ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC 2001

Financing for Development



UNITED NATIONS

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC 2001

UNITED NATIONS

New York
2001

UNITED NATIONS
ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC
2001

ST/ESCAP/2104

UNITED NATIONS PUBLICATION

Sales No. E.01.II.F.18

Copyright © United Nations 2001

ISBN: 92-1-120031-8 ISSN: 0252-5704

FOREWORD

Asia's economic recovery made great progress this past year. Most of the economies hit hardest by the 1997 crisis posted dramatic output gains, inflation remained low, and the signs of social distress that emerged after the crisis have visibly abated. Many countries have shared in this improved growth performance, and the region as a whole is well on its way to regaining the economic dynamism that has long been its hallmark. Still, victory cannot be declared. Economic reforms must continue. Social expenditures must rise to eliminate the blight of poverty and to extend social security coverage. And governments must strengthen their commitment to good governance.

Because human beings are both the means and the end of development, this issue of the *Economic and Social Survey of Asia and the Pacific,* in addition to reviewing the economic progress the ESCAP region has made over the past year, analyses its population dynamics and their related policy implications. Furthermore, it provides a regional perspective on the subject of Financing for Development, an issue that will be considered at the High-Level Event on Financing for Development, to be held under the aegis of the United Nations in 2002. The *Survey* will undoubtedly make an important contribution to the debate at that event.



Kofi A. Annan
Secretary-General

March 2001

ACKNOWLEDGEMENT

The Economic and Social Survey of Asia and the Pacific 2001 was prepared by a team led by Azizul Islam. Ngo Lam and Janet Farooq acted as the coordinators for part one and part two respectively. The other members of the team were Shahid Ahmed, Lene Andersen, Eugene Gherman, Aynul Hasan, Nobuko Kajiura, Muhammad Malik, Hiren Sarkar, Hirohito Toda, Seok-Dong Wang and Marin Yari.

Many others within and outside the ESCAP secretariat contributed by way of writing background papers, providing specific inputs, commenting on drafts, editing and proof-reading. Their invaluable help has been greatly appreciated.

CONTENTS

Page

Part One

RECENT ECONOMIC AND SOCIAL DEVELOPMENTS

I. Global economic developments and implications for the ESCAP region 3

Overview 3

Recent global macroeconomic trends 5

Developed countries 5

Developing countries and economies in transition 8

Trade, commodities and capital flows 9

Implications for the ESCAP region 12

Near-term policy issues 14

II. Macroeconomic performance, issues and policies 21

Regional overview 21

Near-term prospects 23

Policy challenges 23

Developing economies of the ESCAP region 25

Asian least developed countries 25

Pacific island economies 43

North and Central Asia 58

South and South-West Asia 72

South-East Asia 87

East and North-East Asia 101

Developed countries of the region 114

Australia, Japan and New Zealand 114

CONTENTS *(continued)*

		Page
III.	**Socio-economic implications of demographic dynamics**	127
	Introduction	127
	Demographic dynamics	128
	Size and growth of population	128
	Age composition	131
	Urbanization	133
	International migration	137
	Socio-economic implications	140
	Poverty	140
	Environment	145
	Labour force and employment	148
	Education	150
	Health	154
	Savings	157
	Population policy options	158

CONTENTS *(continued)*

Page

Part Two
FINANCING FOR DEVELOPMENT

IV. Introduction 165

V. Domestic resource mobilization 169

Trends in savings and investment 169

The determinants of private savings 169

Instruments and institutions 172

The banking sector 173

Other institutional arrangements for household savings 177

Capital markets 181

Mobilization of government funds 195

Policy issues 199

VI. External private resources 201

Foreign direct investment 201

Trends and features of FDI in the ESCAP region 201

Measures to attract FDI 203

Other private capital flows 208

Bank loans 210

Bond and equity issues on international markets 212

Foreign private participation on local capital markets 215

Innovative financial techniques 217

Policy issues 220

***Annex.* Inward foreign direct investment policy regimes in selected Asian and Pacific countries: highlights** 224

CONTENTS *(continued)*

Page

VII. Official flows 235

Rationale 235

Trends in and current distribution of ODA 236

Selected policy issues 240

Aid fatigue 240

Aid, savings and growth 240

Terms and conditions of aid 241

Aid coordination 241

The focus on poverty eradication 242

Debt relief 243

VIII. International systemic issues 245

Reform of the international financial architecture 245

Context, rationale and objectives of reform 246

Containing contagion 247

Provision of liquidity 250

Financial sector reform 251

Debt workouts 253

Limiting access to foreign borrowing 253

Conclusions 254

IX. Conclusions and recommendations 257

Domestic resource mobilization 257

Macroeconomic policy 257

Stimulation of private sector (household and corporate) savings 258

The mobilization of funds for government 259

International capital flows 259

Foreign direct investment 259

Short-term capital inflows 259

Longer-term capital inflows 260

Official flows 260

International systemic issues 261

International financial architecture as an international public good 261

Regional and subregional cooperation 261

The development of systemic responses 262

BOXES

		Page
I.1.	Inflation targeting	15
I.2.	The accession of China to the Bangkok Agreement	18
II.1.	Key international support measures required for the least developed countries	42
II.2.	Efforts to curb money-laundering activities in Pacific island countries	53
III.1.	Some innovative approaches to lower fertility rates	143
III.2.	The challenge of rapidly spreading HIV/AIDs	160
V.1.	The role of the Central Provident Fund in promoting domestic savings and socio-economic development in Singapore	179
V.2.	Improving the financial infrastructure of stock markets	185
V.3.	Development of the Philippine bond market	188
V.4.	Development of a benchmark curve: the case of Hong Kong, China	189
VI.1.	The potential of structured finance	218

TABLES

		Page
I.1.	Selected indicators of global economic conditions, 1997-2001	4
I.2.	Net long-term flows to developing countries, 1990-1999	11
II.1.	Selected economies of the ESCAP region: rates of economic growth and inflation, 1999-2003	22
II.2.	Selected least developed countries of the ESCAP region: growth rates, 1997-2000	26
II.3.	Selected least developed countries of the ESCAP region: summary of macroeconomic indicators, 1997-2000	30
II.4.	Selected least developed countries of the ESCAP region: exports and imports and their rates of growth, 1997-2000	31
II.5.	Selected Pacific island economies of the ESCAP region: growth rates, 1997-2000	44
II.6.	Selected Pacific island economies: summary of macroeconomic indicators, 1997-2000	47
II.7.	Selected Pacific island economies: merchandise exports and imports and their rates of growth, 1997-2000	49
II.8.	North and Central Asian economies: growth rates, 1997-2000	60
II.9.	North and Central Asian economies: budget balance, current-account balance and inflation, 1997-2000	63
II.10.	North and Central Asian economies: merchandise exports and imports and their rates of growth, 1997-2000	64
II.11.	Selected South and South-West Asian economies of the ESCAP region: growth rates, 1997-2000	72
II.12.	Selected South and South-West Asian economies: summary of macroeconomic indicators, 1997-2000	76
II.13.	Selected South and South-West Asian economies: merchandise exports and imports and their rates of growth, 1997-2000	78
II.14.	Selected South-East Asian economies of the ESCAP region: growth rates, 1997-2000	88
II.15.	Selected South-East Asian economies: summary of macroeconomic indicators, 1997-2000	92
II.16.	Selected South-East Asian economies: merchandise exports and imports and their rates of growth, 1997-2000	93

TABLES *(continued)*

		Page
II.17.	Selected East and North-East Asian economies of the ESCAP region: growth rates, 1997-2000	103
II.18.	Selected East and North-East Asian economies: summary of macroeconomic indicators, 1997-2000	105
II.19.	Selected East and North-East Asian economies: merchandise exports and imports and their rates of growth, 1997-2000	107
II.20.	Developed countries of the ESCAP region: major macroeconomic indicators, 1997-2000	115
II.21.	Developed countries of the ESCAP region: merchandise exports and imports and their rates of growth, 1997-2000	118
III.1.	Estimates of total population, 2000-2025, and the rate of population growth, 1980-2025 in selected economies of the ESCAP region	128
III.2.	Percentage share of selected age groups in total population in selected economies of the ESCAP region, 2000 and 2025	131
III.3.	Estimates of urban population, level of urbanization and rate of growth of the urban population in selected economies of the ESCAP region, 1960-2025	134
III.4.	Population of cities with 10 million inhabitants or more in the ESCAP region, 1975, 2000 and 2015	136
III.5.	Net international migration in selected economies of the ESCAP region, 1995-2000	138
III.6.	Trends in poverty in selected countries of the ESCAP region	141
III.7.	Population growth rate, human development index and its component indices in selected economies of the ESCAP region	145
III.8.	Labour force and unemployment in selected economies of the ESCAP region	149
III.9.	School-age population as a percentage of the total population in selected economies of the ESCAP region	151
III.10.	Gross enrolment ratios by education levels in selected economies of the ESCAP region, 1980 and 1997	152
III.11.	School-age population average annual growth rate in selected economies of the ESCAP region, 2000-2025	154
III.12.	Estimates of life expectancy, infant mortality rates and maternal mortality ratios in selected economies of the ESCAP region	156
III.13.	Trends in health-related services in selected countries of the ESCAP region	157

TABLES *(continued)*

		Page
V.1.	The determinants of savings	170
V.2.	Size of the financial sector in selected ESCAP countries (average 1998-1999)	175
V.3.	Number of listed companies and stock market capitalization	182
V.4.	Stock market trading volume	183
V.5.	Market value of listed bonds at year-end and listed bond turnover on Asian exchanges	187
V.6.	Domestic credit-rating agencies in East and South-East Asia	191
V.7.	Indicators of a good financial infrastructure in East and South-East Asia	193
V.8.	Online stockbroking, end of 1999	195
V.9.	Proportion of tax and non-tax revenue in GDP	196
V.10.	Selected Asian and non-Asian economies, per capita income and tax/GDP ratio	197
VI.1.	Foreign direct investment inflows, 1985-1999	202
VI.2.	Private capital flows to emerging markets, 1992-1999	208
VI.3.	Loans in foreign currency from overseas commercial banks, 1998-1999	211
VI.4.	Bonds and equity issued on international markets by ESCAP economies, 1997-1999	212
VI.5.	Sovereign risk credit rating of economies in the ESCAP region	213
VII.1.	Net ODA from member countries of the Development Assistance Committee as a percentage of GNP, 1990-1998 (ranked by 1998 figures)	237
VII.2.	Least developed countries in the ESCAP region: percentage change in net ODA receipts per capita between 1990-1992 and 1996-1998	238
VII.3.	Developing countries in the ESCAP region with an ODA/GDP ratio of 2 per cent or more	239

FIGURES

		Page
I.1.	Gross private financing to emerging market economies, 1997-2000	13
II.1.	Index of exchange rates of selected least developed countries, 1997-2000	33
II.2.	Index of exchange rates of selected Pacific island economies, 1997-2000	50
II.3.	Inflation rates of selected North and Central Asian economies, 1997-2000	62
II.4.	Index of exchange rates of selected North and Central Asian economies, 1998-2000	66
II.5.	Index of exchange rates of selected South and South-West Asian economies, 1997-2000	80
II.6.	Index of stock markets of selected South-East Asian economies, 1997-2000	98
II.7.	Index of stock markets of selected East and North-East Asian economies, 1997-2000	109
II.8.	Index of exchange rates of developed countries in the ESCAP region, 1997-2000	121
II.9.	Index of stock markets of developed countries in the ESCAP region, 1998-2000	122
III.1.	Population share of various subregions of ESCAP, 2000 and 2025	130
III.2.	A simplified framework of linkages between population, environment and poverty	146
V.1.	Diversification of financial markets	173
VI.1.	Selected developing ESCAP economies: cross-border merger and acquisition sales	203
VII.1.	Net ODA disbursements to developing countries of the ESCAP region, 1990-1998	238

EXPLANATORY NOTES

The term "ESCAP region" is used in the present issue of the *Survey* to include Afghanistan; American Samoa; Armenia; Australia; Azerbaijan; Bangladesh; Bhutan; Brunei Darussalam; Cambodia; China; Cook Islands; Democratic People's Republic of Korea; Fiji; French Polynesia; Georgia; Guam; Hong Kong, China; India; Indonesia; Iran (Islamic Republic of); Japan; Kazakhstan; Kiribati; Kyrgyzstan; Lao People's Democratic Republic; Macao, China; Malaysia; Maldives; Marshall Islands; Micronesia (Federated States of); Mongolia; Myanmar; Nauru; Nepal; New Caledonia; New Zealand; Niue; Northern Mariana Islands; Pakistan; Palau; Papua New Guinea; Philippines; Republic of Korea; Russian Federation; Samoa; Singapore; Solomon Islands; Sri Lanka; Tajikistan; Thailand; Tonga; Turkey; Turkmenistan; Tuvalu; Uzbekistan; Vanuatu and Viet Nam. The term "developing ESCAP region" excludes Australia, Japan and New Zealand.

The term "Central Asian republics" in this issue of the *Survey* refers to Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers.

Mention of firm names and commercial products does not imply the endorsement of the United Nations.

The abbreviated title *Survey* in footnotes refers to *Economic and Social Survey of Asia and the Pacific* for the year indicated.

Many figures used in the *Survey* are on a fiscal year basis and are assigned to the calendar year which covers the major part or second half of the fiscal year.

Reference to "tons" indicates metric tons.

Values are in United States dollars unless specified otherwise.

The term "billion" signifies a thousand million. The term "trillion" signifies a million million.

In the tables, two dots (..) indicate that data are not available or are not separately reported, a dash (–) indicates that the amount is nil or negligible, and a blank indicates that the item is not applicable.

In dates, a hyphen (-) is used to signify the full period involved, including the beginning and end years, and a stroke (/) indicates a crop year, a fiscal year or plan year. The fiscal years, currencies and 2000 exchange rates of the economies in the ESCAP region are listed in the following table:

Country or area	*Fiscal year*	*Currency and abbreviation*	*Rate of exchange for $1 as of November 2000*
Afghanistan	21 March to 20 March	afghani (Af)	3 000.00
American Samoa	..	United States dollar ($)	1.00
Armenia	1 January to 31 December	dram	553.97
Australia	1 July to 30 June	Australian dollar ($A)	1.91
Azerbaijan	1 January to 31 December	Azeri manat (AZM)	4 558.00
Bangladesh	1 July to 30 June	taka (Tk)	54.00
Bhutan	1 July to 30 June	ngultrum (Nu)	46.84
Brunei Darussalam	1 January to 31 December	Brunei dollar (B$)	1.76
Cambodia	1 January to 31 December	riel (CR)	3 880.00
China	1 January to 31 December	yuan renminbi (Y)	8.28
Cook Islands	1 April to 31 March	New Zealand dollar ($NZ)	2.48
Democratic People's Republic of Korea	..	won (W)	2.20
Fiji	1 January to 31 December	Fiji dollar (F$)	2.28
French Polynesia	..	French Pacific Community franc (FCFP)	139.94

Country or area	*Fiscal year*	*Currency and abbreviation*	*Rate of exchange for $1 as of November 2000*
Georgia	1 January to 31 December	Lari (L)	1.97[a]
Guam	1 October to 30 September	United States dollar ($)	1.00
Hong Kong, China	1 April to 31 March	Hong Kong dollar (HK$)	7.80
India	1 April to 31 March	Indian rupee (Rs)	46.84
Indonesia	1 April to 31 March	Indonesian rupiah (Rp)	8 735.00[b]
Iran (Islamic Republic of)	21 March to 20 March	Iranian rial (Rls)	1 744.25
Japan	1 April to 31 March	yen (¥)	111.17
Kazakhstan	1 January to 31 December	tenge (T)	144.10
Kiribati	1 January to 31 December	Australian dollar ($A)	1.91
Kyrgyzstan	1 January to 31 December	som (som)	49.22
Lao People's Democratic Republic	1 October to 30 September	new kip (NK)	8 085.00[b]
Macao, China	1 July to 30 June	pataca (P)	8.07
Malaysia	1 January to 31 December	ringgit (M$)	3.80
Maldives	1 January to 31 December	rufiyaa (Rf)	11.77
Marshall Islands	1 October to 30 September	United States dollar ($)	1.00
Micronesia (Federated States of)	1 October to 30 September	United States dollar ($)	1.00
Mongolia	1 January to 31 December	tugrik (Tug)	1 096.00[a]
Myanmar	1 April to 31 March	kyat (K)	6.70
Nauru	1 July to 30 June	Australian dollar ($A)	1.91
Nepal	16 July to 15 July	Nepalese rupee (NRs)	74.30
New Caledonia	..	French Pacific Community franc (FCFP)	139.94
New Zealand	1 April to 31 March	New Zealand dollar ($NZ)	2.48
Niue	1 April to 31 March	New Zealand dollar ($NZ)	2.48
Northern Mariana Islands	1 October to 30 September	United States dollar ($)	1.00
Pakistan	1 July to 30 June	Pakistan rupee (PRs)	57.48
Palau	1 October to 30 September	United States dollar($)	1.00
Papua New Guinea	1 January to 31 December	kina (K)	2.76[b]
Philippines	1 January to 31 December	Philippine peso (P)	51.43[a]
Republic of Korea	1 January to 31 December	won (W)	1 214.30
Russian Federation	1 January to 31 December	rouble (R)	27.85
Samoa	1 July to 30 June	tala (WS$)	3.47
Singapore	1 April to 31 March	Singapore dollar (S$)	1.76
Solomon Islands	1 January to 31 December	Solomon Islands dollar (SI$)	5.10
Sri Lanka	1 January to 31 December	Sri Lanka rupee (SL Rs)	79.12
Tajikistan	1 January to 31 December	Somoni	2.58[c]
Thailand	1 October to 30 September	baht (B)	43.88
Tonga	1 July to 30 June	pa'anga (T$)	1.99
Turkey	1 January to 31 December	Turkish lira (LT)	667 491.00[b]
Turkmenistan	1 January to 31 December	Turkmen manat (M)	5 200.00
Tuvalu	1 January to 31 December	Australian dollar ($A)	1.91
Uzbekistan	1 January to 31 December	som (som)	675.00
Vanuatu	1 January to 31 December	vatu (VT)	145.12[a]
Viet Nam	1 January to 31 December	dong (D)	14 164.00[d]

Sources: United Nations, *Monthly Bulletin of Statistics*, available at <http://esa.un.org/unsd/mbs/mbssearch.asp> (12 February 2001) and The Economist Intelligence Unit, *Country report*, available at <http://db.eiu.com/client_access.asp> (12 February 2001).

[a] October 2000.
[b] September 2000.
[c] December 2000.
[d] Average 2000.

ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
ATM	automated teller machine
BIS	Bank for International Settlements
CD-ROM	compact disk read-only memory
c.i.f.	cost, insurance, freight
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
ECB	European Central Bank
ECE	Economic Commission for Europe
EU	European Union
FDI	foreign direct investment
f.o.b.	free on board
GDP	gross domestic product
GNP	gross national product
HIV/AIDS	human immunodeficiency virus/acquired immunodeficiency syndrome
ICT	information and communication technology
ILO	International Labour Organization
IMF	International Monetary Fund
IT	information technology
M2	broad money supply
NGO	non-governmental organization
NPL	non-performing loan
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
SMEs	small and medium-sized enterprises
UNAIDS	Joint United Nations Programme on HIV/AIDS

ABBREVIATIONS *(continued)*

UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
VAT	value added tax
WTO	World Trade Organization

Part One

RECENT ECONOMIC AND SOCIAL DEVELOPMENTS

I GLOBAL ECONOMIC DEVELOPMENTS AND IMPLICATIONS FOR THE ESCAP REGION

OVERVIEW

The world economy showed much greater strength in the year 2000 compared both to 1999 and to earlier forecasts for 2000, a performance driven by continued strong growth in the economy of the United States of America, a somewhat faster momentum of recovery in the EU and, in the second quarter of 2000, a tentative turnaround in Japan. Faster economic expansion in the developed countries was accompanied by continued growth in the developing countries, particularly the crisis economies of East and South-East Asia. Furthermore, higher growth has been achieved in an environment of low to moderate inflation that has remained benign by historical standards. Reflecting in part higher energy prices, however, inflation edged slightly upwards in the latter part of 2000 necessitating some policy tightening in the developed countries. As a whole, price pressures in most parts of the developing regions declined further in 2000 (table I.1).

The strength of the world economy in 2000 was reflected in the buoyancy of world trade, the volume of which is estimated to have grown by 10 per cent in 2000, almost double the rate for 1999. Allied with higher prices for some commodities, particularly for oil and oil products, the rising trade volume translated into improved corporate and household earnings, and into enhanced corporate and consumer confidence, thus providing a firm underpinning to the growth process. Financial markets, by and large, remained buoyant but relatively stable during the first half of 2000. In the latter part of the year, there was a perceptible decline in most stock markets in both developing and developed countries, including the United States, owing to a combination of several factors. These included a weakening of several currencies vis-à-vis the dollar, some nervousness because of heightened political tensions in several parts of the world, upward pressure on oil prices and lower than expected corporate earnings in ICT companies. Against the backdrop of these mixed trends, private cross-border financial flows to developing countries, after rising strongly in the first half of 2000, tended to flatten out and display a degree of volatility. The main indicators of global economic performance and conditions are given in table I.1.

Notwithstanding the generally robust performance of the world economy in 2000, there are signs that a significant deceleration in output growth could occur in the coming year. Among the major factors are the recent surge in oil prices, tighter labour market conditions in some developed countries, and the possibility of a rapid slowdown of the United States economy. The world economy could thus be said to be poised between two opposing forces toward the end of 2000. On the positive side, there is the ongoing positive impact of the "new economy" (the ICT revolution); on the negative side are the high oil prices, albeit at a lower level than in the third quarter, and bearish capital market trends impacting negatively on consumer and business confidence. Other challenges to the world economy emanate from the slowing pace of banking and corporate reform in several crisis economies of the ESCAP region, and from the slow progress in such other areas as the new round of trade negotiations and reform of the international financial system.

