the region.

V. Infrastructure financing requirements and potential sources

24. The 2030 Agenda puts infrastructure development at its core with at least 12 of the 17 Sustainable Development Goals having a direct infrastructure link. However, infrastructure financing requirements for new investments and for upgrading the existing stock are substantial. The Asian Development Bank estimates that the region will need to invest $26.2 trillion from 2016 to 2030, or $1.7 trillion per year, to meet its infrastructure needs. This amount includes $3.4 trillion to respond to climate change. The total amount is distributed as follows: $14.7 trillion for power, $8.4 trillion for transport, $2.3 trillion for telecommunications and $800 billion for water and sanitation.[12] For countries other than China, the Asian Development Bank estimates the infrastructure investment gap – the difference between investment needs and current investment levels – at 5 per cent of their projected GDP over the period 2016-2020.[13] These requirements may even be larger if the cost of regional infrastructure connectivity and the growing urban population’s demands are factored in properly. At the same time, keeping in view the essence of the 2030 Agenda, infrastructure development needs to be inclusive, climate-friendly and resilient.

25. To close the infrastructure investment gap, governments need to find appropriate sources of funding and financing.[14] Regarding funding, the basic options are (a) through national, state or local budgets; (b) to be paid for by consumers through a stream of user charges; (c) through external grants by donor agencies or private corporations, though this is usually a limited source; and (d) through commercial revenue generated from a public asset, such as real estate development.

26. Regarding funding through government budgets, policymakers can significantly increase the resources available to fund infrastructure by increasing the tax base, raising tax rates for higher-income brackets and improving compliance. For most countries in the region, improving compliance is the highest priority. In addition, improving expenditure management, for instance by curbing non-developmental expenditures, such as across-the-board subsidies, could free up vital resources. Improving the

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[12] Asian Development Bank, *Meeting Asia's Infrastructure Needs* (Manila, 2017). Available from www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf.

[13] Ibid. The calculations to obtain these estimates were based on 25 developing countries for which adequate data were available, namely Afghanistan, Armenia, Bangladesh, Bhutan, Cambodia, China, Fiji, India, Indonesia, Kazakhstan, Kiribati, Kyrgyzstan, Malaysia, Maldives, Marshall Islands, the Federated States of Micronesia, Mongolia, Myanmar, Nepal, Pakistan, Papua New Guinea, the Philippines, Sri Lanka, Thailand and Viet Nam.

[14] Funding refers to who is paying for the infrastructure services while financing involves the repayment of the capital or money invested, often with interest.

efficiency of public spending in infrastructure could also lead to significant savings. This could be achieved by enhancing project selection, ensuring adequate maintenance, reforming State-owned enterprises and optimizing the use of infrastructure assets.

27. In many economies in the region, the proportion of infrastructure financed by the public sector is about 80 per cent. The rest is covered by the private sector with a very small percentage provided by official development agencies.[15] However, heavy reliance on public financing of infrastructure is problematic for governments facing fiscal constraints and an unsustainable debt position.

28. Infrastructure financing requires the availability of foreign and local currencies for long periods of time. As such, the development of bond and equity markets and the domestic institutional investor sector is crucial. However, this will take time. Most developing countries in the region are characterized by having shallow financial markets, uncertain macroeconomic policy and regulatory environments and a lack of viable project pipelines, and are facing challenges in their efforts to improve the process of project selection, all of which are making it difficult to raise resources in financial markets to finance their infrastructure development.

29. The main source of financing in the region has been loans from commercial banks, multilateral development banks and other financial institutions. New regional development banks, such as the Asian Infrastructure Investment Bank, have increased the pool of available resources for infrastructure financing. However, credit, country and project exposure limits often pose problems for the financing of large projects.

30. Governments usually involve the private sector through public-private partnerships to circumvent limited public budgets and borrowing capacity. Over the last 15 years, private companies have invested about $650 billion in Asian developing countries; 54 per cent went to projects related to energy, 33 per cent to projects related to transport, 10 per cent to projects related to information and communications technology (ICT) and 3 per cent to projects related to water and sewerage. However, their distribution has been very uneven, and for small developing countries, financing infrastructure investment through public-private partnerships is still a challenge. Indeed, 75 per cent of the region's public-private partnerships investment was concentrated in five major countries: China, India, Indonesia, the Russian Federation and Turkey.