Table I.1. Selected indicators of global economic conditions, 1997-2001

		1997	1998	1999	2000[a]	2001[b]
Economic growth (percentage change of GDP)						
World		3.2	1.9	2.8	4.1	3.6
Developed economies		2.6	2.1	2.6	3.7	3.1
Japan		1.6	−2.5	0.2	1.6	2.0
United States		3.9	4.4	4.2	5.2	2.5
European Union		2.5	2.6	2.3	3.5	3.1
Developing economies		5.5	1.7	3.6	5.6	5.5
Economies in transition		1.7	−1.9	2.8	5.3	4.2
Growth in volume of trade (percentage)[c]						
World		9.8	4.3	5.1	10.0	7.8
Developed economies	Export	10.4	3.9	4.8	9.9	7.6
	Import	9.2	5.7	7.6	10.3	7.9
Developing economies	Export	10.7	3.7	3.5	8.8	7.1
	Import	10.4	0.3	0.0	10.0	9.0
Commodity prices (annual percentage change: US dollar terms)						
Non-fuel primary commodities		−3.2	−14.7	−7.1	3.2	4.5
Oil		−5.4	−32.1	37.5	47.5	−13.3
Inflation rate (percentage)[d]						
CPI in the developed economies		2.1	1.5	1.4	2.3	2.1
CPI in the developing economies		9.7	10.1	6.6	6.2	5.2
Interest rates						
United States		5.1	5.5	5.4	6.5	7.0
Germany		3.3	3.5	3.0	4.4	5.4
Japan		0.6	0.7	0.2	0.2	0.6
Euro area		4.2	4.0	3.1	4.4	5.4
Exchange rates (nominal units per US dollar)[e]						
Yen per US dollar		121.0	130.9	113.9	107.0	104.0
Euro per US dollar				0.939	1.074[f]	0.9

Sources: United Nations, "Project LINK World Economic Outlook: World Aggregate Table", October 2000; IMF, *World Economic Outlook* (Washington DC, September 2000); *OECD Economic Outlook* (Paris, November 2000).

[a] Preliminary estimate.
[b] Forecast.
[c] Exports and imports (goods and services).
[d] Developed and developing economies ratios weighted at purchasing power parity.
[e] Period average.
[f] Period average January to October.

This chapter examines recent patterns of economic performance in the main developed and developing countries, their impact on trade and financial flows, on factors behind the recent rise in oil prices and weaknesses in stock markets, and on the economic prospects for 2001. Finally, the major implications for the ESCAP region on account of these external developments are discussed at some length, with special reference to the main issues of concern facing the region.

RECENT GLOBAL MACROECONOMIC TRENDS

Developed countries

The oft-predicted slowdown of the United States economy once again failed to materialize in 2000. In fact, that economy surged ahead during the first half of the year. Both fixed investment and domestic demand remained buoyant during much of 2000. Fixed investment was underpinned by strong business confidence and a large increase in ICT-related investment, while domestic demand was reflected in the growth of retail sales of 6.5 per cent in the year to September 2000. Inflationary pressures, at 3.5 per cent in the year to September, remained muted in 2000. However, there was evidence of some tightening of labour markets in the latter half of 2000. With a budget surplus of some 1.0 per cent of GDP, the burden of adjustment thus fell primarily on monetary policy. The Federal Reserve adopted a gradually tighter monetary policy from mid-1999, causing interest rates to rise by 1.75 percentage points between June 1999 and May 2000. From the third quarter there were indications of the economy slowing down, with third-quarter growth at 2.4 per cent on an annualized basis compared to 5.3 per cent over the previous 12 months and inflationary pressures abating with the likelihood that interest rates had peaked. In fact, there were signs that activity in the manufacturing sector in November 2000 had slowed to its lowest level since April 1991.[1]

Over 2000 as a whole the strength of domestic demand relative to output growth has resulted in a sharp widening of the United States current account deficit, from 1.75 per cent of GDP in 1997 to 4.25 per cent in 2000. The so-called "new economy" phenomenon, with growth sustained by increased productivity above its historical trend,[2] led to buoyant stock markets, at least until April-May 2000, and helped attract substantial capital inflows to the country. These contributed, in turn, to the appreciation of the dollar and perhaps to a wider current account deficit than might otherwise have been the case. The near-term performance of the United States economy is likely to be influenced by the following: will the authorities succeed in managing a soft landing, is the recent upsurge in productivity sustainable, and will the current account deficit have to be corrected and at what speed? It is clear that both demand and supply have grown above the upper level of long-term trends in the United States over the past three years. This outcome has been accommodated by significant productivity increases plus the steady reduction in unemployment. Further supply-side improvements could be expected to continue so long as productivity continues to rise. Nevertheless, the shrinking pool of labour and the mix of skills available within it is likely to constrain output growth in the months ahead. An indication of potential difficulties in this context is the unemployment rate which, at 4 per cent, is at its lowest for more than a generation.

Recent productivity growth is generally viewed as having taken place in response to large-scale investment in ICT since the early 1990s. However, there are serious conceptual and statistical difficulties in identifying and measuring with reasonable certainty the intrinsic, as opposed to the cyclical, increase in productivity at the current, mature stage of the expansion. Equally complex is the task of isolating the impact of monetary policy on asset prices and of delineating its effects on demand, output growth and productivity.[3] It is also worth stressing that the United States is now a substantial external debtor with a large current account deficit. Declining personal savings and high stock prices have fuelled a consumption boom which has been financed, in turn, by the easy availability of foreign capital. A hard landing of the economy may cause stock markets to fall abruptly. But the extent of such a setback will depend largely on an unknown variable: whether or not the current levels of stock prices reflect a bubble or a permanent upward shift in productivity, or a combination of both. Thus, the balance of risks and policy options in this regard remains difficult to assess.

---

1 *Financial Times*, 2 January 2001.

2 See Christopher Gust and Jaime Marquez, "Productivity developments abroad", Federal Reserve Board, Washington DC, unpublished. The paper compares the growth in productivity in the United States with other OECD economies during the 1990s.

3 Bank for International Settlements, *70th Annual Report*, June 2000, pp. 63-68.

At well over 4 per cent of GDP, the current account deficit of the United States would be considered unsustainable according to most conventional norms. However, the strength of the dollar and, until recently, buoyant capital markets have enabled the United States to finance the deficit without difficulty. But, as is usual in periods of sustained expansion, such financing has not been difficult on the assumption that the underlying expansion and the associated capital gains in asset prices can be expected to continue. Large financial inflows on such a basis, however, have the potential to generate significant instability once it is perceived that the expansion would come to an end. In fact, some signs of risk aversion on the part of investors are already beginning to appear; prices of both ICT and "old" economy company shares fell significantly in April-May 2000 and thereafter fluctuated around a bearish trend that intensified towards the end of 2000. In addition, spreads between treasury bonds and all corporate bonds have widened, and those between treasuries and high-yield bonds reached 7 percentage points towards the latter part of 2000, a level last seen only in the early 1990s. Such a steep rise in corporate borrowing costs indicates a degree of nervousness prevalent among investors, both domestic and foreign, emanating from concerns regarding the sustainability of the current account deficit at its present level. Higher financing costs will dampen output growth in the months ahead.

The consensus view is that growth in the United States economy will slow down in 2001 to around 2.5 per cent. The estimate is, however, tentative given the multiplicity of factors and influences bearing on the United States economy discussed above, and the fact that it appears to be slowing more rapidly than was estimated as recently as September 2000.

The EU growth rate picked up significantly from the second half of 1999 and the pace was maintained into 2000. As a result, GDP growth is expected to be 3.5 per cent in 2000 as a whole, the highest rate achieved during the 1990s. There were, in addition, major reductions in unemployment. In the larger economies, Germany, France, Italy, and the United Kingdom of Great Britain and Northern Ireland, economic growth is expected to be in excess of 3 per cent, while among the smaller economies, Austria, Belgium, Finland, Ireland, the Netherlands, Spain and Sweden, output growth is expected to be in excess of 4 per cent. Such acceleration in the growth rate has been aided by broad-based export gains, partly on account of the strong global economy and the weakness of the euro in the EU 11 members of the euro zone.[4]

However, the pickup in the EU 11 was accompanied by higher prices for oil and other raw materials and a weakening euro. As a result, the headline inflation rate passed 2.3 per cent over the 12 months to August 2000, a level which was somewhat above the European Central Bank (ECB) target rate of 2 per cent or less. Core inflation, on the other hand, has remained subdued, a trend assisted by moderate wage settlements and falling utility prices partly attributable to deregulation and privatization. Given the relatively strong pickup in activity and rising oil prices, ECB raised interest rates by a cumulative 2 percentage points between late 1999 and August 2000. But this had little effect on the euro exchange rate initially. The euro began to strengthen in late 2000 as evidence of a slowdown in the United States became more apparent.

It is noteworthy that GDP growth rates and inflation continue to differ significantly among the EU 11 euro zone countries. This poses a considerable challenge for ECB since monetary policy must be set on the basis of conditions in the euro zone as a whole. Most of the economies further ahead in the cycle of growth have experienced higher than average inflation, rapid credit growth and sharply rising property prices, usually unmistakable signs of overheating. A combination of monetary policy initiatives at the ECB level and of fiscal and structural measures at the individual country level, has been put into effect as a response. The EU 11 are presently running a collective budget deficit of 1.2 per cent of GDP but the situation varies considerably among the 11 constituent economies. Fiscal consolidation measures had initially been taken with commendable speed to meet the requirements of entry to the euro zone; implementation has slowed down in recent months in some countries. This has possibly impinged adversely upon the euro itself. The process should be viewed against the fact that

[4] The members are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

the overall tax burden appears to be high by international standards in almost all EU countries.[5] Continuing structural reforms, including fiscal reforms, need to be pursued to ensure that the present recovery is not choked off by the emergence of inflationary pressures.

Another major policy issue confronting EU and ECB has been the persistent weakness of the euro, particularly vis-à-vis the dollar, but against the yen as well (table I.1). While a depreciating euro stimulated export-led recovery within the EU 11, its weakness has generated fears of a rise in inflation within the euro zone, a policy tightening to counter it and the attendant loss of growth momentum. Given these concerns, the overall growth rate in the EU is likely to decelerate somewhat to 3.1 per cent in 2001.

The extent of exchange rate decline exhibited by the euro within such a short period is difficult to explain in terms of macroeconomic fundamentals. One possible reason relates to the relative positions of the euro zone and the United States in the economic cycle, with the less advanced position of the euro zone economies and resultant interest rate differentials contributing to euro weaknesses. Another, more technical, explanation concerns the possible, initial over-valuation of the euro relative to the dollar, on account of the large component of the strong German currency. The consequent unwinding of currency traders' forward positions denominated in this currency after the launch of the euro inevitably caused the latter to weaken. Another explanation lies in the dynamics of international financial flows. The relatively strong performance of the United States economy in recent years caused large financial outflows from the EU 11 to the United States and hence the depreciation of the euro. A final explanation is institutional in nature, namely the short operational history of ECB and, hence, the absence of a proven track record of effective policy response to emerging issues and problems.

Outside the EU 11, growth in the United Kingdom is estimated to reach 3 per cent in 2000, almost one percentage point over the rate achieved in 1999. The United Kingdom economy has displayed significant strength following the slowdown in 1998. The current account deficit has remained relatively low, at around 1.5 per cent of GDP, despite the strong exchange rate; the budget meanwhile has turned into a surplus and inflation has remained within the Bank of England's target range. However, as in the United States, labour market conditions have tightened, with unemployment at only 5.5 per cent (on a claimant count basis) and with significant skill shortages being encountered in certain areas. Some monetary tightening has accordingly taken place, with interest rates rising by 100 basis points between mid-1999 and mid-2000. While the pound sterling weakened against the dollar in the second half of 2000, its trade-weighted exchange rate declined from nearly 110 in October 2000 to 107 in December 2000, roughly the same level as 12 months earlier. Further policy tightening is considered likely only if domestic demand continues to strengthen. Nevertheless, growth is likely to fall marginally from 3 per cent in 2000 to 2.7 per cent in 2001, a level considered to be around the long-term rate of growth of the United Kingdom economy.

Japan experienced two quarters of output decline in the second half of 1999. However, GDP grew by 0.8 per cent in the first half of 2000, including a much more vigorous 4.2 per cent surge, on an annualized basis, in the second quarter. Thereafter, growth appears to have eased somewhat with the Bank of Japan's December Tankan index also indicating a deterioration in business conditions.[6] Nevertheless, for 2000 as a whole, growth is expected to reach 1.6 per cent, a substantial improvement over the 0.2 per cent rate achieved in 1999. The recovery was largely stimulated by a succession of substantial public spending packages. There was also strong expansion in industrial production, which stood 6.6 per cent above its level in October 2000, compared to 12 months earlier. Such expansion was primarily caused by corporate investment in the high-technology sectors and, in contrast to previous years, less so by net exports. In fact, both the trade and current account surpluses declined, albeit marginally, during 2000.

---

5 *The Economist*, 4 November 2000, p. 132.

6 According to initial estimates the Japanese economy grew by 1 per cent on an annualized basis in the third quarter of 2000. However, the Economic Planning Agency has warned that the figure could be revised downwards *(Bangkok Post*, 23 December 2000).

The Japanese recovery remains fragile, notwithstanding these favourable developments. As already mentioned, recovery has been led by huge infusions of public sector funds into the economy, with the most recent public spending package adding a further 11 trillion yen ($102 billion) to the public debt; pump priming at this scale cannot continue into the future for long. Already the fiscal deficit has reached double digits as a percentage of GDP, while the overall level of gross public debt as a ratio of GDP is the highest amongst the developed countries.[7] A critical factor in sustaining growth in the near term would be the recovery of private consumption as an alternative to infusions of public funds. With both retail sales muted and deflationary pressure continuing largely unabated, the prospects of higher private consumption in the months ahead are not overly bright. Japan has experienced a progressive rise in private savings since the late 1980s, with a marked acceleration in such savings since 1997. Combined with a recovery of corporate profits and retained earnings, the private sector's net financial surplus amounted to almost 13 per cent of GDP by the first quarter of 2000.[8] While this has undoubtedly facilitated the financing of successive public spending packages, it has also raised strong doubts as to the sustainability of such a growth-stimulating approach.

Nevertheless, the need for fiscal stimuli remains unavoidable in the short term. At the same time, the Japanese authorities would need to put up a credible medium-term plan to stabilize and progressively reduce the debt-to-GDP ratio in order to calm the financial markets. Another policy issue concerns the monetary stance. This has to remain accommodative to facilitate and sustain economic growth. The ending of the zero interest policy announced by the Bank of Japan in August 2000, while important in terms of its symbolic value, should not presage a tighter monetary stance. Such a stance could further undermine consumer sentiment and the growth process itself.

Another issue is the weak financial position of the banking system and the inability, or unwillingness, of banks to lend, particularly to SMEs. The government's recapitalization programme for the banking system has enabled banks to write-off large amounts of non-performing loans (NPLs). Yet, bank credit is shrinking, reflecting a lack of demand, as large companies prefer to pay back bank debt and/or finance themselves in the capital market, and stricter criteria are applied for bank lending.

Japan faces a dilemma in the corporate sector at present. Firms have attempted to reduce excess capacity by shutting down older manufacturing facilities without causing significant reductions in the labour force employed. In particular, large-scale downsizing has been avoided so far by the bigger corporations.[9] However, given the excess capacity in Japanese manufacturing, it is a course of action which has to be pursued at some stage. On the other hand, any significant decline in employment would further depress consumer confidence and spending, thus producing a negative impact on growth, at least in the short run.

Developing countries and economies in transition

Economic growth in the developing countries strengthened appreciably to reach 5.6 per cent in 2000, 2 percentage points more than in 1999, and at about the same pace as in 1997, the year of the financial and economic crisis in East Asia. The pattern of growth, however, is rather uneven and its momentum appears to be weakening. Growth was aided in 2000 by a favourable international environment, such as buoyant international trade and higher prices for several commodities, as well as by the benefits realized from the continuing programme of domestic reforms initiated in previous years. Higher oil prices, on the other hand, are a boon for net oil producers, but for the net oil importing countries they imply cost-push pressures and widening current account deficits or falling surpluses. In this regard, the overall vulnerability of developing countries to external shocks remains significant; growth in 2001 could be somewhat lower as a result if high oil prices persist and external accounts deteriorate further.

---

[7] IMF, *World Economic Outlook* (Washington DC, September 2000), pp. 21-24.

[8] Bank for International Settlements, *70th Annual Report*, June 2000, pp. 10-22.

[9] It is to the credit of the authorities in Japan that after a decade or so of poor growth in the economy the unemployment rate is still 4.7 per cent, the next lowest after the United States within the G7 economies.

A major factor in the impressive performance by the developing countries as a whole in 2000 was the relatively broad-based and strong recovery in the crisis economies of Asia.[10] Preliminary estimates indicate that the ESCAP region should grow by over 7 per cent in 2000. The pattern of growth within the ESCAP region displays some striking differences. Within South-East Asia, for instance, Malaysia and Singapore have grown rapidly; growth has tended to falter somewhat in Indonesia, the Philippines and Thailand, especially in the second half of 2000, a development reflecting political difficulties and uncertainties in all three countries. Three countries in East Asia, China; Hong Kong, China; and the Republic of Korea, have grown impressively. On the positive side, the recovery process has displayed a welcome shift in some countries from being led by net exports and government spending to a more self-sustaining path of higher business investment and private consumption.

Investment levels have generally not yet risen to pre-crisis levels because of excess capacity in several sectors and the need for most companies to restructure and reduce debt. A particular constraint on the recovery process in the crisis economies has been the inability of SMEs to raise finance, whether for working capital, other operational needs, or for restructuring and rationalizing their operations in the medium term.

The higher oil prices in the later part of 2000, and the attendant possibilities of higher interest rates and stock market weaknesses, pose significant downside risks to recovery in 2001. Domestic stock markets remain highly vulnerable to developments elsewhere, particularly in the United States. Recent stock market weakness has undoubtedly affected business and household confidence in the region in an adverse manner, although it is difficult to determine precisely the extent to which greater stock volatility and lower equity prices are likely to affect the real economy.

The economies in transition almost doubled their growth rate in 2000, compared to 1999, as a result of high oil and gas prices, a faster pace of growth in the EU, continued inflows of foreign investment, particularly FDI, and the strong pace of recovery in the Russian Federation where soaring oil prices combined with a strong industrial performance led to a large trade surplus. As a result, foreign exchange reserves were built up from their low levels of 1999, thus giving stability to the rouble exchange rate. Capital flight diminished as a result. On the fiscal front, the significant buoyancy of output and higher oil prices led to a dramatic improvement in the financial position of all levels of government.

Along with the Russian Federation, a number of the Central Asian republics also enjoyed a major boost to their economic activities and recorded improvements in internal and external financial conditions from higher oil prices and firmer commodity markets. Kazakhstan, for instance, was able to repay a significant portion of its external debt, including all obligations to IMF.

Overall, the economies in transition in Central Asia should be able to sustain significantly positive growth in 2001. However, a possible easing of oil prices and a reduction in the pace of expansion in the Russian economy as it comes up against structural constraints are likely to mean that the robust economic performance in 2000 may not be exactly matched a year hence.

TRADE, COMMODITIES AND CAPITAL FLOWS

International trade expanded in 2000 at a strong pace, almost double that of 1999. Measured by changes in export volume, world trade is estimated to have surged by over 10 per cent in 2000, compared to 5.1 per cent in 1999 and 4.3 per cent in 1998. The share of developed countries, at about two thirds of the total, still dominates world trade, with the United States accounting for one fifth of developed country imports and around 12 per cent of world imports.

The crisis and the subsequent rapid recovery in Asia in 1999 gave rise to sharp swings in world trade flows. Trade by the developing countries had declined by a large margin in 1998, especially in value terms; significant discrepancies emerged between trade volumes and trade values as prices of

[10] The GDP performance and macroeconomic developments in the ESCAP member countries are discussed more fully in chapter II.

some commodities and, indeed, certain manufactures, declined precipitately. In 1999, both exports from and imports into the developing countries staged a major recovery. However, the discrepancy between trade volumes and trade values persisted, albeit to a lesser degree, implying that commodity prices, other than oil, had not yet recovered fully to their pre-crisis levels.

A noticeable feature in 2000 was the strong acceleration in import demand from the developing countries, a recovery resting on the strength of growing domestic investment and household consumption from early 2000 onwards. In addition, many export categories from developing countries have a high import content of components and raw materials; higher exports inevitably generated a strong demand for imports. For developing countries as a group, import volumes were estimated to have increased substantially faster than the overall growth in world trade, by 14 per cent in 2000 compared to 6 per cent in 1999. Notably, import demand from the developing countries of the ESCAP region expanded by 15 per cent.

The strong growth of world trade in 2000 embodied a robust export performance in almost all the main regions of the world. First in the list was the Asian and Pacific region where the dynamism of intraregional and intra-industry trade revived almost to pre-crisis levels, with several economies in the ESCAP region registering export growth by 20 per cent or more in 2000. Such dynamism did not, however, have much of a visible impact on the patterns of external imbalance. Developing countries as a group have traditionally run high levels of current account deficits. However, the crisis in Asia led to severe import compression in several economies of the region in 1998, giving rise to substantial current account surpluses. These surpluses have remained largely intact despite the significant rise in imports in 1999 and 2000. This out-turn suggests that the Asian crisis economies, aided by exchange rate depreciations in 1997 and 1998, have maintained and indeed enhanced their international competitiveness.

Among the developed countries, the United States has run a significant current account deficit for a number of years with the shortfall widening considerably as imports grew faster than exports in both 1999 and 2000. In fact, the deficit reached, on a year-on-year basis, nearly $400 billion by the second quarter of 2000, compared to $275 billion for the same period in 1999. Against this backdrop, the current account surpluses of the EU, except those of Japan and the United Kingdom declined only marginally. The main factors driving trade and current account imbalances in 2000 were essentially the same as those that had operated for much of the 1990s, namely the strong pace of growth in the United States and the strong US dollar, the latter being due in part to the positive interest rate differentials in favour of the United States.

A special factor operating in 2000 was the oil price, its surge during the year and, contrary to expectations, its apparent stabilization at a relatively high level. Certain other commodity prices, principally those of base metals, also rose although the overall commodity price index in dollar terms stood only marginally higher in 2000 compared to 1999. This was due largely to the offsetting weaknesses in the prices of agricultural raw materials.

The rise in oil prices was the result of strong demand driven by the robust pace of global growth superimposed upon a mismatch of inventories. There is little doubt, however, that it is the pace of global economic recovery that has been behind the recent upsurge in oil prices. The 1997-1998 crisis had caused plummeting prices and high inventories with many oil production and refining facilities being mothballed in the process. When recovery gathered pace from 1999, producers first ran down inventories with a view to gauging the sustainability of any increase in demand. Few idle production rigs, platforms or refineries were brought back into operation. Consumers, for their part, scrambled to rebuild inventories over most of 2000, especially for distillates in the summer and then for winter heating oil.

With political tensions rising in West Asia, oil prices came under unusual pressure in the autumn of 2000 and this necessitated a release by the United States Government of some of its Strategic Petroleum Reserve to alleviate market pressures. Prices began to ease thereafter but only marginally so.[11] Oil prices are expected to fluctuate within a band of $28-$33 a barrel until the spring of 2001, and then decline gently.

---

11 On 10 November 2000, the price of Brent crude stood at $32 a barrel, still $10 a barrel more than a year ago.

Table I.2. Net long-term flows[a] to developing countries, 1990-1999

(Billions of US dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999[b]
Total	98.5	124.0	153.7	219.2	220.4	257.2	313.1	343.7	318.3	290.7
Official flows	55.9	62.3	54.0	53.4	45.9	53.9	31.0	39.9	50.9	52.0
Private flows	42.6	61.6	99.7	165.8	174.5	203.3	282.1	303.9	267.7	238.7
International capital markets	18.5	25.4	52.2	99.8	85.7	98.3	151.3	133.6	96.8	46.7
Debt flows	15.7	18.8	38.1	48.8	50.5	62.2	102.1	103.4	81.2	19.1
Bank lending	3.2	5.0	16.4	3.5	8.8	30.4	37.5	51.6	44.6	−11.4
Bond financing	1.2	10.9	11.1	36.6	38.2	30.8	62.4	48.9	39.7	25.0
Other	11.3	2.8	10.7	8.7	3.5	1.0	2.2	3.0	−3.1	5.5
Equity flows	2.8	7.6	14.1	51.0	35.2	36.1	49.2	30.2	15.6	27.6
Foreign direct investment	24.1	35.3	47.5	66.0	88.8	105.0	130.8	170.3	170.9	192.0

Source: World Bank, *Global Development Finance 2000* (Washington DC, 2000).

[a] Net long-term resource flows are defined as net liability transactions or original maturity of greater than one year.

[b] Preliminary.

Base metal prices rebounded in the second half of 2000 after having declined to historical lows in the early part of 1999. Here again, the pace of global growth compounded by low inventories has led to unexpected firmness in prices in 2000. However, a wide range of other commodities remained largely unaffected by these developments because their stock-to-consumption ratios are less amenable to changes in the short term, especially rice, coffee, cocoa, tobacco and tropical logs. As such, their outlook is for continuing weakness in prices, not least on account of persistent excess production and/or stock overhang for a number of years.

Capital flows to developing countries from the international capital markets fell by 14 per cent in 1999 on a gross basis. The decline was considerably larger on a net basis with many countries seeking to reduce their external indebtedness or being unable to roll over short-term loans (table I.2). The share of developing countries in the global capital market fell to 4.5 per cent in 1999, compared to 6.4 per cent in 1998 and 11 per cent in 1997.[12] Within the group of developing countries, those of the ESCAP region increased their share significantly to about 36 per cent in 1999, from 23 per cent in 1998. Preliminary estimates suggest that the group of developing countries of the ESCAP region has again raised its relative share in global capital flows to over 40 per cent for 2000.

Gross private capital flows to developing countries are expected to recover moderately in 2000 on the basis of initial estimates up to mid-2000. At this level they would represent a return to the levels of 1995 but still below the levels seen in 1996 and 1997, just prior to the crisis in Asia. After rising strongly in 1999, FDI flows are also expected to level off as foreign investors, already wary of greenfield investments in the developing countries, find fewer opportunities for the acquisition or merger of existing facilities in these countries. Similar trends in resource flows are also in evidence with respect to official assistance. After their visible, crisis-induced rise over the years 1997-1999, official flows are expected to move downwards to their pre-crisis levels. With regard to official assistance, the most notable recent development has been the enhanced initiative for heavily indebted poor countries. Under the enhanced initiative, the qualifying period for debt relief would be reduced, qualifying thresholds for

[12] World Bank, *Global Development Finance 2000* (Washington DC, 2000), pp. 21-23.

certain indicators such as the debt-to-export ratio and the export-to-GDP ratio would be lowered and a link would be established between debt relief and poverty reduction.

While the overall matrix of factors and determinants of capital flows to developing countries remains broadly unchanged, some new features emerged in 2000. The tightening of monetary policy in the developed countries and volatility in the stock markets have considerably restricted access to external finance for developing countries. Not only did interest rates go up but also yield spreads for developing countries tended to widen as stock market volatility induced investors to be more risk-averse. So strong is the flight to quality that even spreads between United States treasury bonds and corporate bonds reached levels last seen only in the early 1990s, as noted earlier.

A related feature of the capital markets in the second half of 2000 was the major downward correction of many ICT-related shares, in both the developed and developing countries. In 1997, the ICT sector accounted for 10 per cent of private capital raised in the developed countries and 12 per cent in the developing countries. Its relative share was estimated to have risen to 44 per cent, and 77 per cent of new equity issues in the developing countries for the first half of 2000.[13] Thus, as the weight of ICT firms had rapidly reached a very high level in a number of developing country stock price indices through rising share values, their vulnerability to downside risks and sharper declines intensified.

IMPLICATIONS FOR THE ESCAP REGION

The external conditions for sustained growth in the ESCAP region appear to be mixed for 2001. Economic growth in the developed countries should continue to be positive. On present evidence the likely slowdown in the United States, starting in the latter part of 2000, is unlikely to be prolonged. Given existing patterns of productivity growth, the United States economy will most likely continue to enjoy above-trend output expansion despite the currently low level of unemployment. A modest slowdown is also forecast for the EU. Japanese economic growth could be higher in the coming year, although signs are somewhat discouraging at this stage.

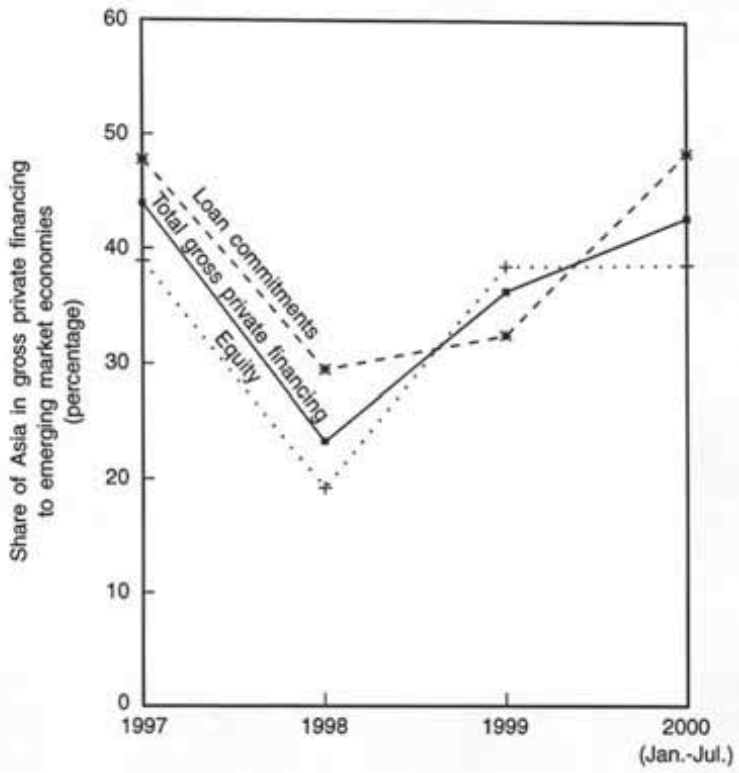
In aggregate terms, the growth rate of developed country imports from all sources is expected to slow from over 10 per cent in 2000 to just below 8 per cent in 2001. As some two thirds of such trade is with other developed countries, the impact of a slowdown of this magnitude is likely to be modest for the developing countries. Exports by developing countries are estimated to slow from 8.8 per cent to just over 7 per cent in 2001. As such, the likely adverse impact of external demand on output growth in the region should be manageable in the coming year. Nevertheless, the countries of the region need to strengthen domestic impulses for growth.

An imponderable factor, however, is the possibility of a sharp slowdown in the United States economy in 2001, a development which could dampen further export growth from both developed and developing economies. Among other major unfavourable knock-on effects from such an adverse development could be: lower commodity and manufactured goods prices, weakening import demand from various interdependent countries; and possibly a sharp slowdown of world trade in value terms. However, an offsetting factor is the growing importance of intraregional trade within the ESCAP region; chances of the entire region experiencing a simultaneous slowdown in trade and growth, though possible, are not very likely.

On the other hand, the prognosis for capital flows to developing countries is more uncertain when account is taken of their recent levelling off. The slowdown appeared to persist in the second half of 2000. A brighter note is that the Asian and Pacific region increased its share in private capital flows in 1999 as most crisis economies rebounded strongly from the recession. In the first half of 2000, the upward trend continued (figure I.1). It is worth noting here that a major portion of equity capital was directed as investments in ICT firms. Easier financing conditions meant that the boom in ICT investments so visible in the United States in the early part of 2000 was also partially replicated in the region.

[13] *The Economist*, 28 October 2000, p. 113.

Figure I.1. Gross private financing to emerging market economies, 1997-2000



Source: IMF, *World Economic Outlook* (Washington DC, September 2000).

Note: Equity comprises bond issues, other fixed income and equity issues.

In the above context, it is important to note that private equity capital flows have become more sensitive to fluctuations in ICT-related share prices worldwide. As ICT share prices retreated in April-May 2000 from their peak, reached in March 2000, equity flows to the region slowed in tandem, thus causing gross private financing to the region to decline in the second quarter of 2000.

A positive and growing correlation between changes in stock prices in the developed countries and those in the rest of the world, including markets in the ESCAP region, appears to have emerged in recent years.[14] Such a correlation implies that volatility has been transmitted, and occasionally magnified, from the developed countries to the developing countries in the region. The latter usually have fewer companies listed on their stock markets and stock market indices are, in turn, dominated by a small number of large companies. Such a transmission means a heightened perception of risk by investors who then tend to reduce their exposure during and after a bout of volatility in the region's markets. In this context, there is some evidence over the past year that ICT stocks are regarded by investors as relatively high-risk assets. As such, these stocks tend to suffer disproportionately large price swings regardless of the markets in which the shares are traded.

The recent rise in oil and energy prices, superimposed upon the weakened exchange rates of several economies in the region, is one obvious source of risk. With regard to oil prices, it is worth

[14] *The Economist*, 21 October 2000, p. 135.

stressing that the current context and circumstances are not identical to those of previous oil price shocks. Absolute oil prices in the spot markets have certainly risen sharply in the recent past, by nearly 60 per cent between October 1998 and October 1999, and by a further 51 per cent between October 1999 and October 2000. But even at these levels, they are far below the pace of price increases, for example during the second shock in 1979/80. In real terms, the current prices are roughly comparable to what they were in the mid-1980s. However, the recent price rises are bound to have a negative impact in the short term since oil prices had remained much lower for most of the last 15 years.

Higher oil prices mean reduced consumer purchasing power, given unchanged income and consumption patterns in the short run. According to one set of calculations, an increase in oil prices from $20 to $30 per barrel would result in a loss of consumer spending in the United States of about $20 billion overall; this amount is equivalent to between 0.2 and 0.3 per cent of GDP, a magnitude no more than the margin of error in most economic forecasts.[15] A $5 increase in oil prices would increase inflation in OECD countries by between 0.2 and 0.4 percentage points. In oil-importing developing countries, higher fuel prices would put pressure on production costs and could add to inflationary pressures if higher costs were passed on to consumers. Higher fuel prices could also constrain overall demand by reducing disposable incomes. However, there is at present no consensus that high oil prices are here to stay and, barring any further intensification of political tension in West Asia, oil prices are expected to ease in the spring of 2001.[16] The Organization of Petroleum Exporting Countries (OPEC) itself has indicated that it would like to see oil prices stabilize within a range of $25 to $28 a barrel, and it would attempt to produce oil at a level consistent with this objective. In view of this uncertainty, governments need to keep a watchful eye to minimize the adverse consequences of high and volatile oil prices.

NEAR-TERM POLICY ISSUES

Several countries adopted floating rate regimes in the wake of the economic crisis in the region and many currencies experienced fairly large depreciations in 1998. Most of these currencies, however, regained some of the lost ground in 1999, allowing interest rates to come down and helping to keep inflationary pressures muted. Most of the crisis currencies, among many others, have weakened again from the second half of 1999, thus amplifying further the "flow through" effects of higher oil prices and rendering more probable the emergence of inflationary pressures in due course. Exchange rate weakness raises new and complex policy issues.[17]

The adoption of some form of inflation targeting as a replacement for fixed exchange rate arrangements (see box I.1) is a possible option. That, in turn, raises a number of policy concerns.[18] For one thing, the exchange rate itself is a major element in inflation. Given the high share of imports in production cost and/or consumption in most countries, the exchange rate cannot be excluded entirely from the policy matrix. Another concern is whether the inflation target range adopted is the "right" one. This issue has three aspects: (1) whether the authorities can live with it in the context of the evolving domestic political and social conditions; (2) whether the target is consistent with the needs of longer term structural change in the economy, involving shifts of resources between different uses; and (3) whether the authorities have adequate flexibility and instruments to deal with unexpected shocks, such as the recent rise in oil prices.

Moreover, a mechanical adherence to inflation targeting could lead to frequent modifications in the monetary policy stance and to possible fluctuations in the inflation rate itself in the interim period leading up to the targeted horizon. In other words, the efficacy of the new policy approach remains to be tested with no guarantee that it will lead to a superior outcome in terms of investment and output levels over the medium term. It also remains to be

---

15 *The Times*, 3 October 2000.

16 International Energy Agency forecast, *Bangkok Post*, 10 November 2000.

17 Briefly discussed in *Survey 2000*, p. 21.

18 See papers presented at the Bank of Thailand's International Economic Conference on Practical Experiences on Inflation Targeting, Bangkok, 20 October 2000.

Box I.1. Inflation targeting

Following the 1997 crisis, several economies in the ESCAP region adopted floating exchange rate regimes. In consequence, the use of a fixed exchange parity as a nominal anchor for monetary policy has been replaced in certain instances, for example the Republic of Korea and Thailand, with some form of inflation targeting. There has been a move in this direction since the early 1990s in a number of developed countries.[a]

Inflation targeting has been defined as "a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal."[b] In defining inflation targeting as a framework for monetary policy rather than a precept, there is an implication that it is not simply a mechanical rule, but rather a policy approach in which various factors are taken into account in the pursuit of the inflation target. In other words, inflation targeting is a form of conditional discretion available to the central bank in which the discipline of a clear objective, as embodied in an inflation target, is combined with flexibility as to how it should be achieved. The inflation targeting approach is, therefore, wider than the use of the fixed exchange rate parity or adherence to money supply growth as policy tools.

An important feature of inflation targeting is that it tends to go hand-in-hand with central bank independence. The theoretical case for central bank independence is based upon the problem of time inconsistency. Governments often face pressures that tend to bias them in favour of tolerating the risk of increased inflation. These biases emerge on account of the lags associated with monetary policy decisions. The benefits of long-run price stability lie in the future whereas the costs (including political costs, such as electoral unpopularity) that have to be borne in attaining it lie in the present. Given these inconsistencies, governments are more likely to defer such costs and, in the process, build in a semi-permanent bias towards inflation. An independent central bank, on the other hand, specifically given the task of achieving and maintaining a particular level of inflation, and appropriately empowered to do so through political consensus, is expected to be able to counter such a bias.

A further feature of inflation targeting is the need for openness and accountability. The central bank announces a formal target for inflation in a public document. Thereafter, both the general public and the financial markets have to be kept fully in the picture about the plans, objectives and decisions of the central bank with regard to the attainment of the target. In turn, the central bank is held accountable for its decisions and their outcome. This means that both the public and financial market participants know the environment in which they are operating along with an official view as to how that environment might evolve within a defined period ahead.

How does inflation targeting operate in practice? There are, of course, many influences bearing on inflation, such as the exchange rate, import prices, growth in wages and earnings, improvements in productivity, distribution bottlenecks and the fiscal regime, to name only the main ones. None of these is amenable to direct control by the central bank. As far as the central bank is concerned, the main policy tool available to it is the interest rate, usually the discount or repo rate, through which it provides liquidity to the financial system and determines the term structure of interest rates. All other influences have normally to be taken as given. The volume and cost of liquidity are, however, expected to influence a number of different macroeconomic variables with a bearing on inflation.

Increases or decreases in the interest rate are expected, for instance, to achieve changes in the growth rate of monetary aggregates, the yield curve, expectations of inflation, the size and components of the output gap, asset prices and exchange rate forecasts. Taking all these factors into account and making allowance for the lags in the impact of monetary policy and its imprecise transmission mechanisms, the authorities can determine a time path with a probability distribution of future inflation and the associated risks and uncertainties and calibrate their interest rate changes to accord with the chosen inflation target.

In virtually all countries that have adopted inflation targeting, the policy approach has been successful. Inflation targets have in most cases been achieved or surpassed. However, a more objective assessment of the efficacy of inflation targeting must await the completion of, at least, a full business cycle since in most countries the targets have been introduced in periods of

(Continued overleaf)

[a] Australia, Canada, Finland, New Zealand, Spain, Sweden, Switzerland and the United Kingdom.

[b] Ben S. Bernanke and others, *Inflation Targeting. Lessons from the International Experience* (Princeton University Press, 1999).

(Continued from preceding page)

considerable economic slack. Furthermore, many countries, both developed and developing, without explicit inflation targeting have also experienced low inflation in recent years. The advent of inflationary pressures in the future and how the inflation-targeting countries fare in dealing with them will show more realistically the effectiveness of inflation targeting as an alternative to other policy frameworks.

Finally, what relevance does inflation targeting have for developing countries or economies in transition? The determinants of the inflationary process in these economies are substantially different. Import prices play a more significant role in the consumer price index in developing countries. The exchange rate is thus a major element in inflation. In addition, in many of these countries the fiscal deficits have been monetized, which reflects relatively undeveloped domestic financial markets, and this phenomenon plays a central role in monetary expansion. Moreover, in such countries inflation rates have been chronically high for a considerable period. An inflation target, if pitched too low, would suffer from a lack of credibility. But there is, in fact, no simple method of determining what would be an appropriate inflation except by reference to the actual experience in the immediate past. If so, historical inflation would become embedded in the target and monetary policy alone would not be able to alter inflationary expectations significantly. Moreover, if inflation were very high to begin with, interest rates would have to rise to high levels and probably result in major output losses and unemployment before affecting inflation. The social and political costs would be excessive in return for the benefit of price stability. A mechanical adherence to an inflation target accompanied by constant "fine tuning" on the monetary policy front could lead to fluctuations in the inflation rate itself and distortions in the structure of relative prices with adverse implications for the real economy.

For inflation targeting to be operationally effective it must satisfy a number of conditions. It should be politically acceptable; be consistent with the needs of longer-term structural change in the economy; and should have flexibility in dealing with external shocks such as an oil price rise or a deterioration in the terms of trade. For most developing countries these conditions would be very difficult to satisfy with a single number as the inflation target. A relatively broad range for future inflation might therefore be preferable as a policy option. While this may not have the same direct appeal of a single number, it could lower inflationary expectations over time.

seen whether inflation targeting would be conducive to greater stability in the financial and stock markets themselves. Market participants will need time to become accustomed to that new policy framework where it is being implemented.

Weaknesses in the region's stock markets have paralleled the volatility in exchange rates in the region. With the exception of China, most stock markets fell precipitately from the beginning of the year – with declines up to the end of November 2000 in the range of 40-50 per cent in Indonesia, the Philippines, the Republic of Korea and Thailand, and within 10-20 per cent band in Hong Kong, China; and Malaysia. These falls reflect stock market volatility around a bearish sentiment the world over dating from April-May 2000. During the same period, for instance, in the United States NASDAQ (where many of the ICT companies are listed) had declined by over 33 per cent.

The comparatively larger setbacks in stock market indices in the ESCAP region reflect not only the rapid growth of market valuations of ICT-related enterprises in 1999 and their resultant larger weights in these indices, but also the sharply differing behaviour of shares of ICT and non-ICT companies over the last two years. ICT companies, for instance, have acquired price/earnings ratios several times higher than those of the non-ICT companies and have been far more volatile.[19]

The most likely explanation for these phenomena is that the commercial introduction of new technologies very often poses a variety of new risks, some of which come to light only ex post facto. In addition, the ICT sector in most countries comprises a large number of small companies. Their survival rates in a rapidly developing sector have tended to be short and variable, thus giving rise to large fluctuations in the stock prices of all companies in the ICT sector. The bearish sentiment currently enveloping many stock markets can probably be attributed to the initially exaggerated expectations that the introduction of any new technology brings in its wake. Inevitably, the inflated valuations are then

[19] IMF, *World Economic Outlook* (Washington DC, September 2000), pp. 70-80.