31. It is also important to keep in mind that the private cost of capital is usually more expensive than public financing, as the private sector requires returns commensurate to the risk taken. As a result, private partners in public-private partnership projects often require credit enhancement mechanisms and/or guarantees to cover political and economic risks. Public-private partnership projects need to create sufficient additional value to offset the higher financing and transaction costs. A related point is that public-private partnerships are most promising as a source of financing in revenue-generating

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[15] Georg Inderst, "Infrastructure investment, private finance and institutional investors: Asia from a global perspective"; ADBI Working Paper Series, No. 555 (Tokyo, Asian Development Bank Institute, 2016). Available from www.adb.org/publications/infrastructure-investment-private-finance-and-institutional-investors-asia-global.

sectors, such as energy or transport, from which user charges can be used to repay the investment.

32. Whereas public-private partnerships cannot fill all infrastructure gaps, this mechanism may contribute to a significant share of infrastructure investments. For example, the private sector has financed about 50 per cent of investment in power generation assets in South-East Asia over the period 2000-2013.[16] Similarly, in transport, the private sector contribution accounted for an impressive 34 per cent of total investment in roads and highways in India in the eleventh five-year plan (2007-2012).[17] In addition, public-private partnerships are not just about financing. Other benefits that make this mechanism an attractive option are efficiency gains, risk transfers and life-cycle cost optimization.

33. Given the importance of infrastructure financing, efforts to encourage regional cooperation in this area need to be intensified. In that regard, ESCAP has played a pioneering role in the formulation of regional transport networks, such as the Asian Highway and the Trans-Asian Railway networks, which have supported countries' prioritization and planning of national transport projects. These efforts are commendable and need to be pursued in other infrastructure sectors, as they provide coherence within the region and help potential investors better understand the broader context of national infrastructure projects. Other useful areas for regional cooperation are the dissemination of best practices and the incorporation of sustainability considerations into public-private partnership schemes.

VI. Domestic public resource mobilization

34. In the light of the difficulties in raising private funding for infrastructure financing and considering the strong demand for public funding to implement the 2030 Agenda in general, the mobilization of additional domestic public resources is essential. However, this will be challenging in Asia and the Pacific, as the region has one of the world's lowest tax revenue levels. In recent years, total tax revenue averaged 17.6 per cent of GDP in the region, compared to global average of 21.3 per cent for developing countries and of 26.4 per cent for developed countries.[18,19] This level only surpasses those for the Middle East and North Africa, where non-tax resource revenue has more than compensated for low tax revenue.

35. The region's average conceals the vast differences among countries. In addition, the tax mix in the Asia-Pacific region is biased towards indirect taxes. Direct taxes account for only 37.6 per cent of the total tax revenue in the region, compared to 55.8 per cent for OECD countries. This difference is not

[16] For historical investment data, see annex of International Energy Agency, *World Energy Investment Outlook* (Paris, 2014). For private investments, see World Bank, Private participation in infrastructure database. Available from https://ppi.worldbank.org/ (accessed on 10 November 2016).

[17] PricewaterhouseCoopers Private Limited, *The Road Ahead: Highways PPP in India* (n.p., 2012).

[18] Three years average between 2012 and 2014, or the latest three years, in which data are available.

[19] The figure excludes social contribution, which is normally considered to be part of the overall tax revenue in the Organization for Economic Cooperation and Development (OECD) countries. Given that social contribution levels in the Asia-Pacific developing countries are significantly lower, separating the social contribution level from taxes would make it possible to better evaluate the tax performance of the countries.

surprising because indirect taxes, such as value-added tax (VAT) or excise taxes, typically pose smaller tax administration challenges for developing countries compared to direct taxes. However, this is not entirely desirable because indirect taxes tend to be more regressive.

36. At the same time, the mobilization of public revenue, especially taxation, is increasingly becoming a cross-border issue in line with the gradual deepening of regional economic integration and globalization. The misuse of tax treaties and tax heavens along with trade-based tax evasion and fraud are becoming significant drains on public revenue for all countries. OECD estimates that the global revenue losses from such activities are between $100 billion and $240 billion annually.[20]

37. The greater cross-border mobility of capital and production also creates strong tax competition among countries to attract foreign investment and penetrate export markets, especially in developing countries where costly tax incentives are often provided to compensate for weak market institutions and an unfavourable business environment. Data show that tax incentives are generally more prevalent in the Asia-Pacific region than in other regions.

38. Corporate income taxes have also come under pressure. While declining corporate tax rates is a worldwide phenomenon, the problem seems to be exacerbated in Asia and the Pacific as countries expand tax incentives and cut rates to attract foreign investment. Unlike in other regions, corporate tax reform in Asia and the Pacific has been rate-reducing and base-reducing. A study based on 14 Asia-Pacific countries has found support for the hypothesis that countries in the region compete in setting their corporate tax rates. A recent KPMG study has warned that the paucity of coordination and harmonization on tax matters in the ASEAN region, especially in the light of the ASEAN Economic Community, could result in continued tax competition, which would have adverse effects on tax bases in the region.