"corrected", in some instances over-corrected, in the light of actual performance and outcomes. While this was primarily true of ICT companies in 2000, non-ICT companies (for instance banks), have also been negatively perceived and assessed on account of their exposures and linkages to ICT companies. Furthermore, recent sober appraisals suggest that the performance of individual ICT companies, or even of the ICT sector as a whole, is unlikely to exceed historical norms over the long term.

While the short-term rise and fall of stock prices is a normal market phenomenon, the onset of a prolonged bearish market sentiment is not entirely without some negative near-term side effects. As in the United States, most ICT companies in other parts of the world (including those in the developing countries of the ESCAP region) have financed their investment needs by riding on the buoyant stock markets in which ICT shares have commanded considerable premiums. As the appetite of investors for risk appears to have diminished, however, this financing route has clearly lost some of its attractiveness in recent months. To the extent that such financing was fairly priced, it was an efficient method to allocate capital for the introduction and wider diffusion of ICT in the economies of the region. To the extent that speculative bubbles were involved in the financing process, there was a diversion of capital from other uses and then the build-up of excess capacity in the ICT sector, with all the attendant risks of a shake-out of these companies in the not too distant future. This poses a new policy challenge for reviving and stabilizing the stock markets. In the short term, alternative ways of financing investment expenditures need to be explored.

It should also be stressed that exchange rate and stock market weaknesses, those within the ESCAP region in particular, are a manifestation of the interrelated issues of financial and corporate sector reform and restructuring. There is a perception that progress in this area has slowed over the last several months, partly because of political and administrative difficulties, but perhaps more as a result of the sheer size and complexity of the problems.

It is estimated, for instance, that the final cost of resuscitating the banking systems of the crisis countries could amount to as much as 50-60 per cent of GDP in Indonesia, 40 per cent in Thailand, 15 per cent in the Republic of Korea and 12 per cent in Malaysia.[20] Moreover, there is a fear that some proportion of the so-called "performing" loans may need to be restructured in due course, involving banks in further losses. Thus, the problem of financial and corporate sector reform is far from being solved in several countries.

There are no simple and speedy remedies for dealing with these problems. Broadly speaking, countries in the region need to re-commit themselves to, and persevere in, the pursuit of structural reform. They also need to strengthen the institutions dealing with the reform process. Market confidence can be damaged significantly if the perception gains ground that reform fatigue has set in. In such a scenario, the implementation of even the existing reform agenda would become much more difficult. It needs to be emphasized that a well-functioning financial sector and better corporate governance are not simply ends in themselves: these institutional prerequisites have large externalities as they reduce the risks of business financing, thus helping to draw a bigger pool of both investors and entrepreneurs into the economy. It is thus important to accelerate the pace of corporate and financial sector reform.

As the APEC forum assembled in Brunei Darussalam for its annual summit meeting in November 2000, members faced a significant new development. A number of Asian governments were looking at bilateral deals to maintain the momentum of trade liberalization, especially in view of the fact that progress on global and regional trade liberalization appears not to have been satisfactory. In theory, these would not be contrary to APEC, whose open regionalism can accommodate such narrower trade deals.

There are two reasons why bilateral free trade agreements appear to be attractive. First, there seems little prospect of a new round of trade negotiations at WTO in the near term after the Seattle debacle. Developing countries are unhappy over the positions of many developed countries in carrying out their commitments in the areas of textiles and

[20] Bank for International Settlements, *70th Annual Report*, June 2000, pp. 46-50. See also Dominic Casserley and Greg Gibb, "Banking in Asia", *Asia-Pacific Development Journal*, vol. 7, No. 1 (June 2000).

Box I.2. The accession of China to the Bangkok Agreement[a]

The Bangkok Agreement was signed in 1975 at the initiative of ESCAP. The Agreement aims at promoting intraregional trade through preferential tariff arrangements among the member countries, Bangladesh, India, Lao People's Democratic Republic, Republic of Korea and Sri Lanka. So far two rounds of trade negotiations have taken place and the schedule for the third one is being planned by the ESCAP secretariat.

A recent development could have a profound impact on the patterns of trade and, by implication, investment relationships among the Bangkok Agreement countries. China informed ESCAP in January 2001 that its accession to the Bangkok Agreement had been ratified. As of 1999, the value of exports from China to other Bangkok Agreement countries rose to just over 5 per cent of its total merchandise export value from 1.39 per cent in 1990. Imports from those countries to China went up from under 1 per cent of total imports in 1990 to almost 11 per cent in 1999 (see table).

[a] First Agreement on Trade Negotiations among Developing Member Countries of the Economic and Social Commission for Asia and the Pacific (Bangkok Agreement).

The main benefits for the other countries from China's membership arise from the tariff concession accorded by China. For example, it is willing to import 634 imports from Bangladesh, the Republic of Korea and Sri Lanka at concessional tariffs. The margin of preference on those items, compared with most-favoured-nation duty, ranges from 10 to 84 per cent.

The estimated effects on trade creation are quite considerable. The export value of selected food items from Bangladesh and Sri Lanka to China, for example, is expected to rise by 25 and 16 per cent respectively. The corresponding increases in the value of selected manufactured exports from these two countries are more modest, at 18 and 7 per cent. The trade-creation effects as regards exports from the Republic of Korea are comparatively much smaller, amounting to about 9 per cent for selected food items and 7 per cent on certain manufactured products.

The accession of China most certainly makes membership of the Agreement a worthwhile goal to pursue for many other countries of the region. With India already a member, the Bangkok Agreement countries together have a market of more than two and a half billion consumers. Pakistan is already into the process of accession and Fiji, the Islamic Republic of Iran, Mongolia, Myanmar, Nepal and Viet Nam are actively considering accession.

The value of China's merchandise exports to and imports from the Bangkok Agreement countries

(Millions of US dollars)

	Bangladesh	*India*	*Lao People's Democratic Republic*	*Republic of Korea*	*Sri Lanka*	*Total Bangkok Agreement countries*	
						Value	*Percentage*[a]
Exports	701	1 162	22	7 808	259	9 952	5.1
Imports	14	862	10	17 228	9	18 087	10.9

Source: IMF, *Direction of Trade Statistics Yearbook 2000* (Washington DC, 2000).

[a] Exports to or imports from the Bangkok Agreement countries as a percentage of China's total export or import value.

agriculture, as well as over the use of anti-dumping procedures to limit imports from the developing countries. At the same time, there are strong differences of views regarding the treatment of labour and environmental standards in any future round of trade negotiations. Second, the region's ASEAN Free Trade Area (AFTA) is also experiencing its own problems. In particular, Malaysia is to delay until 2005 the phased abolition of tariffs on automobiles, although AFTA is still on track for zero tariffs on 90 per cent of manufactured goods traded within the core group of members. But failure to keep

liberalization on track is a clear setback, thus enhancing the attractiveness of bilateral agreements. However, it is important to ensure that an increase in the number of bilateral trade pacts does not undermine regional trading arrangements and reduce pressure for a new round of negotiations at WTO itself. In this context, China's accession to the Bangkok Agreement is a welcome development (see box I.2).

Regarding reform of the international financial system, fitful progress has been made in some areas; there are also concerns regarding the proliferation of working groups set up by different agencies and the apparent lack of coherence among them. In this context, the newly established Financial Stability Forum is a step in the right direction. But urgency is clearly lacking in its deliberations and the process of international financial system reform continues to pose a huge and critical challenge for the international community. The absence of more concrete progress, as in the case of trade liberalization, has encouraged some countries to strike out on their own. The Chiang Mai initiative by ASEAN is a case in point. Under this initiative, ASEAN members, plus China, Japan and the Republic of Korea, agreed to set up a swap facility to provide liquidity for mutual support in times of need. Here again, care must be taken to ensure that such initiatives do not lead to a weakening of the resolve of countries to participate actively and meaningfully in multilateral initiatives in this area.

II MACROECONOMIC PERFORMANCE, ISSUES AND POLICIES

REGIONAL OVERVIEW

Following the impressive recovery of 1999, the economic performance of the ESCAP region strengthened further in 2000. The average growth rate of the developing economies of the region increased by 1 percentage point while the developed economies improved their collective growth rate by 1.3 percentage points. As in 1999, both developing and developed economies achieved higher GDP growth in a lower inflationary environment despite rising energy prices and weaker exchange rates in a number of countries. All the main geographical subregions contributed to the higher GDP growth and enjoyed lower inflation, with the exception of the Pacific island economies where collective GDP growth became negative in 2000. In East and North-East Asia deflation in 1999 was followed by modest inflation in 2000.

Of the 25 developing economies in the region listed in table II.1, 17 improved their GDP growth rates in 2000 compared with 1999 while one matched its 1999 performance in 2000. Economies enjoying higher growth were spread across the entire ESCAP region. However, the most impressive subregion in growth performance was South-East Asia. It not only improved its 1999 GDP growth by over 2 percentage points, but exceeded significantly the growth forecast made 12 months earlier. The developed economies, too, led by Japan, substantially improved upon, or maintained, their 1999 performance. With respect to inflation, 14 developing economies enjoyed lower inflation in 2000 compared with 1999 while China saw a marginally positive inflation in 2000 after experiencing deflation in 1999. Hong Kong, China continued to experience deflation in 2000 as in 1999.

A favourable external environment, reflected in the buoyancy of world trade, combined with domestic measures to improve and sustain the momentum of growth in the region. These two factors, in turn, enhanced corporate and consumer confidence, thus providing a more durable underpinning to the growth process.

On the external side, world trade surged by over 10 per cent in volume terms in 2000. The strong growth of world trade embodied a robust export performance by the ESCAP region where the dynamism of intraregional and intra-industry trade revived almost to pre-crisis levels. Several economies in the region registered an export growth of 20 per cent or more in value terms. The strong export growth was led by electronics and electronic components, of which the ESCAP region is a major supplier. Foreign capital flows to developing countries as a group fell absolutely and as a share of total capital flows, but flows to the ESCAP region rose marginally. More significantly, the ESCAP region's share of flows to the developing economies nearly doubled, from 23 per cent in 1998 to 40 per cent in 2000. Such flows aided the process of financial and corporate-sector restructuring.

On the domestic side, declining interest rates and continuing fiscal stimulus supported output growth while exchange rate weakness and improved capacity utilization enhanced competitiveness and stimulated export growth. Furthermore, there was evidence that private domestic demand was beginning to play a bigger role in the growth process than in 1999.

Table II.1. Selected economies of the ESCAP region: rates of economic growth and inflation, 1999-2003

(Percentage)

	Real GDP					Inflation[a]				
	1999	*2000[b]*	*2001[c]*	*2002[c]*	*2003[c]*	*1999*	*2000[b]*	*2001[c]*	*2002[c]*	*2003[c]*
Developing economies of the ESCAP region[d]	6.1	7.1	6.0	6.3	6.6	2.8	2.7	3.7	4.2	4.7
South and South-West Asia[e]	5.2	5.6	6.2	6.8	6.8	7.6	8.6	7.2	6.4	6.3
Bangladesh	4.9	5.5	6.0	7.0	7.2	8.9	3.8	10.0	5.0	5.0
Bhutan	6.0	6.0	5.5	..	..	4.5[f]	..	..	..	..
India	6.4	5.9	6.5	6.9	7.2	3.4	6.5	5.0	5.0	5.0
Iran (Islamic Republic of)	2.4	4.5	5.5	6.5	6.7	21.1	19.9	17.4	15.3	14.0
Nepal	3.9	6.0	6.7	6.5	6.5	11.3	3.3	5.0	5.0	5.0
Pakistan	3.1	4.5	5.0	5.0	5.0	5.7	3.6	4.5	5.0	5.0
Sri Lanka	4.3	5.7	6.0	6.1	6.1	4.7	5.7	6.7	6.0	5.5
Turkey	−5.1	6.0	4.8	5.5	5.0	64.9	54.2	29.3	20.9	21.8
South-East Asia	3.4	5.9	5.2	5.5	5.9	7.3	2.5	4.2	4.6	5.1
Indonesia	0.2	4.4	5.0	5.7	6.1	20.5	3.7	7.0	7.6	8.8
Lao People's Democratic Republic	7.3	6.5	6.9	7.2	7.3	134.0	15.0	10.0	10.0	10.0
Malaysia	5.4	8.2	7.0	7.2	7.5	2.8	1.8	2.9	3.2	3.8
Philippines	3.3	3.7	3.4	3.8	4.6	6.7	4.3	6.1	5.6	5.3
Singapore	5.4	10.1	6.3	6.3	6.2	0.1	1.5	2.1	2.0	2.3
Thailand	4.2	4.5	4.6	4.6	5.2	0.3	1.7	2.6	3.5	3.7
Viet Nam	4.8	6.7	7.0	7.0	7.5	4.3	−1.5	4.5	6.5	7.0
East and North-East Asia	7.6	8.2	6.4	6.5	6.8	−0.6	0.9	2.4	3.4	4.0
China	7.1	8.0	7.8	7.7	8.2	−1.4	0.5	1.8	4.5	5.4
Hong Kong, China	3.0	9.7	6.1	5.2	5.2	−4.0	−3.2	2.1	3.7	4.2
Republic of Korea	10.7	9.2	5.1	5.8	5.9	0.8	2.3	3.4	3.2	3.6
Taiwan Province of China	5.7	6.4	5.8	5.9	6.2	0.2	1.4	2.1	1.6	1.9
Pacific island economies	3.9	−3.1	2.5	4.3	3.8	9.7	7.8	3.5	4.0	3.9
Fiji	6.6	−12.5	1.5	4.0	1.5	2.0	1.0	3.0	2.5	2.5
Papua New Guinea	3.2	0.8	3.1	4.7	5.0	14.9	12.2	3.5	5.0	5.0
Samoa	5.3	3.5	3.5	3.5	3.5	0.3	2.0	2.5	2.5	2.5
Solomon Islands	−1.7	−13.5	−1.5	4.5	5.5	7.8	4.0	8.0	4.0	3.0
Tonga	2.2	5.2	2.5	2.0	2.0	4.4	4.5	6.5	2.5	2.0
Vanuatu	−2.5	4.0	3.0	2.0	1.0	2.8	1.5	3.0	2.0	2.0
Developed economies of the ESCAP region	0.5	1.8	2.1	2.5	2.8	−0.2	−0.2	0.2	0.6	1.0
Australia	4.7	4.3	3.4	3.4	3.6	1.5	4.6	3.6	2.2	2.7
Japan	0.2	1.6	2.0	2.4	2.7	−0.3	−0.6	−0.1	0.5	0.9
New Zealand	3.9	4.0	3.5	3.0	2.8	1.1	2.8	3.1	1.8	1.5

Sources: ESCAP, based on IMF, *International Financial Statistics*, vol. LIII, No. 9 (September 2000); ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); United Nations, "Project LINK World Economic Outlook", October 2000; The Economist Intelligence Unit, *Country Forecast: Turkey*, December 2000; and national sources.

[a] Referring to changes in the consumer price index.
[b] Estimate.
[c] Forecast/target.
[d] Based on data for 25 developing economies representing about 95 per cent of the population of the region (excluding North and Central Asia); GDP at market prices in United States dollars in 1995 have been used as weights to calculate the regional and subregional growth rates.
[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2000/01 = 2000 for Bhutan, India and the Islamic Republic of Iran; fiscal year 1999/2000 = 2000 for Bangladesh, Nepal and Pakistan.
[f] Referring to annual inflation in December.

Near-term prospects

Notwithstanding the various positive features in the economic performance of the region in 2000 listed above, near-term prospects are mixed. On the external side, growth in the developed countries is likely to slow in 2001, a particular imponderable being the slowdown of the United States economy, which is the biggest single market for several economies in the region, and the strength of recovery of the Japanese economy. A sharp slowdown in the United States and any loss of momentum in Japan would inevitably have adverse effects on growth in the region, directly through lower demand for exports and indirectly through an easing of both overall commodity prices and of manufactures, such as electronics. However, continuing growth in the region itself and in the EU could offset the adverse effects to some extent. The effects of these developments would vary between individual economies depending upon the pattern of trade and output-mix of the countries concerned.

Oil prices are another source of risk and uncertainty. While some easing of oil prices has occurred in recent months, they appear, nonetheless, to have stabilized at a relatively high level, more than twice their average level in 1998. Any pickup in the global economy in the second half of 2001 would, almost certainly, generate renewed upward pressure with adverse consequences for inflation and consumer demand in the oil-importing countries. Moreover, the relative volatility of oil prices in 2000 and in the early part of 2001 creates uncertainty for business investment and household spending.

On the domestic side, three years of budget deficits have raised the level of public debt. Likewise, higher recovery-induced imports have narrowed the current-account surpluses of several economies. This has resulted in weaker exchange rates and some increase in investor nervousness, reflected in declining stock market indices in most countries of the region. On the other hand, external debt, especially short-term debt, has declined while external reserve positions have improved or stabilized in virtually all the economies of the region. These developments, combined with improving corporate balance sheets, suggest that vulnerability to a slowdown is much less than in 1997.

Taking all these factors into account, the prognosis is a moderate deceleration in the rate of GDP growth in the developing economies of the ESCAP region of around 1 percentage point in 2001 compared with 2000. Two subregions, South-East Asia and East and North-East Asia, are likely to account for much of the slowdown. The developed economies of the region, South and South-West Asia and the Pacific island economies, on the other hand, are likely to maintain, or increase slightly, their growth rates in 2001. Within the developed economies the performance of the Japanese economy will have a considerable bearing on the overall outcome. In South and South-West Asia, external factors are comparatively less important; hence, the growth momentum of 2000 is likely to be maintained, or improved in 2001, provided implementation of the domestic reform agenda is sustained. In the Pacific island economies, it is expected that the contractions in output that political problems caused in 2000 would be reversed.

The growth slowdown is forecast to be accompanied by a pickup in inflation of 1 percentage point in 2001. This phenomenon is likely to be particularly evident in South-East Asia. East and North-East Asia should experience a modest increase in price pressures. The "flow through" effect of firm oil prices superimposed upon weak exchange is likely to be the principal cause of a pickup in inflation. Among the developed countries in the region, inflation is expected to remain stable. Japan is not expected to overcome price deflation in 2001.

Policy challenges

The principal policy challenge confronting the region as a whole is to maintain the momentum of growth in 2001 and beyond in the face of potential unfavourable developments in the external environment. Slower GDP growth would add to the public debt and possibly constrain vital social expenditures. Maintaining the momentum of growth within a framework of macroeconomic prudence requires action in a number of areas at the national or subregional levels.

At the national level, all governments need to maintain a strong commitment to macroeconomic balance. In view of the rising levels of public debt, countries need to take a fresh look at streamlining

and rationalizing public spending in order to avoid the debt trap in which debt-servicing obligations rise faster than revenues. This has to be complemented by improved revenue collection. Measures to enhance domestic savings should continue to be emphasized together with efforts to deepen and widen financial markets.

Some of the economies of the region have become very dependent on electronics as a source of export earnings. However, there appears to be evidence of overcapacity in this line of manufacturing, making the relevant corporate entities and economies more vulnerable to an external slowdown. Governments need to help domestic businesses to prepare for a possible worsening in the external environment over the next few months through improved information on alternative markets and with advice on how to diversify their activities.

Weaker exchange rates have stimulated exports, but should they persist they will increase the risk of inflation. In addition, stable exchange rates are important as anchors for investment decisions, particularly by foreign investors. A moderate degree of instability in the exchange rate is unlikely to do significant harm in the short term; over the medium to long term it could reduce the flow of foreign investment and thus reduce access to vitally important foreign technology and markets. Some countries have adopted inflation targeting, and others are considering doing so, as an alternative to fixed exchange rates. However, countries need to examine carefully the efficacy of inflation targeting as an alternative to stable exchange rates.

At the subregional level, governments need to consult more frequently on a wider range of policy questions than before. One area in this respect could be progress in the implementation of agreements concerning regional trading arrangements and the maintenance of market access if international trade growth slows. Another area is the need to avoid national actions in trade and financial matters that could have a destabilizing impact on others.

A number of governments in the region are looking at bilateral deals to maintain the momentum of trade liberalization, in view of the fact that progress on global and regional trade liberalization appears not to have been satisfactory. In this connection, it is important to ensure that an increase in the number of bilateral trade pacts does not undermine regional trading arrangements or reduce pressure for a new round of negotiations at WTO itself.

An issue of particular concern is the problem of weak stock markets in the region and their growing correlation with developments in the stock markets of the developed countries, particularly the United States. Weak stock markets lower business and household confidence, induce stronger risk aversion on the part of investors, and make it harder to raise capital regardless of the prospects of particular companies or business sectors. It would be very difficult to insulate regional stock markets completely from developments elsewhere. However, it would be useful to explore alternative routes for raising capital by domestic businesses and thus maintain investment levels in the economies of the region. State-funded or state-guaranteed equity participation funds could be one short-term solution. Their viability needs to be critically examined. Another solution could lie in the investment of pension or provident funds in equities within prudent limits.

A connected problem in this regard is the perceived slow pace of progress in many countries in financial-sector and corporate-sector restructuring. This, too, is undermining the stock markets in the region. While much has been achieved in this area over the last three years, the sheer scale of the remaining problems, for instance, resolving the NPLs in the banking systems of several countries, suggests that a great deal remains to be done. Any perception of reform fatigue needs to be countered. It is, therefore, important to accelerate the pace of financial and corporate-sector restructuring with time-bound targets in the months ahead and to strengthen the relevant institutions and procedures, such as debt recovery agencies and bankruptcy courts.

Governments should insist on greater transparency in the corporate sector to facilitate greater participation by both domestic and foreign investors and to continue to improve standards of supervision and regulation in the financial and corporate sectors. However, governments themselves should also seek to meet the highest standards of governance.

Over the last few years the rise of the "new economy" and the development of ICT-related activities has put a large premium on technological

upgrading in both industry and services. As a consequence, many old economy skills are becoming obsolete. The enhancement of human resources skills to facilitate the introduction of ICT in order to remain competitive in world trade and to attract foreign capital has become an urgent necessity in the region. Governments need to make a greater investment in education and training, particularly in those countries having to make a transition from labour-intensive, relatively low value-added activities to higher technology, relatively high value-added activities.

International financial system reform continues to be of critical importance for the region with its need for substantial access to global capital flows on a stable basis. The absence of concrete progress in this regard has encouraged some countries in the region to strike out on their own. The Chiang Mai Initiative by ASEAN is a case in point. While such initiatives have their merit, care must be taken to ensure that they do not lead to a weakening of the resolve of all countries to participate actively and meaningfully in multilateral initiatives in this area.

DEVELOPING ECONOMIES OF THE ESCAP REGION

Asian least developed countries

Most of the Asian least developed countries either maintained their recent growth performance or recorded somewhat higher growth in 2000 despite lower prices for several commodities and higher petroleum costs. This outcome reflected in part improved agricultural production, better export performance, facilitated in some cases by the regional economic recovery, and an absence of serious exogenous shocks. Equally notably, the rates of inflation were among the lowest recorded during the past decade, despite the continued weakness of currencies in several countries and the relatively high levels of fiscal deficit. However, these positive developments rest on a fragile foundation, especially in view of the narrow production base, the delicate fiscal position and an undiversified export basket. Moreover, the need for further acceleration of growth does not need to be emphasized in view of the low living standards in these countries. This remains a major issue on the United Nations agenda.

Growth performance

In Bangladesh, GDP went up by 5.5 per cent in 2000 from 4.9 per cent during the previous year because of good harvests and improved industrial production (table II.2). Growth in 2000 was led by the agricultural sector which expanded strongly by 6.4 per cent, compared with less than 5 per cent in 1999, on the back of higher (by over 6 per cent) crop and horticulture output. The *aman* harvest, in particular, rose by some 33 per cent, that of the *aus* crop, by just over 7 per cent, and *boro*[1] by 4.5 per cent while wheat production declined by 3.6 per cent. As a result, total food grain production (almost 25 million tons in 2000) was 14 per cent higher than the previous year's level and this helped reduce food grain imports to 2.1 million tons, compared with 5.5 million tons in 1999, to meet the flood-related production shortfall. Production of tuber increased by over 11 per cent, to 2.3 million tons, but that of jute declined by 12 per cent, to 3.9 million bales in 2000.

Industrial expansion, at 5.6 per cent in 2000, was marginally higher than the 4.9 per cent rate in 1999 and reflected strong mining, quarrying and power generation activities; their value added jumped by 6.5 per cent from just over 1 per cent in 1999. Manufacturing output grew by 4.2 per cent in 2000 compared with the flood-hit rate of 3.2 per cent a year earlier; in particular, small-scale manufacturing production, which had risen by less than 1 per cent in 1999, was 4 per cent higher. However, the construction subsector declined slightly by 1 percentage point (to 8 per cent in 2000) as major repair and maintenance of infrastructure damaged by the floods was nearing completion. Generally, manufacturing activities remained beset by such problems as power shortages and transport bottlenecks, trade union militancy, and some loss of external competitiveness. Meanwhile, the service sector has been growing at largely the same rate, some 5 per cent, over the past several years. Stronger performance from many services, including wholesale and retail trade, hotels and restaurants, transport and communications and public administration, offset a slowdown in others such as real estate, renting and business activities, and education services.

[1] *Aman, aus* and *boro* are all a variety of paddy.

In Bhutan also, the agricultural sector (including forestry and logging), accounting for more than one third of GDP, is a major determinant of overall growth performance. GDP was estimated to expand by 6 per cent in 2000. Agriculture recovered substantially to grow by 2.3 per cent in 1999. The government policy of maintaining forest coverage at not less than 60 per cent of the total land area, and a ban on log and raw timber exports contributed to a slower growth of some 3 per cent in this subsector in 1999.

Table II.2. Selected least developed countries of the ESCAP region: growth rates, 1997-2000

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Bangladesh	1997	5.4	6.0	5.8	4.9
	1998	5.2	3.2	8.3	4.8
	1999	4.9	4.8	4.9	4.9
	2000	5.5	6.4	5.6	5.0
Bhutan[a]	1997	7.3	3.1	3.8	16.1
	1998	5.1	1.3	6.9	5.8
	1999	6.0	2.3	12.2	6.7
	2000	6.0	..	..	..
Cambodia	1997	4.1	5.8	20.4	−4.0
	1998	2.1	2.5	8.6	−1.0
	1999	5.0	1.5[b]	11.4	5.8
	2000	5.5	2.6	10.0	6.1
Lao People's Democratic Republic	1997	6.9	7.0	8.1	7.5
	1998	4.0	3.7	9.2	4.8
	1999	7.3	8.2	7.9	6.9
	2000	6.5	4.4	7.3	6.4
Maldives	1997	9.1	1.4	18.0	8.9
	1998	9.1	5.9	14.8	8.3
	1999	8.5	7.5[c]	8.4	8.9
	2000	7.6	4.4[c]	9.2	8.0
Myanmar	1997	5.7	3.7	8.9	6.7
	1998	5.8	4.5	6.1	7.0
	1999	10.5	10.9	13.1	9.1
	2000	..	..	..	..
Nepal[a]	1997	4.9	4.1	6.4	4.9
	1998	3.0	1.0	2.3	6.4
	1999	3.9	2.7	4.2	5.2
	2000	6.0	5.0	8.3	5.9

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); and national sources.

Notes: Data for 2000 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] GDP at factor cost.
[b] Excluding forestry, agricultural growth was 8 per cent.
[c] Including coral and sand mining.

On the other hand, industrial output went up from nearly 7 to over 12 per cent between 1998 and 1999, with the relative share of manufacturing and electricity generation reaching about 22 per cent of GDP. The value added from electricity generation rose by 5.3 per cent in 1999 (from 3.8 per cent in the previous year) following a 50 per cent increase in the electricity export tariff to India, effective mid-1999. The relative importance of the power sector is expected to increase significantly with the completion in 2001-2002 of two new power projects, Basochu with 58 MW of capacity, and Kurichu with 60 MW. The major Tala hydropower project is to be built with an installed capacity of 1,020 MW in 2006. Meanwhile, construction activities are, and will probably remain, on an upward trend; this sector expanded by almost 31 per cent in 1999 and its GDP share went up by 2 percentage points to 10.5 per cent between 1998 and 1999.

The service sector, accounting for almost 28 per cent of GDP, grew by 6.7 per cent in 1999 from 5.8 per cent recorded a year earlier. Tourism was the most important component of this sector and in fiscal 2000, tourist arrivals increased by 12.5 per cent to 7,383 persons and tourism revenue, by 13.8 per cent to $9.3 million.

In Cambodia, strong growth in garment production, tourism, non-forestry agriculture and construction pushed GDP up by 5 per cent in 1999, compared with an earlier estimate of 4 per cent. In particular, improved weather conditions helped lift agricultural output by nearly 8 per cent; but a tighter logging policy reduced the value added from this sector (including forestry) to 1.5 per cent. Manufacturing production, led by export-driven textiles and garments, grew by 9 per cent and the recovery in tourism contributed to a 6 per cent growth in the service sector in 1999, its relative share being almost 37 per cent of total output. GDP had been forecast to go up by 5.5 per cent in 2000 and by 6 per cent in the following year, but the severe flooding in September 2000 will have an adverse impact on total production. The floods claimed 184 lives, destroyed over 100,000 hectares of rice and tens of thousands of hectares of other crops, and affected as many 2.2 million people, or nearly 20 per cent of the population; crop and property damage was estimated at $50 million.

Agriculture and forestry expanded by 2.6 per cent in 2000 while industrial sector growth of more than 11 per cent was largely underpinned by a rise of almost 7 per cent in manufacturing output in 2000. A major part of this output, textiles and garments, was facing quotas in some export markets. The service sector was expected to perform well, with value added being higher by nearly 6 per cent in 2000. This was the result of recent measures to encourage tourism, notably the declaration of an open skies policy that allowed foreign airlines to fly direct to Siem Reap, the nearest airport to the Angkor temple complex; tourist arrivals year-on-year increased by 50 per cent as of the end of May.

The GDP of the Lao People's Democratic Republic went up by 7.3 per cent in 1999 from 4 per cent during the previous year. The agricultural sector, with about 52 per cent of the total output, grew by over 8 per cent, driven by larger dry season paddy production resulting from the recent intensification of public investment in irrigation. Industry provided some 22 per cent of total output. Its performance remained strong, albeit at a moderate pace compared with the previous year, owing to falling demand for processed timber and garments from the regional markets. Hydroelectricity generation rose by 22 per cent as new projects came into operation. The service sector (accounting for 26 per cent of GDP) expanded by nearly 7 per cent in 1999, compared with 4.8 per cent in the preceding year. This robust performance was driven by tourism-related activities, such as transport, hotels and restaurants, and commerce, which were being promoted under the campaign "Visit Laos Year" in 1999-2000.

GDP growth in 2000, estimated at 6.5 per cent, was slightly lower with a more moderate expansion of 4.4 per cent in the agricultural sector. The industrial and service sectors remained healthy, with output being 7.3 and 6.4 per cent respectively, higher because of an enlarged flow of both imports and exports, and a greater number of incoming tourists. These two sectors were expected to perform even more strongly, with annual growth rates projected to be respectively around 6.9 and 7.3 per cent for the period 2001-2003. Increased public investment through central bank financing to counter the weakening of private investment owing to the regional

financial crisis has caused a high level of fiscal deficits in recent years, with the consequent high rates of inflation. External financing is expected to fund most of the public investment programme over the period 2000-2003, complemented by greater revenue collection. The fiscal shortfalls as a proportion of GDP would be lower as a result.

In 1999, economic growth in Maldives continued to be strong owing to capacity expansion in the tourism sector and higher fish catch, although GDP increased by a marginally slower pace of 8.5 per cent. Consolidation in the tourism industry, among other factors, was expected to have a moderating impact on output expansion, 7.6 per cent in 2000 and 6.5 per cent in 2001. The primary sector (agriculture, fisheries and coral and sand mining) was projected to expand by 4.4 per cent in 2000, down from a robust 7.5 per cent in 1999. Fisheries directly employed over 19 per cent of the domestic labour force and constituted one tenth of GDP. The total fish landings and earnings from fish exports in the first quarter of 2000 were lower than those of the corresponding period in 1999. Meanwhile, the secondary sector (construction, manufacturing and electricity) performed slightly better with output rising by over 9 per cent in 2000 from 8.4 per cent in the previous year.

There was, however, a small decline in the relatively high growth rates of value added from the tertiary sector (distribution, transport, tourism, real estate and services, including banking and government administration), to 8 per cent in 2000 compared with nearly 9 per cent in 1999. Tourism directly accounted for 17 per cent of GDP and indirectly contributed an additional 30 per cent through its linkages to construction, distribution and transport. There were 139,700 tourist arrivals, with some four fifths from Europe, in the first quarter of 2000, but growth was slower than the corresponding quarter of 1999, so that capacity utilization declined from over 89 to 84 per cent while the average length of stay also dropped from 8.7 to 8.5 days. Ten new resorts with almost 1,800 beds had been completed by March 2000; no significant additions are anticipated because of environmental considerations.

According to official data, GDP in Myanmar surged by 10.5 per cent in fiscal 1999 from 5.8 per cent in 1998 owing to infrastructure building and efforts to bring more land into production; high growth was also forecast for 2000.[2] The reported economic upsurge, which was higher than the official forecast in early 2000, was partly the result of improved data collection which captured more of the large, informal economy. Agricultural output, accounting for almost 59 per cent of GDP in 1997, was reported to have risen by nearly 11 per cent in 1999 from 4.5 per cent during the previous year as a result of extensive farming; incentives to private investors had been on offer since 1998 to bring unused land into production. Land reclamation and the injection of private capital combined with improved weather conditions to boost rice output to 19.8 million tons in 1999 from 18.6 million tons in 1998. Nevertheless, agriculture remained constrained by shortages of key inputs such as fertilizers, seeds and diesel for irrigation pumps. There were also limited irrigation facilities and inadequate logistics, transport and marketing services.

With the recent commissioning of oil and gas projects, energy production expanded significantly by 54 per cent in 1998 and 69 per cent in 1999. Industrial output rose by over 13 per cent in 1999 from about 6 per cent in 1998. There was higher output of cotton yarn and fabrics, which increased by almost 19 and 62 per cent respectively, while cement production rose by over 5 per cent; the production of these three items maintained an upward trend in the first quarter of 2000 on a year-on-year basis. The service sector, which had expanded by over 9 per cent in 1999 from 7 per cent in the previous year, was expected to rise modestly in 2000 as the wage hikes for more than one million civil servants in April 2000 would boost the retail trade sector. Tourist arrivals, however, fell by over 14 per cent in 1999 (to about 246,000 persons) and the slide appears to have accelerated in the first quarter of 2000 with arrivals totalling just under 50,000 or about 20 per cent lower year-on-year.

In Nepal, GDP grew strongly by 6 per cent in fiscal 2000, the previous year's rate being less than 4 per cent. Agricultural production, with a share of more than 40 per cent in total output, went up by 5 per cent, compared with 2.7 per cent in 1999, mainly because of the favourable monsoon and an increased

[2] Other available estimates, including those from the Economist Intelligence Unit, indicate a more moderate rate of GDP expansion of about 5.7 per cent in 1999 and 5 per cent in 2000. These rates appear to be within the medium-term growth trend of the country.

supply of fertilizers following private-sector involvement in their distribution. There were larger harvests of all major food grains, such as paddy, maize and wheat, while the cash crop output, including sugar cane and potatoes, was up by 6.4 per cent.

Value added from the non-agricultural sector also increased strongly by 6.6 per cent in 2000. The electricity, gas and water subsectors grew robustly by over 16 per cent, compared with 6.8 per cent in 1999, following the operation of new hydro-electricity projects. Manufacturing output went up by nearly 12 per cent, or twice as fast as the previous year, as a result of significantly higher production of garments, processed food, beverages, and chemical products. The service sector also performed strongly, expanding by almost 6 per cent in 2000 in part owing to the revival of construction that, in turn, was attributable to higher farm incomes and government development spending. In addition, growth in tourist arrivals plus the promotion of internal tourism lifted output from wholesale and retail trade, restaurants and hotels from 2.5 per cent in 1999 to about 6 per cent in the following year. However, banking services and real estate activities did not expand as fast, despite signs of improvement in the latter.

Inflation

Inflation in Bangladesh dropped sharply, from nearly 9 per cent in flood-affected 1999 to 3.8 per cent in 2000, with the higher increases in food prices (by just over 4 per cent) being offset by a modest rise in non-food prices by 2.6 per cent. Consumer prices appeared to have stabilized at a relatively low level as they rose by only 0.5 per cent between July and September 2000, compared with 1.2 per cent during the same period a year earlier. However, inflation was expected to be somewhat higher by the end of 2001, reflecting more expensive costs of energy-related products and services; there was also a relatively high level of fiscal deficits and money supply (M2) growth during the last two years (table II.3).

Bhutan experienced a similarly sharp fall in consumer prices, from about 12 per cent in 1998 to 4.5 per cent in December 1999, as a result of moderate increases in the costs of both food and non-food items. This downward trend, in turn, reflected a significant drop of inflation in India in 1999 as there were close economic linkages between the two countries. There was, however, greater upward pressure on prices with the Thimphu food price index edging up by 5.3 per cent for the quarter ending June 2000, thus reversing the downward trend of the previous two quarters.

Consumer prices were also remarkably stable in Cambodia, with inflation falling from almost 15 per cent in 1998 to 4 per cent in 1999 and 3 per cent in 2000, the net result of falling food prices owing to increased supplies of rice and other crops, the improved fiscal balance in 1999 and lower M2 growth in 2000. Indeed, there were some deflationary pressures as consumer prices fell year-on-year by 2.5 per cent in the second quarter of 2000 while month-on-month inflation was negative throughout the quarter. Price increases are expected to be modest in 2001 even allowing for the impact of higher oil prices, a higher level of economic activities, and rising food prices in consequence of the widespread flood-related crop damage in September 2000.

Inflation in the Lao People's Democratic Republic went up from 87 per cent in 1998 to peak at 167 per cent as of March 1999. Thereafter, it was on a steep downward trend, averaging 134 per cent for 1999 as a whole, and just 15 per cent in the following year. Notably, year-on-year inflation was brought down to 6.6 per cent in August 2000 and it continued at a single-digit level through October 2000. The stabilizing factors included large increases in the output of rice and other commodities, an improved fiscal position, tight money policy, and the relative stability of the exchange rate from the latter part of 1999. Inflation was forecast to be below 10 per cent for the near to medium term in spite of higher energy prices.

Maldives had experienced a modest rate of deflation in 1998. Consumer prices were then on an upward trend with inflation reaching 3 per cent in the following year. Notwithstanding higher fuel prices, however, inflation slowed to 2 per cent. The moderate inflation rate largely reflected lower prices of fish, clothing and footwear against a backdrop of slow M2 growth and the relative stability of the exchange rate.

Inflation in Myanmar was also on a sharp decline from over 51 per cent in 1998 to 18 per cent during the following year; price increases then averaged only 6 per cent year-on-year in the first quarter of 2000, easing further to 4.3 per cent year-on-year in the second quarter. There were higher supplies, including increased rice production, relatively moderate budget deficits and lower M2 growth in 1999. The relative stability of the exchange rate

Table II.3. Selected least developed countries of the ESCAP region: summary of macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*
Bangladesh	Savings/GDP	15.9	17.3	17.7	17.8
	Investment/GDP	20.7	21.6	22.2	22.4
	Budget balance/GDP[a]	−4.5	−4.2	−5.3	−5.8
	Current account balance/GDP	−1.3	−0.6	−1.1	0.4
	Money supply growth (M2)	9.9	11.4	12.8	18.6
	Inflation rate[b]	2.5	7.0	8.9	3.8
Bhutan	Savings/GDP	38.8	37.9	..	..
	Investment/GDP	48.1	47.3	..	..
	Budget balance/GDP	−2.1	3.0	−0.9	−4.0
	Current account balance/GDP	−14.1	−11.7	−26.1	−28.8
	Money supply growth (M2)	59.0	14.0	32.0	21.4
	Inflation rate[b]	6.5	12.1[c]	4.5[c]	..
Cambodia	Savings/GDP	6.1	5.4	7.3	6.2
	Investment/GDP	13.0	12.9	15.8	17.5
	Budget balance/GDP[a]	−4.2	−5.9	−4.4	−6.0
	Current account balance/GDP	−8.6	−7.8	−8.1	−9.0
	Money supply growth (M2)	16.6	15.7	17.3	12.0
	Inflation rate[b]	7.9	14.8	4.0	3.0
Lao People's Democratic Republic	Savings/GDP	9.4	15.5	13.4	13.0
	Investment/GDP	26.2	26.8	23.6	25.1
	Budget balance/GDP[a]	−10.1	−11.4	−10.5	−8.5
	Current account balance/GDP	−16.8	−10.6	−6.9	−9.3
	Money supply growth (M2)	113.3	78.4	78.4	36.0
	Inflation rate[b]	27.5	87.4	134.0	15.0
Maldives	Budget balance/GDP	−2.0	−2.8	−4.2	−1.5
	Current account balance/GDP	−10.8	−6.8	−15.2	−13.2
	Money supply growth (M2)	23.1	22.8	3.6	0.7[d]
	Inflation rate[b]	7.5	−1.4	3.0	2.0
Myanmar	Savings/GDP	11.8	12.0	13.1	..
	Investment/GDP	12.5	12.9	11.1	..
	Budget balance/GDP[a]	−0.1	−0.4	−1.7	−0.5
	Current account balance/GDP	−0.2	−0.2	−0.1	−0.1
	Money supply growth (M2)	28.8	34.2	29.7	33.2[e]
	Inflation rate[b]	29.7	51.5	18.3	7.0
Nepal	Savings/GDP	14.0	13.8	13.3	13.2
	Investment/GDP	25.3	24.8	20.2	20.9
	Budget balance/GDP	−5.1	−5.9	−5.3	−5.1
	Current account balance/GDP	−8.0	−1.5	0.3	−1.5
	Money supply growth (M2)	11.9	21.9	20.9	20.7
	Inflation rate[b,f]	7.8	8.4	11.3	3.3

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); IMF, *International Financial Statistics*, vol. LIII, No. 9 (September 2000) and *International Financial Statistics*, vol. LIII, No. 12 (December 2000); and national sources.

Notes: Data for 2000 are estimates; savings/GDP refers to gross domestic savings/GDP; and investment/GDP refers to gross domestic investment/GDP.

[a] Excluding grants.
[b] Referring to changes in consumer price index.
[c] Referring to annual inflation in December.
[d] January-August.
[e] January-May.
[f] National urban consumer price index.

also helped curb import price increases. Some upward pressures on consumer prices could be felt in 2001 as local demand was expected to pick up following the pay hike granted to civil servants in April 2000 as well as faster M2 growth in 2000.

Nepal was another country with a sharply lower inflation of just over 3 per cent in 2000 in the wake of a substantial increase in 1999. This was largely a result of high food prices following a poor crop caused by adverse weather conditions. Local prices of food grains, especially rice, were comparatively stable owing to increased supplies and low prices of imported foodstuffs in 2000. In this context, mention should be made of the deceleration of price pressures in India, as noted earlier. The prices of pulses, vegetables and fruits, oil and butter, and sugar and sugar-related products were declining from the previous year's levels. Non-food prices were generally higher, in part owing to a hike in electricity and water charges, although the extent of increase was, by and large, modest.