39. For all the challenges emanating from the internationalization of taxation, effective regional and global tax cooperation and joint actions by stakeholders is a precondition for any viable solution. Cooperation can also be an important catalyst for national efforts to enhance public revenue mobilization and deploy conducive tax and spending policies through broad knowledge exchange, policy debate, peer learning, and targeted technical assistance and capacity-building activities.

40. An emerging area that is highly relevant for the financing of the 2030 Agenda is related to the implications of the region’s very rapid urbanization. The unprecedented growth and dominance of megacities in the Asia-Pacific region has put enormous fiscal pressure on governments, especially municipal governments. Sustainable urbanization requires public investments in urban infrastructure and public services in the scale of trillions of dollars, yet the municipal governments in the region are often ill-equipped to meet the challenge. Almost all Asian countries suffer from serious vertical imbalances, with subnational governments’ expenditure far exceeding their revenue. As a result, many cities in the region are rapidly accumulating debt, which, in turn, is threatening to destabilize the whole financial system.

41. Property taxes often fund the bulk of expenditures of municipal governments in developed countries. In developing countries, however, municipal governments are able to tap only a fraction of the potential of property taxes because of capacity and institutional constraints, a weak tax

[20] See www.oecd.org/tax/beps/.

culture and lack of mature property registration systems. As a result, Asia-Pacific cities need to develop a diversified mix of revenue mobilization vehicles that includes not only property taxes but also local business or income taxes, service charges and innovative solutions such as land value capture and transport and fuel taxes. Providing greater policy space for municipal governments in local fiscal governance while enhancing their accountability on this front is a desirable direction moving forward.

42. Against this background, tax cooperation at global and regional levels has been gaining momentum. At the global level, the signatories of the Addis Ababa Action Agenda committed to scale up international tax cooperation efforts. They also welcomed new initiatives by international organizations and country groupings to combat cross-border tax evasion, improve the transparency of international taxation and enhance policy coordination across countries.

43. At the regional level, Latin America, Africa and Europe have been at the forefront in the areas of regional tax policy coordination, knowledge exchange and capacity support through region-wide tax cooperation organizations, such as the African Tax Administration Forum, the Inter-American Center of Tax Administrations and the Intra-European Organisation of Tax Administrations. These organizations not only provide a central platform for regional tax cooperation but they also play a significant role in supporting their respective regions' engagements in international tax cooperation and reforms through coordinated regional positions and inputs and targeted implementation support that considers the local context.

44. In contrast, the Asia-Pacific region still lacks a broad-based region-wide platform for cooperation on tax and public finance issues. While certain relatively successful sub regional forums, such as the Study Group on Asian Tax Administration and Research and the Pacific Islands Tax Administrators Association, have been established, their coverage and capacities remain limited, and the region's least developed and smaller developing economies are not adequately represented in global and regional tax cooperation mechanisms.

45. Limited inclusive and region-wide cooperation and capacity support has prevented Asia and the Pacific from engaging proactively and making substantial contributions to the ongoing global tax cooperation and reform initiatives. Compared to other developing regions with broader-based, more institutionalized and better financed region-wide forums, Asia and the Pacific, especially the region's developing countries that are not part of OECD or the Group of 20, has largely remained passive in international tax norm-setting processes and negotiations. With regard to those negotiations, for the most part, they have lacked a united voice and opportunities to provide well-developed regional inputs.

VII. Promoting financial inclusion

46. The Addis Ababa Action Agenda calls for countries to implement broad strategies to enhance financial inclusion, including the roles of various financial institutions, regulatory issues and innovative tools. The Agenda commits to strengthening capacity development for developing countries, including through the United Nations development system, and encourages cooperation and collaboration among financial inclusion initiatives. It also calls for an expansion of peer learning and experience-sharing among countries

and regions, including through the Alliance for Financial Inclusion and regional organizations.[21]

47. An important goal of financial inclusion is to enhance access of small and medium-sized enterprises to credit. These types of enterprises constitute the largest number of companies in any country and play a fundamental role in creating employment, developing skills and diffusing technological knowledge. Studies have also shown that financial access helps generate more new firms that are generally vibrant and creative.[22] However, to tap their potential, small and medium-sized enterprises need to overcome an important obstacle: limited access to credit and financial services. An important reason for this is that financial institutions, particularly commercial banks, often take the view that loans to small and medium-sized enterprises are too risky and cumbersome because they involve very high transaction costs.