Trade and exchange rates

In Bangladesh, export earnings had risen by an average of about 14 per cent in 1996-1998 although the 1998 floods contributed to a slowdown in export growth, to just under 3 per cent to reach $5.3 billion in 1999. The value of exports in 2000, at $5.8 billion, was thus higher by 8.3 per cent, mainly because of larger earnings from leather products (by over 16 per cent), fish and shrimps (by nearly 26 per cent), ready-made garments including hosiery and knitwear (by 8.3 per cent), chemicals (by 19 per cent), and fertilizers (by just over 3 per cent). However, jute goods, tea and handicrafts registered various rates of decline owing to lower external demand and, in the case of tea, falling production as well. The United States, Canada and the EU remained the principal markets for ready-made garments.

Spending on merchandise imports, which had totalled some $8 billion, was expanding at a slower pace, by 6.6 per cent in 1999 and 3.3 per cent in 2000 (table II.4). This was largely attributable to a sharp decline of nearly 60 per cent in food grain imports after a bumper harvest; food grain imports had risen by 170 per cent in value in 1999 to make up for the substantial, flood-related losses in rice and wheat production. On the other hand, import payments on several categories went up significantly in 2000, for example, by 91 and 48 per cent (to $225 and $400 million) for crude oil and petroleum products; by 19 per cent (to $410 million) for iron and steel; and by 13 per cent (to $1.2 billion) for textiles. Although the import bill for capital goods declined by just over 1 per cent, to $1.9 billion, the stronger pace

Table II.4. Selected least developed countries of the ESCAP region: exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					*Imports (c.i.f.)*				
	Value (millions of US dollars)	*Annual rate of growth (percentage)*				*Value (millions of US dollars)*	*Annual rate of growth (percentage)*			
	1999	*1997*	*1998*	*1999*	*2000*	*1999*	*1997*	*1998*	*1999*	*2000*
Bangladesh[a]	5 324.0	14.0	16.8	2.9	8.2	8 018.0	3.1	6.1	6.6	3.3
Bhutan[a]	108.1	1.7	12.1	−2.2	6.8[b]	165.2	18.3	3.7	21.4	12.6[b]
Cambodia[c]	933.0	34.5	14.3	9.2	1.0[b]	1 227.0	3.0	7.4	0.7	6.8[b]
Lao People's Democratic Republic[a]	305.5	−1.4	6.3	−10.3	7.1	554.3	−6.1	−14.7	0.3	29.5
Maldives[c]	88.6	15.8	5.4	−4.9	−0.5	312.0	15.6	1.5	7.2	5.0[b]
Myanmar[a]	1 503.0	8.8	12.2	21.6	..	2 440.0	15.0	8.2	−9.9	..
Nepal[a,c]	1 275.0	84.9	−24.5	29.7	44.7	1 601.0	31.7	−12.3	−1.7	22.2

Sources: ESCAP calculations based on national sources and IMF, *Staff Country Reports.*

[a] Fiscal year.
[b] Projection.
[c] Including re-exports.

of economic activities pushed up import demand considerably. The value of imports went up year-on-year by 30 per cent to $1.5 billion during the first four months of fiscal 2001. Meanwhile, export earnings also climbed on a year-on-year basis by 27 per cent to $2.2 billion during the same period.

The current account surplus deteriorated slightly because of a higher deficit in the trade accounts in 2000 and despite inflows of remittances by overseas workers; these inward transfers stood at $311 million in August and $775 million at the end of November 2000. As regards trade-related policies, the 2000 budget reduced import duty slabs from five to four, and duties on all primary raw materials were lowered from 7.5 to 5 per cent. At the same time, the exchange rate of the taka against the United States dollar fell by about 5.6 per cent, from 51 taka per dollar as of 1 June 2000 to 54 taka as of August 2000; the unofficial market rate was 3 to 4 taka higher per United States dollar.

In local currency terms, exports from Bhutan increased by just over 9 per cent (to 4,872 million ngultrum) in 2000 largely as a result of the tariff rate revision on electricity exports to India from 1 to 1.5 ngultrum per unit. On the other hand, import value went up by 15.5 per cent on account of higher capital imports related to the construction of the Basochu, Kurichu and Tala power plants. The overall trade deficit expanded by 27 per cent, and as a percentage of nominal GDP, it went up from about 14 to 16.6 per cent between 1999 and 2000. India accounted for more than 90 per cent of exports from, and two thirds of imports into, Bhutan and the trade deficit with India went up significantly (by over 80 per cent, to 1,471 million ngultrum) in 2000. This was because a rise of 10 per cent in exports (consisting primarily of electricity, mineral products, chemicals, and wood) was more than offset by higher imports (by over 21 per cent) from India, particularly of machinery and equipment for the Tala hydropower project.

The trade deficit, combined with a large amount of aid-related service transfers mainly in connection with turnkey project grants from India, resulted in a 30 per cent increase in the current-account deficit to 5,544 million ngultrum (or 29 per cent of GDP) in 2000. Of this amount, the bilateral deficit with India amounted to 4,337 million ngultrum, or about 38 per cent larger. In comparison, the current-account deficit with other countries went up at a more moderate rate of 10 per cent to 1,206 million ngultrum (or just over 6 per cent of GDP). The ngultrum, which is pegged at par with the Indian rupee, depreciated by just under 4 per cent against the United States dollar in fiscal year 2000.

In Cambodia, the current-account deficit (excluding official transfers) was estimated to have increased by about 50 per cent (to $346 million) in 1999 along with a higher trade deficit (by 52 per cent) of $294 million. Export performance remained strong although difficulties in the textile and garment sector, and weak commodity prices, contributed to a slowdown of export growth in 1999. Earnings from exports and re-exports, at $933 million, were about 9 per cent higher, largely consisting of receipts from garment and forestry products. Import spending, which had expanded by over 7 per cent in 1998, was up only marginally to about $1.23 billion during the following year. In recent years, the main export destinations were Viet Nam, followed by Thailand, the United States, Singapore and China, while the main import suppliers included Thailand; Viet Nam; Japan; Hong Kong, China; and China.

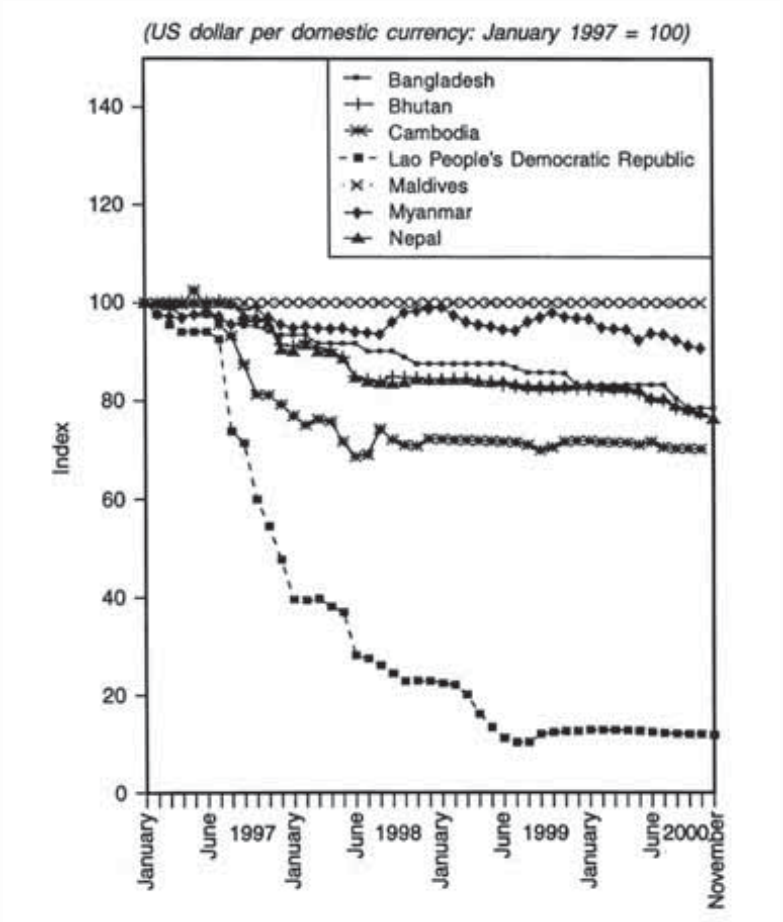
Both the trade and current-account deficits were expected to be larger in 2000. There were some uncertainties concerning textile and garment manufactures, the largest source of export earnings, not least because of labour unrest and the perceived loss of price competitiveness. However, the United States increased the size of the garment quota by 5 per cent in May 2000 and the EU guaranteed access of garment exports until 2002. There were higher tourism receipts, but continued aid inflows and foreign investment were necessary to finance the current-account deficit, which has remained at around 8-9 per cent of GDP over the past several years. The riel exchange rate has been broadly stable since the end of 1998 although the average value in 1999 of 3,808 riel to one United States dollar was some 40 per cent below that prior to the Asian financial crisis.

The merchandise trade deficit in the Lao People's Democratic Republic widened by 17 per cent to $249 million (or 17.3 per cent of GDP) in 1999. Import spending in 1999 was, by and large, stagnant at about $554 million. Export earnings went down by some 10 per cent, to $933 million, with wood products showing the sharpest decline to $55 million in 1999 compared with over $115 million in 1998. Proceeds from coffee exports declined to $15 million from $48 million in 1998. In addition, there was a small drop in garment export value, but earnings from electricity and motorcycle exports went up significantly. Service exports showed a marked

improvement with a higher surplus of over $98 million (or 6.8 per cent of GDP) from $71 million (or 5.6 per cent) in 1998. In particular, receipts from inward tourism increased sharply, by over 21 per cent. The current-account deficit stood over $90 million (or 6.9 per cent of GDP) in 1999.

The merchandise trade deficit for 2000 was expected to be wider at some $322 million (or 19 per cent of GDP), compared with $248.7 million or 17.3 per cent in 1999, as import expenditure expanded by over 29 per cent, compared with an export growth rate of 7 per cent in the first half of the year. The value of garment exports recovered strongly (by 12 per cent) with an extension of the generalized system of preferences from the EU while electricity exports were estimated to rise by almost 9 per cent. Earnings from wood products were on a declining trend because of continuing weak demand in regional markets and tighter logging control induced by heightened environmental concerns. The faster expansion of merchandise imports in 2000 reflected a rebound in imported capital goods in line with the projected strong growth in the industrial and service sectors, especially tourism. Overall, the current-account deficit was estimated to widen to 9.3 per cent of GDP, despite the sizeable surpluses in the service account and in net factor incomes and transfers. Meanwhile, a tight monetary policy stance and lower fiscal deficits helped reduce inflation and exchange rate volatility from the latter part of 1999 (figure II.1).

Figure II.1. Index of exchange rates of selected least developed countries, 1997-2000



Sources: IMF, *International Financial Statistics*, various issues, and *Far Eastern Economic Review*, various issues.

Exports and re-exports from Maldives were down by 5 per cent to $89 million in 1999 and were expected to remain more or less at this lower level in 2000. Owing to weaker prices, earnings from fish exports declined year-on-year by 22 per cent during the first quarter of 2000, despite a 14 per cent increase in export volume. On the other hand, the value of imports surged by 7 per cent to $312 million in 1999 and by another 5 per cent in 2000. This upward trend reflected higher expenditure associated with the ongoing expansion of tourism-related activities and services; earnings on inward tourism accounted for almost 80 per cent of the value of exports of goods and services. The trade deficit, enlarging from $265.5 million in 1999 to $284 million in 2000, was offset to a considerable extent by surpluses in the service and other accounts to result in a current-account shortfall of $60 million (or just over 15 per cent of GDP) in 1999 and an estimated deficit of $57 million (or 13.2 per cent) in 2000.

New trade legislation became effective from May 2000 and contained, among other things, a new import tariff structure with nine tariff bands ranging from 0 per cent for staple foods to 100 per cent for cars and 200 per cent for plastic bags; the nominal duty rate averaged 20 per cent. The protective impact of these measures is limited owing to the very small size of import-competing domestic production. On the other hand, duty exemptions granted to promote investment or economically important projects were estimated to cause revenue losses of some 30 per cent. The exchange rate has remained fixed at 11.7 rufiyaas to one United States dollar since 1995, providing an anchor for macroeconomic policies and business planning. Although the export of fisheries has lost some market share in recent years, the relative appreciation of the local currency in real terms was not seen as an obstacle to export expansion. Indeed, tourism was not greatly sensitive to changes in the exchange rate while the availability of flexible and low-wage expatriate labour contributed to the durable competitiveness in this sector.

Myanmar experienced a rising trend in export earnings in dollar terms, with exports reaching $1.5 billion in fiscal year 1999; this represented an increase of over 21 per cent or almost twice the previous year's rate. The main destinations of exports were India, followed by Singapore, China, Thailand and Japan, while major suppliers of imports were Singapore, followed by Thailand, Japan, China and Malaysia. Myanmar exports primarily agricultural commodities and natural resources such as rice, pulses and beans, rubber, and forestry and fishery products. Strong external demand for hardwood, including from nearby countries such as China and Thailand, resulted in surging export earnings from teak and other hardwoods. There are, however, growing concerns regarding the impact of heavy logging on forest resources and the environment. Despite higher rice output in 1999, exports of rice and rubber were down in both value and volume terms owing to weak international prices and demand, and efforts to ensure adequate supplies for local needs. The upward trend in overall export earnings continued into the first quarter of 2000; there was a marked upturn in both the volume and value of fish and maize exports, while rising prices of both rice and rubber were expected to boost export earnings from these commodities in 2000.

Import spending, on the other hand, fell by almost 10 per cent (to $2.4 billion) in fiscal 1999. The import of capital and intermediate goods such as machinery, electrical goods and metals fell steeply, in part as a result of the decline in FDI approvals. There was a noticeable upward movement in import expenditure in 2000. In a bid to conserve foreign exchange, monthly import spending by traders was limited from late September 2000 to a maximum of 1 million kyat (equivalent to about $154,000 at the official exchange rate, and around $3,000 at the free market rate).

The current account deficit in Myanmar fell markedly in 1999 to $222 million from over $494 million a year earlier owing to the large drop in the merchandise trade deficit. However, the inflows of aid, plus remittances by overseas workers, fell in 1998 and were most likely affected in 1999, partly because of the repatriation of workers from Thailand. Of the prevailing three-tiered exchange rate, the official one is pegged against the special drawing rights while the Foreign Exchange Certificates were traded close to the free-market rate. This rate was not expected to strengthen in 2000 owing to the high level of pent-up demand for both final and intermediate products, and capital goods relative to the available hard currency resources. In addition, there was continued upward pressure on consumer prices, albeit at a declining rate. There is a large gap

between the official and free market exchange rate; the feasibility and the desirability of realignment require close examination.

In Nepal, exports and re-exports went up by nearly 30 per cent (to $1,275 million) in fiscal year 1999 and were projected to have surged further by 45 per cent in 2000. Such high growth was largely underpinned by export shipments to India which expanded by 42 and 80 per cent in 1999 and 2000. Thus, India was the source of some 44 per cent of Nepal's export earnings in 2000, rising from 35 per cent in the previous year. The expansion of exports to other countries averaged over 24 per cent annually during fiscal years 1999 and 2000; it was attributed mainly to higher exports of ready-made garments (by 43 per cent), handicraft goods (20 per cent), and paper and paper products (39 per cent).

Import spending also went up sharply by over 22 per cent in fiscal year 2000; it had declined by almost 2 per cent, to $1.6 billion a year earlier. Imports from India increased by 27 per cent, a faster rise than the rate of 17 per cent in 1999; those from other countries expanded by 19 per cent in 2000 but had fallen by over 10 per cent in the previous year. Aid-financed imports, which used to be nearly one fifth of the total in the 1980s, have now shrunk to less than 10 per cent, a trend which was due in part to the more rapid expansion of economic activities and services that are not related to or financed by ODA.

Notwithstanding higher export earnings, the trade deficit widened by almost 7 per cent (to just under 15 per cent of GDP) in 2000; a small decline in the bilateral deficit with India (by over 6 per cent) was offset by a larger increase (by almost 15 per cent) in the trade shortfall with the rest of the world. The net service income was estimated to have declined by about 12 per cent; certain constraints in air services (brought about by the suspension of air flights to Kathmandu) contributed to low receipts from tourism. In consequence, the current-account surplus, equivalent to 0.3 per cent of GDP in 1999, became a relatively modest deficit of 1.5 per cent in 2000. The Nepalese rupee had remained fairly stable until the third quarter of 2000 when it depreciated by 3 per cent against the United States dollar. Keeping with the virtually free mobility of goods, services and capital between these two countries, the local currency was freely convertible with the Indian rupee at a fixed peg.

Capital inflows and outflows

The overall balance of payments in Bangladesh turned around from a deficit of $171 million in 1999 to a surplus of $325 million in 2000 owing partly to an improved current-account position, from a deficit of about 1 per cent of GDP in 1999 to a surplus of 0.4 per cent in 2000. FDI inflows were estimated to have declined to $150 million in 1999 from $308 million in 1998, while aid commitments and disbursements stood at $2.04 billion and $1.23 billion respectively in 2000. The stock of foreign exchange reserves remained largely stable at $1.5 billion as of June 1999 and $1.6 billion (equivalent to three months of import coverage) a year later. Improvements in the capital and financial accounts were expected to compensate in part for the projected deterioration in the trade, current transfers and services accounts and lead to a stable position in the overall balance of payments in 2001.

In Bhutan, the trade and current-account deficits were more than offset by capital inflows (including grants and loans) resulting in a balance-of-payments surplus in 2000. Total grant receipts, at 3,616.3 million ngultrum, were marginally higher than the 1999 level; they were also equivalent to some 42 per cent of government spending. A decline of grant-in-aid from third countries was more than offset by higher grants from India. Meanwhile, external debt went up by almost 12 per cent to $174 million in 2000 as a result of greater recourse to external funding for government development activities. As a percentage of GDP, the amount of total debt was equivalent to 38 per cent in 1999 and over 39 per cent in 2000. Rupee debt rose by 22 per cent in 2000 owing to loan disbursements related to the Tala and Kurichu hydropower projects. However, the rupee debt-service ratio dropped to 2.3 per cent in June 2000 from 8.4 per cent in June 1999 because of the liquidation of the Government of India credit line. The convertible currency debt-service ratio also declined to 11 per cent in June 2000 from 16 per cent in June of the previous year, as a result of the liquidation of the Druk Air loan of $22.6 million. Rupee-denominated reserves increased by 23 per cent while convertible currency reserves, at $217.5 million, were about 11 per cent higher over the same period.

The current-account deficit, excluding official transfers, has remained at around 8-9 per cent of GDP in Cambodia over the past several years. The

shortfall in net services was projected to increase to $131 million in 2000 (from an estimated $122 million in 1999) while official transfers were to rise to $243 million (from $220 million). Meanwhile, FDI inflows amounted to $120 million in 2000 and the balance-of-payment deficit was projected to be slightly lower at $93 million in 2000, compared with $98 million in the previous year. Continued donor support, among other things, would help ensure external financial viability for the country. The rescheduling of debt with the Russian Federation, the United States and other major creditors was undertaken in 2000. Debt service payments are projected at 4 per cent of gross current-account receipts over the period 2000-2003, amounting to about 6 per cent of gross official reserves, which were $466 million at the end of July 2000, equivalent to 3.5 months of import spending.

The capital account of the Lao People's Democratic Republic registered a surplus of $87 million in 1999, compared with $62 million a year earlier. There were higher FDI inflows, reaching $79 million in 1999. Meanwhile, the drop in official capital transfers by over one half (to $57 million), owing to declining long-term loan disbursements, was more than offset by a sharp fall in capital outflows (of some 122 per cent). However, the capital-account surplus was insufficient to cover the current-account shortfall of over $90 million, equivalent to almost 7 per cent of GDP, resulting in a small deficit of some $3 million in the balance of payments. The capital-account surplus was estimated to go up to $175 million in 2000 because of higher FDI ($112 million) and ODA loan disbursement ($88 million), resulting in a surplus of over $17 million in the balance of payments.

Official reserves were in the range of $106-$135 million in 2000, equivalent to 2.3-2.5 months of imports, or 9-11 per cent of the amount of convertible currency external debt. On the basis of the official exchange rate, the total debt reached $2.6 billion or about 154 per cent of GDP at the end of 2000; of this amount, some $1.25 billion were of a convertible nature. About 98 per cent of the non-convertible debt was owed to the Russian Federation and negotiations on the exchange rate for its conversion and rescheduling through the Paris Club are still pending.

The current-account deficit of Maldives more than doubled to over 15 per cent of GDP in 1999 and remained at a high level of over 13 per cent in the following year. Meanwhile, official capital inflows were estimated to have declined from $5.6 million in 1999 to $3.3 million in 2000 while those of private capital fell from $43 million to $30 million in the same period. As a result, the balance-of-payments shortfall went up from about $7 million to just over $24 million in 2000 while gross foreign-exchange reserves decreased from $128.5 million in 1999 (equivalent to 3.3 months of imports of goods and non-factor services) to $116.4 million (2.9 months of such imports) in 2000. The increasing monetization of the fiscal deficit and the ongoing consolidation in the tourism sector were expected to reduce the available level of external reserves in the medium term.

In Myanmar, the amount of foreign reserves rose marginally to almost $278 million at the end of August 2000, or less than two months of import coverage. Given the limited access to foreign aid or loans, the country is highly dependent on FDI and overseas workers' inward remittances. Asian countries have been the key sources of foreign investment. Despite a strong economic turnaround, however, the total FDI approvals declined from a peak of $2.8 billion in 1996 to $56 million in 1999 with the mining sector attracting the largest share. In the first quarter of 2000, FDI approvals for four new projects in the oil and gas sector, and five projects in the manufacturing sector, amounted to $64 million; implementation of these projects could bring in more hard currencies in 2000-2001. The relatively difficult operating environment, including a limited legal framework and complex foreign exchange system, may serve as a constraint on external private resource inflow. Myanmar was expected to continue to accumulate arrears on its external debts.