48. In addition to commercial banks, microfinance institutions, which include not-for-profit organizations and non-governmental organizations, self-help groups, inclusive businesses and social enterprises, provide a wide range of financial services to the poor and to micro, small and start-up enterprises. Pioneered by the Grameen Bank in Bangladesh, microfinance institutions have employed innovative solutions, such as a shared liability model and collateral-free lending, which have resulted in very low default rates. In recent years, however, some microfinance markets have become saturated, with borrowers becoming over-indebted by taking on too much credit from multiple microfinance institutions and other informal sources of credit.[23] This highlights the importance of establishing effective regulations for microfinance institutions.

49. To further expand lending to small and medium-sized enterprises by private financial institutions, countries' lending infrastructure, which includes credit bureaus, credit guarantees agencies and collateral registries, needs to be improved. National development banks can also play a key role in providing financing to small and medium-sized enterprises in specific sectors of strategic importance through innovative products, such as growth acceleration programmes. In addition, new companies that provide financial services by making use of software of modern technology, known as fintechs, offer exciting possibilities for meeting the financial needs of small and medium-sized enterprises, but proper regulation should be put in place. A major challenge to regulators is to strike the right balance between facilitating innovation and preserving financial stability.

VIII. Suggestions to move forward

50. Considering the analysis contained in the previous sections, in this concluding section, suggestions for deepening regional financial cooperation are provided, so that it can better support the implementation of the 2030 Agenda. The Ministerial Conference may wish to consider these

[21] General Assembly resolution 69/313, annex, paras. 33 and 39.

[22] World Bank, *Finance for All?: Policies and Pitfalls in Expanding Access* (Washington, D.C., 2008). Available from https://openknowledge.worldbank.org/handle/10986/6905.

[23] Jessica Schicks and Richard Rosenberg, "Too much microcredit?: A survey of the evidence on over-indebtedness", CGAP Occasional Paper, No. 19 (Washington, D.C., World Bank, 2011). Available from http://documents.worldbank.org/curated/en/553421468148522571/Too-much-microcredit-A-survey-of-the-evidence-on-over-indebtedness.

recommendations and provide guidance for the region on how to boost financial cooperation in Asia and the Pacific, and for the secretariat in supporting these efforts.

A. Financial stability

51. Existing regional financial safety nets, which offer short-term liquidity over and above the IMF emergency lending programmes, are useful for managing risks arising from increasing financial market and capital flow volatility effectively. The following elements can be considered to assess the efficacy of these facilities:

- These facilities need to be operationally flexible and able to safeguard short-term risks associated with volatility in financial markets or capital flows, along with significant fluctuations in exchange rates;
- The existing facilities should be backed by a robust framework of regional surveillance supported by regionally harmonized and enforceable macroprudential policy frameworks;
- Efforts should be made to gradually reduce the current fragmentation of subregional facilities and frameworks and cross-country procedural differences and move towards a region-wide crisis management framework as a long-term goal;
- The ability of subregional surveillance and coordination mechanisms, such as the Chiang Mai Initiative Multilateralization, should be strengthened to supplement existing IMF emergency support programmes. For this purpose, there is need in the region to develop capacities to formulate and monitor conditionality associated with emergency lending.

B. Capital market cooperation

52. Because of the insufficient development of capital markets, a large share of the region's savings is channelled to more mature economies outside the region. To retain such funds within the region, domestic financial markets and institutions need to be developed further. For this purpose, the demand and supply sides of capital markets need to be strengthened by developing a diverse issuer and investor base. In that context, it is important to foster the development of domestic institutional investors with long-time horizons, such as insurance companies, pension funds and asset management companies.

53. Similarly, it is important to further develop national financial market infrastructures, including the regulation of the issuing and trading bonds and securities, payment systems, central securities depositories and cross-border clearing and settlement systems. A well-functioning financial infrastructure is essential for trades to be executed rapidly and safely, thereby contributing to the liquidity of the market. It also contributes to building confidence among issuers and investors in the integrity and fairness of the price discovery process, which are essential for encouraging their participation in the market.

54. In addition, different standards and requirements may prevent investors from credibly assessing investment opportunities across multiple countries. Therefore, effective partnership with international financial and securities regulators to streamline relevant financial regulations and improving corporate governance are needed to facilitate the trading of securities across countries, laying the groundwork for the development of a regional financial market at a

later stage. Mutual recognition agreements could also play a useful role for that purpose.

55. Most economies in the region – except for Japan; Republic of Korea; Singapore; and Hong Kong, China – impose foreign exchange restrictions, which serve as an obstacle to deepening regional financial integration. While such restrictions may help to mitigate vulnerabilities stemming from capital outflows, they can have adverse implications on the levels of investments by non-resident institutional investors and cross-border transactions. Capital account liberalization, therefore, must proceed gradually and be supported by the development of appropriate macroprudential policies to preserve financial stability amid increasing volumes of cross-border transactions.