Nepal has adopted very liberal trade, industrial, foreign exchange and tax policies to attract FDI. The exact amount of such investment was difficult to determine, not least because of the absence of proper reporting systems. In addition, capital mobility between Nepal and India is unregulated and transactions can take place outside the banking system. Apparently, the volume of investment reported and compiled for balance-of-payments purposes, 578 million Nepalese rupees and 223 million Nepalese rupees respectively for 1999 and 2000, was only a fraction of the actual inflows. Foreign aid has been the major source of external resources; official

capital amounted to 13.65 billion Nepalese rupees in 2000, an increase of 15 per cent over the previous year's level; nearly 95 per cent of this amount was concessional multilateral loans. Government external debt increased from 161 billion Nepalese rupees in July 1998 to 190 billion Nepalese rupees (or 51 per cent of GDP) in 2000. The debt-servicing burden, although increasing, has not become a critical problem. It was equivalent to 15 per cent of government current expenditure in 1999, estimated to rise to 19 per cent in 2000, and projected at 18 per cent for 2001. The balance-of-payments position remained strong with rising foreign exchange reserves, which at 94 billion Nepalese rupees as of mid-July 2000 was sufficient to cover almost 11 months of merchandise imports.

Fiscal developments

The budget of Bangladesh for fiscal year 2000 aimed at maintaining macroeconomic stability and ensuring high growth, with priority given to social-sector development. A variety of measures were introduced to ensure greater resource mobilization, including higher efficiency in tax collection and a broadening of the tax base. An environment more conducive to greater participation by overseas Bangladeshi nationals in the capital market was to be created along with tax incentives to encourage FDI. At the same time, the tax burden of low-income groups was reduced, customs duty schedule was revised, and 31 new retail items and 12 services were brought under the coverage of VAT. Despite these measures, the fiscal position deteriorated as government revenue was lower than the original estimate by 12 per cent (to 213.4 billion taka) while recurrent expenditures rose by 3 per cent (to 184.4 billion taka) in 2000. The revised development expenditure, at 165 billion taka, was 6.5 per cent higher than the budget estimate. The overall budget deficit was equivalent to about 5.8 per cent of GDP. Net foreign financing of the deficit fell steadily from 63 per cent in 1998, to 61 per cent in the following year and to 53 per cent in 2000; in comparison, bank financing of the deficit went up from 12 to 24 per cent between 1999 and 2000.

The 2001 budget envisaged higher overall revenue and expenditure, both by 13 per cent. The recent trends in development spending focused considerably on human resources development as well as on the resolution of infrastructure, and other, bottlenecks. These are crucial in ensuring a better environment to attract more external capital from private sources, especially FDI. Although FDI has not been flowing strongly into the country, amounting to less than 1 per cent of GDP in recent years, it constitutes a significant component of project financing in the natural gas, power generation, and telecommunications subsectors. The overall budget deficit was projected to rise to 5.9 per cent of GDP in 2001, and about one half of this shortfall was to be met by foreign financing, as against 53 per cent in the previous year.

In Bhutan, the rise in government wages and salaries in 1999 and in the number of projects under implementation led to higher current and capital expenditure in 2000. Government revenue went up strongly, by 18 per cent, owing to improved tax administration as well as successful measures to broaden the tax base. Non-tax revenue (including surplus transfers from public enterprises, such as the Chhukha hydropower project), totalled over 55 per cent of domestic revenue. Tax revenue, mostly generated through enterprise profit taxes and taxes on goods and services, grew by 25 per cent, to meet 18.5 per cent of total expenditure, as compared with 17.5 per cent in 1999. Both current and capital expenditure were on an upward trend, rising by some 18 per cent each. The budget deficit was enlarged to 766 million ngultrum; at 4 per cent of GDP, this shortfall was considerably larger than the 1999 level of just under 1 per cent. Around three fifths of the fiscal resource gap was met through external borrowings in 2000.

Budgetary performance in Cambodia improved significantly in 1999 with revenue rising (by 2.5 percentage points) to 11.5 per cent of GDP as a result of more effective tax collections, exceptional increases in non-tax revenue, and the successful introduction of VAT. Total expenditure, at almost 16 per cent of GDP, was kept within tight control, defence and security outlays being in line with the budgeted levels while social spending on a commitment basis slightly exceeded budgetary provisions. The higher current-budget surplus, at 1.8 per cent of GDP, helped lower the overall fiscal shortfall to 4.4 per cent of GDP. The government managed to reduce significantly its debt to the central bank with substantial external financial assistance.

The budget for 2000 projected a current surplus of 1.4 per cent of GDP and a larger budget deficit of 6 per cent. In the first half of 2000, domestic revenue increased by 5 per cent year-on-year, although this was below the targeted rate because of lower receipts, by some 11 per cent, of taxes on international trade. The share of domestic taxes in total tax revenue was 61 per cent in the first half of 2000, rising from 55 per cent during the comparable period in 1999. The additional measures aimed at strengthening tax administration and making up for the first-half revenue shortfall included the reinstatement of pre- and re-shipment inspection and improved customs duties valuation, and greater efforts to collect arrears from telecommunications, and the leasing of state assets. Domestic capital revenue from the privatization programme declined to insignificant levels, however. Total expenditure increased year-on-year by 23 per cent in the first half of 2000, with current expenditure up by 10 per cent and capital spending by 45 per cent. Expenditure on agriculture, education, health and rural development was to rise considerably in the second half of 2000 with the implementation of financial decentralization and action programmes for priority areas.

During fiscal year 2000, government revenue in the Lao People's Democratic Republic went up to over 12 per cent of GDP (to 1.68 trillion new kip) from nearly 11 per cent a year earlier. There were both higher tax and non-tax revenue receipts largely owing to stronger economic performance and more effective tax collections, including through the operation of the Large Taxpayers Unit. Public spending declined from 21.4 per cent of GDP in 1999 to 20.7 per cent in 2000 (to 2.71 trillion new kip) with some 37 per cent being for recurrent purposes. This slower pace was largely due to the streamlining of capital expenditure, including the postponement of non-priority projects. Current outlay on wages and allowances, however, went up by 1 percentage point of GDP, as did development allocations for the social sector and improved revenue from non-tax sources.

The fiscal deficit, in consequence, fell from 10.5 per cent of GDP to 8.5 per cent between 1999 and 2000. Further fiscal improvement was expected in 2001; higher revenue, by 1 percentage point of GDP, and lower capital spending, to 12 per cent of GDP, will help lower the overall deficit to about 8 per cent of GDP. About two thirds of this budget shortfall (600 billion new kip) were to be covered by ODA project loans.

Government expenditure accounts for more than one half of GDP in Maldives. Tourism provides directly about one third of government revenue (through a fixed tax and rents from resort leases) and a large indirect share as well through custom duties on tourism-related imports. The budget deficit deteriorated from 2.8 to 4.2 per cent of GDP between 1998 and 1999; higher receipts from import duties, resort rentals and profit transfers were more than offset by a 15 per cent increase in total expenditure and net lending. In particular, capital expenditure went up because of the purchase of vessels and infrastructure development associated with an expansion of tourism facilities and the policing of the country's exclusive economic zone. In the 2000 budget, total revenue and grants were to remain largely unchanged at just under 47 per cent of GDP while spending, including net lending, was to drop from 51 per cent of GDP in 1999 to 48.4 per cent. The projected decline in fiscal deficit to 1.5 per cent of GDP would depend considerably on, among other things, the anticipated drop in spending on internal security, advance loans and dividend payments by public enterprises, and the containment of costs associated with the closure of Air Maldives. An unbudgeted public-sector wage increase of 35 per cent granted in September 1999 was expected to affect the 2000 budget outcome.

Central government revenue in Myanmar declined from 7.3 per cent of GDP in 1998 to 4.9 and 4.5 per cent respectively during the following two years. Although public spending was also on a declining trend, from 7.7 per cent of GDP in 1998 to 6.7 and 5 per cent in 1999 and 2000, the budget deficit went up from 0.4 per cent of GDP in 1998 to an annual average of over 1 per cent in 1999 and 2000. Budget receipts from state economic enterprises comprised a significant share of GDP. Total revenue from these enterprises, however, declined from 15 per cent of GDP in 1998, to 14 and 13 per cent in the following two years. A similar downward trend was also registered in their expenditure, from 20.4 per cent of GDP in 1998 to 18 and 15 per cent in 1999 and 2000 respectively, contributing to a decreasing budget deficit from the state economic enterprise sector which had been 5.3 per cent of GDP in 1998, 3.3 per cent in 1999 and 2.4 per cent in 2000.

Government expenditure in Nepal increased by 13.4 per cent (to 67.6 billion Nepalese rupees or almost 18 per cent of GDP) owing to the rebound in

development spending (by nearly 17 per cent). There was also the continued growth of 10 per cent in current outlays (constituting some 51 per cent of total spending) in fiscal year 2000. Notably, internal and external debt servicing absorbed 30 per cent of the recurrent expenses while the deteriorating law and order situation in some parts of the country necessitated more resources for internal security purposes. There were higher than average allocations of capital spending for education and economic services, especially agriculture and irrigation. Government revenue also went up strongly by over 14 per cent (to 42.6 billion Nepalese rupees or 11.3 per cent of GDP) with some 78 per cent coming from tax revenues. This outcome was attributable largely to higher collection of import duties, the implementation of VAT and more effective income-tax collections. The fiscal deficit was marginally lower at 5.1 per cent of GDP in 2000, against 5.3 per cent in the previous year. Foreign loans and (non-inflationary) domestic borrowings via treasury bills and saving certificates underwrote respectively about 71 and 29 per cent of the budget shortfall in 2000.

Money and finance

In Bangladesh, the monetary stance has been eased to stimulate economic activities. The bank rate was reduced from 8 to 7 per cent in August 1999 and cash reserve requirements were lowered from 5 to 4 per cent in October 1999. M2 went up by nearly 19 per cent in 2000, compared with less than 13 per cent a year earlier. The expansion, however, was also due to higher government borrowings from the banking sector, rising by 31 per cent in 2000 compared with 21 per cent in the previous year. Domestic credit to the private sector rose by less than 11 per cent, compared with almost 14 per cent a year earlier, indicating some apparent crowding-out effect. However, this could also reflect subdued private-sector demand. Private-sector credit picked up considerably in the first four months of fiscal year 2001.

The ongoing deregulation of interest rates continued with the interest bands for small and medium cottage industries (term loan) and agricultural credit being withdrawn in July 1999; the band on export credit (8-10 per cent) remained, however. In addition, loan classification and provisioning procedures were revised and upgraded along with the introduction of strict directives to prevent insider lending. Meanwhile, the stock markets in Dhaka and Chittagong remained, by and large, in a bearish mood in 2000, notwithstanding the establishment of a compulsory Investor's Protection Fund and a central depository system, the formation of the South Asian Federation of Exchange to promote national and regional investment, and the tightening of regulations to promote stock market transactions.

Monetary expansion in Bhutan continued at a relatively high rate, with M2 expanding by 21 per cent (to 8,930 million ngultrum) in 2000, following a 32 per cent expansion a year earlier. Growth in net foreign assets slowed to 17 per cent in 2000 from almost 25 per cent in the previous year; net domestic credit, on the other hand, doubled to 752.1 million ngultrum in June 2000. Credit to government enterprises fell by 10 per cent, but that extended to the private sector was up by over 4 per cent. In this context, bank finance channelled to construction and trade activities went up by 15 and 10 per cent respectively; however, there were declines of between 6-17 per cent in the volume of bank credit to the agriculture, transport and manufacturing sectors. The credit-to-deposit ratio also fell significantly to under 23 per cent in 2000 from 25.5 per cent a year earlier, a reflection perhaps of inadequate investment opportunities. Meanwhile, a variety of measures were being introduced to increase flexibility in the interest rate structure, improve the legal framework (including that concerning loan recovery and collateral standards), and enhance financial sector competition.

The expansion of 17 per cent in M2 in Cambodia in 1999 was largely due to an increase in net foreign assets. Despite strong growth in private sector credit (by 17 per cent), net domestic assets declined with lower credit being extended to the government. M2 growth, at an estimated 12 per cent in 2000, remained on a downward trend and contributed to the sharp deceleration of inflation in 1999 and the low level of inflation registered for 2000. Under the Financial Institutions Law, all banks were required to reapply for new banking licences by the end of May 2000; licences had been revoked from those considered non-viable in a preliminary review while those for the remaining banks were to be completed by the end of November 2000. Reform of the Foreign Trade Bank of Cambodia and payments system was also being undertaken.

Bank financing of public investment in irrigation in the Lao People's Democratic Republic led to high rates of expansion in M2 growth of 113 per cent in 1997 and of 78 per cent in the following two years. This, in turn, contributed to severe inflation (peaking at 134 per cent in 1999) and exchange rate depreciation in an economy highly dependent on imported consumption and capital goods. Monetary policy was significantly tightened, including through steep increases in the interest rates (to an annualized rate of up to 60 per cent) and high-interest bearing deposit certificates were introduced to absorb excess liquidity in the course of 1999. Central bank authorities also decided to stop granting credit for budget financing. M2 growth decelerated to 36 per cent, along with the steep drop in inflation (to 15 per cent) in 2000. The restored confidence in the currency was mirrored in a doubling of local currency savings and term deposits (to 198 billion new kip) between December 1999 and October 2000. Seven state commercial banks were restructured and merged into three. Their operations are being strengthened to enhance debt-recovery capability. Measures were also introduced to encourage prudential banking practices and to enhance supervisory capacity.

Foreign currency deposits and loans had been fully liberalized and a fixed exchange rate introduced in Maldives in 1995. Monetary management has thus relied on the imposition of bank-by-bank credit ceilings, a high reserve requirement, and interest rate controls, especially the 20 per cent ceiling on lending rates and the maximum spread of 7 points between lending and deposit rates. The annual rate of M2 growth decelerated sharply to an average of about 2 per cent in 1999-2000, from over 22 per cent in the previous biennium. The financial sector remained basically robust; the volume of NPLs dropped from nearly 9 per cent of total loans in 1997 to 4 per cent in 1999 with the loan loss provisions rising to 70 per cent of such impaired assets. Risk-weighted capital ratios, averaging more than 30 per cent in 1999, were well above international standards. Commercial banks also retained a net foreign-currency asset position in excess of 20 per cent.

The sharp decline in inflation to 7 per cent in 2000 led to positive real interest rates in Myanmar despite falling nominal rates. The central bank rate had fallen from 15 per cent in the first quarter of 1999 to 10 per cent by the second quarter of 2000; similar downward drifts were registered in deposit rates and lending rates on working capital to state-owned enterprises. The upswing in credit extension, by 31 per cent year-on-year in the first quarter of 2000, was attributable to the state sector, which accounted for 68 per cent of all such credit. M2 was on a similarly high trend, expanding by over 33 per cent for the year. Private banking was gaining in relative importance, with an estimated share of 70 per cent of demand deposits and 50 per cent of time and savings deposits as of March 1999. A downturn in the construction and property sectors between 1997 and 1999 led to a higher level of NPLs. Other difficulties and constraints faced by the banking system included outdated communications, accounting and clearing systems, an acute shortage of qualified and experienced staff, and inadequate financial and economic data. At another level, the prevailing interest rates did not always reflect accurately the scarcity of capital. An uneven playing field existed between state-owned banks and their private counterparts, since private banks operated with limits on foreign exchange dealings and stricter reserve requirements.

M2 in Nepal has grown at a comparatively high rate of about 21 per cent a year during the past three years, with the time deposit component going up by about 5 percentage points faster. This upward trend in part reflected an easier policy stance to boost domestic economic activities as well as the relatively large budget deficits (averaging over 5 per cent) in recent years. The lending and deposit rates of the commercial banks came down by about 5 percentage points within a period of two years. At the same time, the amount of net foreign assets of the monetary sector was 22 per cent higher in 2000, on top of a growth rate of nearly 18 per cent in the previous year. For fiscal year 2001, M2 was projected to go up by 15.5 per cent on the basis of a higher GDP growth target of 7 per cent and a lower inflation rate of 5 per cent.

Policy issues and responses

The least developed countries are, almost without exception, heavily dependent on external resources to help bridge the persistent fiscal and external current-accounts deficits. The need to contain fiscal shortfalls has become even more pressing, given the ongoing decline in concessional ODA to these countries and the likelihood of graduation of some of them from this grouping in the near future.

Public spending needs to be rationalized and kept under tight control. The limited amount of available resources has been thinly distributed over a large number of programmes and projects, a problem that tends to be compounded by selection criteria which are not always based on clear and consistent considerations of costs and benefits. However, it remains essential to ensure that public expenditure on human resources development activities is not undermined in view of the urgent need for capacity-building in most least developed countries.

Several least developed countries have set up independent committees to review and rationalize government expenditure, while efforts have been made to enhance transparency and accountability in the management of state assets and public procurement activities. Civil service reforms have been introduced in several of these countries to foster a more transparent, accountable and productive civil service. Better pay scales and ancillary benefits, and optional retirement schemes are among the incentives on offer to bring about greater efficiency and dedication in the public service.

The absence in many least developed countries of a well-developed capital market for effective and widespread secondary transactions in financial instruments, such as treasury bills and equity stocks, has remained a major constraint in mobilizing domestic resources. A compounding factor in this context is the inadequate availability of human resources and institutions for the effective and timely regulation and monitoring of the operations of capital-market institutions to ensure prudential and transparent practices. These constraints underscore the importance of a sound banking system to perform the essential intermediation functions required in a modern and growing economy.

The needs for banking sector reform have been recognized by the least developed countries. Cambodia, for example, passed legislation which created a solid legal basis for a sounder banking system. The legislation contains provisions in such areas as licensing requirements; prudential operational criteria, with special emphasis on controlling undue exposures; improving debt-recovery mechanisms; and higher net worth and solvency specifications. Likewise, the Asset Reconstruction Companies and Credit Rating Agency in Nepal have added further strength to the domestic financial sector and regulatory framework.

Another formidable challenge in least developed countries is the promotion of greater participation by the private sector in a wider spectrum of economic activities. State-owned enterprises continue to dominate certain sectors of several of the countries; most of such enterprises have incurred persistent and, not infrequently, heavy losses. Many least developed countries have resorted to privatization as a means to encourage the growth of private enterprise and to re-direct government operations to their core areas and competencies. However, the performance of divested enterprises has been, at best, mixed in terms of output, employment, prices and product quality. The speed and sequencing of privatization will need to be kept under review, along with the preconditions for successful privatization, including appropriate regulatory frameworks. Meanwhile, the practice of administered pricing and various types of subsidies would deserve a careful review, especially as regards their implications for fiscal burden, allocative efficiency and equity. Besides, efforts have to be redoubled to improve the operational efficiency of state-owned enterprises. In this connection, the continuing politicization of the labour unions in such enterprises, particularly in such critical sectors as transport, banking, telecommunications, and power generation, should be avoided through national consensus.

Least developed countries face difficult challenges in their efforts to integrate with the emerging new economy, characterized by a rapid and ongoing revolution in information technology. This applies to those least developed countries that are currently members of WTO (Bangladesh, Maldives and Myanmar) as well as those in the process of accession. The difficulties are greatly compounded for those least developed countries that are land-locked (Bhutan, Lao People's Democratic Republic and Nepal) or sea-locked (Maldives and least developed countries in the Pacific subregion) since transport tends to be more costly in terms of both financial expenses and time requirements. Least developed countries themselves need to take action in many areas in order to be able to avail themselves of the opportunities offered by the new economy and to minimize the associated risks, but they also require much stronger international support than has been available to them so far (see box II.1).

Box II.1. Key international support measures required for the least developed countries

In 1971, the international community recognized the existence of a category of countries, the least developed countries, whose distinctness lies in their profound structural handicaps in terms of economic, institutional and human resources and unfavourable geophysical location. To respond to this challenge, a variety of international support measures were envisaged during the 1980s and the 1990s. These were embodied in the Substantial New Programme of Action for the 1980s for the Least Developed Countries adopted at the first United Nations Conference on the Least Developed Countries in 1981, and in the Paris Declaration and Programme of Action for the Least Developed Countries for the 1990s adopted at the Second United Nations Conference on the Least Developed Countries in 1990. However, the international support measures have not materialized to the extent expected. Despite major policy reforms having been initiated by many least developed countries, their growth has been too slow to make any significant impact on poverty. In addition, they have remained on the periphery of global trade and capital flows.

In order to provide a new impetus for assistance to these countries, the General Assembly, in its resolution 52/187, decided to convene the Third United Nations Conference on the Least Developed Countries in 2001. In preparation for this Conference, a regional high-level preparatory meeting for the Asian and Pacific region was organized jointly by ESCAP and UNCTAD in collaboration with the Government of Bangladesh in Dhaka in November 2000. The meeting formulated a set of national actions and international support measures pertaining to four key areas: social development, economic infrastructure, trade and financing development. Most of the recommendations relating to the last area have been incorporated in part two of this *Survey*. This box highlights the key international support measures proposed in the Meeting for the first three areas:

(1) In order to provide adequate resources for social development, as well as for infrastructure, in the least developed countries, the international community should fulfil the provisions contained in various declarations and programmes of action emanating from United Nations-sponsored global conferences such as the World Summit for Social Development, the Global Conference on the Sustainable Development of Small Island Developing States, and the Second United Nations Conference on the Least Developed Countries.

(2) To ensure sustainability of social services, there should be adequate provision for the required current expenditure to meet personnel, maintenance and other operational costs. Such current expenditure has a clear developmental impact. Aid agencies should take this aspect into account in prescribing fiscal deficit ceilings for least developed countries.

(3) The international community and donor agencies are urged to provide technology and technical assistance for the development of human resources related to infrastructure.