C. Financing infrastructure development

56. Given the scale of infrastructure investment requirements, financing sources, in addition to the public sector, need to be identified. While the banking sector has traditionally played a major financing role, capital markets should complement these resources by providing an alternative intermediation mechanism between investors and project developers. To better understand how the capital market can most effectively support infrastructure development in the region, it is necessary to conduct national and regional studies that take into account the international experience and the diverse characteristics of Asia-Pacific countries.

57. In addition, the process for selecting infrastructure projects must be improved so that funding is prioritized for projects that will make the most contributions to the implementation of the 2030 Agenda by ensuring that infrastructure development is inclusive, climate-friendly and resilient. For this purpose, a regional viewpoint and a multi-sectoral focus are necessary. A regional viewpoint would consider each project in the context of the development needs of the region. A multi-sectoral approach would carefully weigh the economic, social and environmental gains and losses of each project to select those that bring the most benefits to the three dimensions of sustainable development.

58. Cross-border projects often receive a lower priority than national ones because the latter have a lower risk profile and a shorter gestation time. They are, however, critical for achieving regional connectivity. Setting up dedicated financing mechanisms for these projects could help to raise their priority level while serving as a coordination platform among the involved countries. These mechanisms could take different forms, such as a project preparation facility exclusively for cross-border projects or loan-grant blending instruments to improve their financial viability.

59. To circumvent limited public budgets and borrowing capacities, governments could also consider involving the private sector through public-private partnerships and develop coherent and coordinated financing strategies to close infrastructure financing gaps. To engage the private sector, governments need to create an enabling environment characterized by, among other things, coherent policies, explicit priorities and expected timelines for projects to be developed, and a clear legal and regulatory framework. In this context, it is important to ensure that risks are properly allocated between the public and private partners.

D. Domestic resource mobilization

60. Because of the generally low tax-to-GDP ratios in the region, there is considerable scope to enhance domestic resource mobilization. For that purpose, Asia and the Pacific needs to develop a regional approach and vision about public finance strategies and policies. This calls for the rethinking and recalibration of existing policies and practices associated with sustainable development principles and the region's challenges and priorities, such as rapid urbanization and widening inequality. Moreover, the vision should leverage on the region's own policy lessons and experiences and consider the local institutional, cultural and historical context. Such an approach would also support national efforts to enhance public revenue and to implement suitable tax and spending policies for sustainable development.

61. To address the regional challenges to enhance domestic resource mobilization as a means of implementation of the 2030 Agenda, there is need for a broad-based discussion among policymakers, tax administrators and relevant regional and subregional organizations in the Asia-Pacific region. In that regard, ESCAP can leverage its intergovernmental mechanisms, including the Committee on Macroeconomic Policy, Poverty Reduction and Financing for Development, in close collaboration with development partners. It is also important to facilitate the exchange of knowledge and policy lessons and experiences, and coordinate capacity-building initiatives in the following areas:

- Tax and public expenditure policies for inclusive and sustainable development;
- International tax reforms and their implications for developing countries in the region;
- Specific local challenges, such as municipal public finance for urbanization;
- Cross-cutting issues, such as social contracts for responsible and efficient public spending and taxpayer consent for sustainable revenue mobilization.

E. Financial inclusion

62. Enhancing access to financial services is important to reduce poverty and promote economic growth and employment generation through the dynamism of small and medium-sized enterprises. In this regard, fintech companies have enormous potential to enhance financial inclusion. However, there are potential risks to financial stability that can arise if the expansion in the access to credit in the economy occurs too rapidly. Risks include excessive indebtedness of low-income borrowers, fraud, high transaction costs and exploitation of customers.

63. To mitigate those risks, appropriate supervision and regulatory frameworks must be developed to support the extension of financial inclusion. In this regard, a proportionate approach to regulation, which adjusts prudential norms according to the risk profile and systemic importance of individual banks and microfinance institutions, should be considered. In addition, it is important to support the building of capacities of countries in setting and implementing appropriate regulations for promoting financial inclusion. ESCAP, as an intergovernmental platform covering the entire region, could play a significant role for this purpose.

64. It is also important to extend financial education to inexperienced users of financial services and to strengthen consumer protection regimes and build a stronger financial infrastructure to ensure that financial transactions take place in a timely and secure manner.

65. To further strengthen regional cooperation in this area, ESCAP member States may wish to consider the possibility of establishing an intergovernmental working group to advance financial inclusion in the region.

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