(4) Where countries of the region agree, the international community should facilitate regional cooperation with a view to linking the transport and telecommunications networks of least developed countries with those of neighbouring countries. This is particularly vital for landlocked and island countries to be able to engage effectively in international trade and tourism.

(5) Recognizing that in spite of best efforts, private-sector participation in infrastructure development in the least developed countries, especially in providing access to remote, sparsely populated and mountainous areas, would be difficult, it was suggested that the international community should set up a special fund for infrastructure development. The modalities for creating such a fund should be immediately conceptualized and vigorously pursued.

(6) Asian and Pacific least developed countries called on their trading partners to provide bound, duty- and quota free access to all products exported by least developed countries.

(7) There should be simplification and harmonization of rules of origin to promote the exports of the least developed countries.

(8) Special and differential measures in favour of the least developed countries should be an integral part of the multilateral trading system.

(9) Preferential market conditions should be allowed for the least developed countries with respect to the movement of natural persons.

(10) Longer periods of transition should be given to the least developed countries in the implementation of WTO Agreements.

(11) The effective implementation of the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries should be accelerated.

(12) The multilateral trade rules governing regional trade arrangements should be supportive of regional integration efforts and provide adequate flexibility to the Asian and Pacific least developed countries in adjusting to a more liberalized and competitive trade regime under these arrangements.

(13) Fast-track accession to WTO should be allowed for the least developed countries without asking them to assume obligations or commitments that go beyond what is applicable to WTO least developed country members.

Pacific island economies

GDP growth in this subregion remained positive in 2000 although the political crises and civil unrest in Fiji and Solomon Islands during the first half of the year contributed to a substantial contraction in their total output. In most cases, the growth rate recorded was lower than in 1999. Inflation within the subregion was generally on the decline, reflecting stable import prices from the main trading partners, especially Australia and New Zealand. However, higher oil prices put pressure on inflation and the budget from the second half of 2000. The various reforms and revenue-enhancing measures contributed to declining or low levels of budget deficits and a comparatively moderate rate of money supply growth in several countries in 1999. However, the fiscal position became relatively more fragile in some economies in 2000 as a result of revenue shortfalls or higher public spending or both.

Growth performance

In Fiji, GDP grew marginally in 1998 but expanded strongly by 6.6 per cent in 1999. The growth momentum, however, was stopped in 2000 with the political crisis and its severe economic reverberations. Despite a considerable increase in the sugar cane crop, GDP was estimated to fall by 12.5 per cent, the deepest contraction recorded since 1961 when GDP statistics were compiled (table II.5). Sugar cane output of 4 million tons, with sugar production of 450,000 tons for 2000, was much higher than the respective levels a year earlier. Nevertheless, the agricultural sector expanded by only 1 per cent owing to the adverse impact of the political crisis on domestic transportation and marketing of farm produce. The sector itself had grown by a massive 18.3 per cent in 1999. Its future outlook is clouded by land tenure problems for tenants (who are mostly third- to fourth-generation immigrants from India), lower investment in sugar cane cultivation, and the uncertainties of continuing market support from the EU, especially since the coup.

Tourism, Fiji's biggest industry with a relative share of some 20 per cent of GDP, was also on a downward trend with average daily arrivals of 600, about half the pre-crisis volume. There has been some recent recovery after heavy discounting on airfares and accommodation, but hotel occupancy rates were low, at 20 to 30 per cent for June 2000, compared with 80 to 90 per cent for the same month last year. As a whole, earnings on tourism were reduced by more than 50 per cent in the second half of 2000 and by 30 per cent for the calendar year, causing a contraction of some 20 per cent in the service sector for the year. Recovery of this sector is heavily contingent on the restoration of political stability and law and order. Manufacturing activities, particularly the large and rapidly growing garment industry, were hampered by international union boycotts of Fiji and reduced domestic demand for local manufactures because of the crisis. All these contributed to an estimated decline of 10 per cent in industrial sector output activity in 2000; industrial growth had been especially robust at over 10 per cent in the previous year.

The ratio of investment to GDP in Fiji, which exceeded 13 per cent in 1999, fell marginally to 12 per cent in the following year and is expected to remain dampened in the short term. No large public-sector investment projects are on-stream while several new hotel projects ready for, or already

Table II.5. Selected Pacific island economies of the ESCAP region: growth rates, 1997-2000

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Cook Islands	1997	−2.8	12.2	6.4	−7.4
	1998	−2.3	2.8	−6.2	−3.4
	1999	2.7	2.5	4.6	2.5
	2000	3.3	..	..	..
Fiji[a]	1997	−0.9	−13.0	1.4	2.4
	1998	1.4	−7.2	3.1	3.3
	1999	6.6	18.3	10.4	2.6
	2000	−12.5	1.0	−10.0	−20.0
Kiribati	1997	2.3	−12.0	18.8	5.1
	1998	8.3	12.9	24.8	5.1
	1999	1.5	..	..	..
Papua New Guinea	1997	−5.2	−6.0	−12.3	4.2
	1998	1.4	−6.1	9.9	0.4
	1999	3.2	3.7	6.6	0.2
	2000	0.8	0.9	−4.3	4.5
Samoa	1997	1.5	−5.9	−1.0	5.7
	1998	2.6	7.0	−9.4	7.1
	1999	5.3	6.0	4.0	5.5
	2000	3.5	3.0	1.0	5.0
Solomon Islands	1997	−0.9	3.7	−11.7	−1.6
	1998	1.3	−4.2	11.4	4.0
	1999	−1.7	−7.5	25.1	−5.5
	2000	−13.5	−10.5	−21.5	−12.0
Tonga	1997	−1.4	−3.0	−8.1	1.8
	1998	0.1	−2.1	−5.7	3.2
	1999	2.2	−0.9	9.3	2.7
	2000	5.2	8.0	2.7	4.4
Tuvalu	1997	3.5	5.8	4.0	2.7
	1998	14.9	0.7	21.5	16.0
	1999	3.0	..	..	..
Vanuatu	1997	0.6	4.9	−18.0	2.0
	1998	6.0	6.7	8.9	5.4
	1999	−2.5	−11.3	7.5	−0.6
	2000	4.0	..	..	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); and national sources.

Notes: Data for 2000 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.

under, construction are now put on hold; and so, too, are other private sector projects. On the other hand, savings went up from 13 per cent of GDP in 1997-1998 to around 19 per cent in 1999 in the wake of vibrant agricultural and economic performance. The savings rate was expected to fall off sharply to a crisis-induced level of 12 per cent in 2000.

After a marginal recovery in 1998, the economy of Papua New Guinea grew strongly at 3.2 per cent in the following year, but was estimated to have stagnated in 2000. The new government, which came into power in July 1999, has embarked on an extensive programme of structural reform, including improvements in standards of governance and of discipline in fiscal and economic management. GDP is projected to expand by about 3.1 per cent in 2001 and 4.7 per cent in the following year, with the main stimulus coming from the construction of the long-awaited gas project and the coming on-stream of a large nickel mine. Indeed, poor governance had led to a slump in investment, especially in construction, during the period 1998-1999. The trend was recently reversed; investment is expected to reach 42 per cent of GDP in 2000 from 29.4 per cent of GDP in 1999. The savings rate is estimated to increase substantially to 34.4 per cent in 2000 despite a shortfall in the National Provident Fund of more than $56 million (almost 1.5 per cent of GDP).

Mining and petroleum have long dominated the country's industrial sector whose contraction in 2000, at 4.3 per cent, was significantly down from a growth rate of 6.6 per cent a year earlier and of about 10 per cent in 1998. The higher expansion in 1998 was due to the coming on-stream of the Lihir gold mine and the resumption of full production at the Ok Tedi and Porgera mines after drought-related disruptions and the commencement of production at the Gobe oil fields. The contraction in industrial output in 2000 was mainly due to a fall in oil production at Kutubu fields, coupled with disruptions in production at the Moran oil fields in late August 2000 when the pipelines were damaged by a landslide. Meanwhile, agriculture (including forestry and fisheries) recovered somewhat from the drought-affected contraction of over 6 per cent in both 1997 and 1998, with output growth of 3.7 per cent in 1999. The sector remained rather subdued, with an expansion of 1 per cent in 2000, because of a sharp decline of more than 30 per cent in coffee production. Law and order problems and the deterioration in transport infrastructure have acted as the two main constraints on agricultural production in general, and the coffee industry in particular.

The Samoan economy has continued to perform well in recent years with remarkable price stability and output growth of 2.6 per cent for 1998 and 5.3 per cent in 1999; the outlook for 2000 remains healthy and GDP was expected to be 3.5 per cent higher. Agriculture accounted for two thirds of domestic employment and most of export earnings. Favourable weather conditions and good fishery harvests drove output up by 6 per cent in 1999 although the expansion dropped back to 3 per cent in the following year. Industrial activities, including the production of automotive parts, recovered from a sharp contraction in 1998 to grow by 4 per cent but the levels of industrial value added slowed somewhat to about 1 per cent in 2000 as a result of a slowdown in the construction sector following strong growth in the previous year. The service sector, with a relative share of 58 per cent of GDP in Samoa, expanded by 5 per cent in 2000 largely because of a boost in tourism; tourists initially bound for Fiji, which became affected by the political crisis, chose instead to visit Samoa. A new air services agreement was signed with New Zealand to open more routes between the two countries.

In Solomon Islands, the economy has been largely paralyzed by the civil and military unrest, which erupted in 1999 and dragged on until the October 2000 Peace Agreement, with over 100 deaths. The widespread looting and vandalism that followed drastically cut investment and created great consumer and business uncertainties. This devastation came in the midst of the drive for reform, supported by ADB and the World Bank, to improve standards of governance, among other objectives. GDP was then expected to grow strongly, but it declined by 1.7 per cent in 1999 and is expected to drop by 13.5 per cent in 2000. The downward economic spiral will continue if the Peace Agreement cannot be upheld. Indeed, the agricultural sector (including forestry and fisheries) has remained on a declining trend, with output contracting by slightly over 4 per cent in 1998 and widening to over 10 per cent in 2000. In particular, the sole palm oil plantation, with $20 million in export earnings and employing 2,000 persons, was closed in June 1999 and there was lower production of other major export

crops, especially copra and cocoa. Fishing operations by the country's largest company were suspended in late 2000.

The Gold Ridge, the first large-scale mining operation in Solomon Islands, helped boost industrial sector production by over 25 per cent in 1999; its output was to grow by another 35 per cent in 2000, but the mine was closed in June because of the civil unrest. Prospecting and construction activities, and other manufacturing operations (including the brewery), were also stopped, with the result that industrial value added would be over 21 per cent lower for the year. Output from the service sector also fell by some 12 per cent during the year. Electricity generation faced severe problems of uncollectable fees and charges after significant donor-funded investment to upgrade supply and extend the transmission network. Tourism and the retail industry have crashed, causing many hotels and shops to close. Rehabilitation of mining, industrial and servicing equipment and operations would be costly and would take several years.

The Tongan economy recovered from a stagnant economic performance lasting three years to expand by 2.2 per cent in 1999 and another 5.2 per cent in 2000. The agricultural sector has been on a decline since 1997 because of droughts (during the period 1997-1998) and severe cyclones (from the end of 1998 and to early 2000); it rebounded with 8 per cent growth in 2000. Meanwhile, higher construction and rehabilitation activities lifted industrial output by 9.3 per cent in 1999 with further growth of 2.7 per cent expected in the following year. Tonga was one of the first nations to greet the new Millennium and tourist arrivals were up 40 per cent in the last quarter of 1999; this also benefited retailing and manufacturing, with the latter driven largely by food and beverage processing. The service sector (accounting for 52 per cent of GDP) expanded by almost 3 per cent in 1999 and by another 4.4 per cent in 2000. Tonga's future economic prospects are very much contingent on both tourism and inward remittances from Tongans living abroad.

In Vanuatu, per capita income has declined slightly in recent years owing to a high population growth rate of 3.1 per cent. Total output contracted by 2.5 per cent in 1999, but is expected to expand by 4 per cent in 2000. The agricultural sector (with 22 per cent of GDP) declined by 11.3 per cent in 1999 mainly because of much lower copra prices and production; the 2000 coconut crop also faced a new threat in weevil infestation. Meanwhile, beef output was on the rise following a downturn during the East Asian financial crisis; niche marketing of this high-quality product, mainly to Japan, and the sale of 20-kilogramme packs to departing tourists was successful. Services, particularly tourism and finance-sector-related activities, accounted for more than two thirds of the country's GDP. Tourist arrivals for 1999 were adversely affected by the recent political turmoils in Fiji, which acted as a transport hub for Vanuatu; the value added from services was thus dampened to 0.6 per cent for the year. Local bottlenecks in accommodation and air transport capacity have also served as a constraint on the vigorous and sustained development of tourism activities.

Among the smaller Pacific island economies, GDP in Cook Islands rebounded by 2.7 per cent in 1999 with further growth of 3.3 per cent expected in 2000. Output had declined since 1995 mainly as a result of an extensive restructuring of the public service, including the corporatization of public-sector enterprises. Expansion in black pearl production and construction activities contributed to strong industrial growth of almost 5 per cent in 1999. Meanwhile, a higher volume of tourist arrivals, by 6.5 per cent in 1999, helped lift the value added from services by 2.5 per cent. There was a diversification of the market with tourists from Canada accounting for one third of the increase.

In Kiribati, higher copra production, an expansion in public administration and the construction of aid-funded projects were behind the high GDP expansion of 8.3 per cent in 1998. Economic activities tapered off in the following year and the Japanese-funded construction of a new wharf underpinned output growth of 1.5 per cent in 1999. The economy of the Marshall Islands recovered from a three-year decline owing to reform-related expenditure and employment cuts, and bad weather conditions. The modest GDP growth of 0.5 per cent in 1999 was attributed to aid-funded public works, the construction of a tuna-processing factory and higher agricultural production. The Federated States of Micronesia also went through a two-year economic slippage with output expanding by 0.3 per cent in 1999. This subdued recovery was driven by a higher level of private-sector activities in one state, Chuuk, while economic activities continued at a slow pace elsewhere in the country. The economy of

Tuvalu experienced an economic boom in 1998, with GDP growing by almost 15 per cent, largely on account of a one-third expansion in public-sector activities; the sector was equivalent to one fourth of GDP. Output went up moderately at 3 per cent in 1999, largely reflecting an expansion in public construction activities.

Inflation

After the devaluation-related pickup in consumer prices in 1998, inflation in Fiji has been on a downward trend at just 2 per cent in 1999 and about 1 per cent in 2000 (table II.6). The continued strength of the United States dollar and higher oil prices were

Table II.6. Selected Pacific island economies: summary of macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*
Fiji	Savings/GDP	13.1	13.3	19.0	12.0
	Investment/GDP	12.5	12.0	13.4	12.0
	Budget balance/GDP	−6.4	4.6	−0.7	−4.0
	Current account balance/GDP	−1.6	−3.5	7.9	1.9
	Money supply growth (M2)	−8.7	−0.3	14.2	6.6[a]
	Inflation rate[b]	3.3	5.7	2.0	1.0
Papua New Guinea	Savings/GDP	23.0	28.3	29.3	34.4
	Investment/GDP	27.1	30.3	29.4	42.0
	Budget balance/GDP	0.1	−2.1	−2.2	−1.5
	Current account balance/GDP	−4.2	−0.5	1.3	6.5
	Money supply growth (M2)	7.7	2.5	9.2	2.5[c]
	Inflation rate[b]	3.9	13.6	14.9	12.2
Samoa	Budget balance/GDP[d]	0.3	2.1	0.3	−5.0
	Current account balance/GDP	3.9	9.6	−8.9	−5.7
	Money supply growth (M2)	16.5	2.2	12.5	11.1[a]
	Inflation rate[b]	6.8	2.2	0.3	2.0
Solomon Islands	Budget balance/GDP[d]	−4.6	−1.6	−2.3	−4.5
	Current account balance/GDP	−10.0	2.7	11.7	0.8
	Money supply growth (M2)	6.7	2.5	7.0	1.1[a]
	Inflation rate[b]	8.1	12.3	7.8	4.0
Tonga	Budget balance/GDP[d]	−1.2	−4.3	1.0	−0.7
	Current account balance/GDP	−1.6	−11.8	−5.0	−4.3
	Money supply growth (M2)	7.8	14.7	11.9	4.5[e]
	Inflation rate[b]	2.1	3.3	4.4	4.5
Vanuatu	Budget balance/GDP	−2.7	−6.7	−1.2	−1.8
	Current account balance/GDP	−7.6	2.0	−4.5	−3.2
	Money supply growth (M2)	−0.4	12.6	−9.2	−8.3[a]
	Inflation rate[b]	2.9	3.9	2.8	1.5

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); IMF, *International Financial Statistics,* vol. LIII, No. 9 (September 2000) and *International Financial Statistics,* vol. LIII, No. 12 (December 2000); and national sources.

Note: Data for 2000 are estimates.

[a] January-September.
[b] Referring to changes in the consumer price index.
[c] January-June.
[d] Excluding grants.
[e] January-August.

largely offset by falling prices of domestically produced and marketed goods and services owing to a slump in demand and economic activities following the political turmoil. Consumer prices would likely be higher in 2001 as a result of the continuing high levels of domestic oil prices, an upswing in domestic activities, and a possible further depreciation of the Fijian dollar; the currency went down by 7.8 per cent in relation to the United States dollar in 2000.

The kina in Papua New Guinea had experienced considerable downward volatility in value since its floatation in 1995. Consumer prices edged up marginally, from 13.6 per cent in 1998 to just under 15 per cent in 1999, despite the imposition of price controls on utilities and domestic air travel, and a relative stabilization of the currency in the second half of 1999. The price controls, however, caused large losses in state-owned enterprises. Inflation was expected to be lower, at just over 12 per cent in 2000, as the currency continued to hold firm owing to improved fiscal and economic conditions and the inflow of large concessional loans.

Samoa has experienced remarkable price stability with inflation of less than 3 per cent over the past three years and, notably, a negligible rise in consumer prices in 1999. There was, to begin with, low inflation in the Australia and New Zealand, the country's two major sources of imports; in addition, the local currency remained firm against the Australian and New Zealand dollars. In addition, supplies of agricultural produce were ample, especially in 1998-1999, while import prices benefited directly from the ongoing process of tariff reductions. Inflation picked up to an estimated 2 per cent in the following year, partly on account of higher oil prices and a depreciation of the country's currency by some 10 per cent against the United States dollar.

Consumer prices were brought under control in Solomon Islands after a decade of relatively high inflation, often at a double-digit rate; these prices went up by less than 8 per cent in 1999 and by just 4 per cent in 2000. The indexation of wages to inflation was stopped; productivity improvements would determine future wage increases. Public-sector wages were also frozen in 1999. On the other hand, the main cost-push forces included the shortage of fresh food induced by the civil unrest and a small depreciation of the local currency against the Australian dollar and the Japanese yen. Australia and Japan account for about 60 per cent of imports; prices of imports from these countries went up by 8.3 per cent in 1999. In addition to higher oil prices, further inflationary pressures would be felt if the local currency were to weaken.

Inflation was on a marginally rising trend in Tonga, from an annual average of 2.7 per cent during the period 1997-1998 to around 4.4 per cent annually in the following biennium. Domestically produced goods and services rose by 3.4 per cent in 1999. The slight rise in the inflation rate (to 4.5 per cent) in 2000 was largely attributable to increases in oil prices and in the salaries of public-sector employees (by 20 per cent) during the second half of 2000, together with higher import prices caused by the depreciation of the local currency by around 6 per cent against the currencies of Australia and New Zealand.

Vanuatu is another island country with considerable price stability, inflation standing at 2.8 per cent in 1999 and 1.5 per cent in 2000 and the outlook on prices remaining largely stable. Easier supplies of subsistence food products and the appreciation of the local currency (by 3.3 and 7.7 per cent) against the Australian and New Zealand dollars contributed to a stabilizing influence on consumer prices in 2000. These two developed countries have been the main import suppliers to Vanuatu and many other island economies as well.

Most other Pacific island economies use the currencies of Australia, France, New Zealand and the United States as legal tender, and changes in their price levels generally mirror those in the metropolitan countries. By and large, inflation was low or falling in these economies, except in Cook Islands and Tuvalu. Consumer prices in the Marshall Islands rose by 1 per cent in 1999. In Cook Islands, an unexpected inflation of just over 5 per cent in 2000 reflected a rebound from the prolonged decline in the earlier years. In Tuvalu, higher prices for transport services and miscellaneous items lifted the inflation rate to 7 per cent in 1999.

Trade

In Fiji, the merchandise trade deficit improved sharply to stand at $207 million in 1999, with export earnings rising by almost two fifths, to $568 million, on account of a surge in sugar and garment exports (table II.7). Meanwhile, the value of imports dropped by 1.6 per cent to $775 million. The continuing

Table II.7. Selected Pacific island economies: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					Imports (c.i.f.)				
	Value (millions of US dollars)	Annual rates of growth (percentage)				Value (millions of US dollars)	Annual rates of growth (percentage)			
	1999	1997	1998	1999	2000	1999	1997	1998	1999	2000
Fiji	568.0	-21.1	-16.1	39.4	2.0	775.0	-1.9	-16.8	-1.6	-5.0
Papua New Guinea	2 019.0	-14.7	-16.1	12.8	6.7	1 118.0	-2.6	-27.0	3.2	2.2
Samoa	18.1	50.0	26.3	-2.1	-9.0	114.8	-3.0	-5.2	20.9	-13.6
Solomon Islands	150.8	6.8	-8.8	6.0	-33.6	134.7	12.6	-14.5	-16.0	-27.2
Tonga	12.5	-23.1	-38.5	73.3	4.0	62.6	-2.7	-9.5	-0.7	-3.3
Vanuatu	25.3	16.7	-0.7	-17.1	8.0	77.2	-3.1	-5.5	5.0	1.0

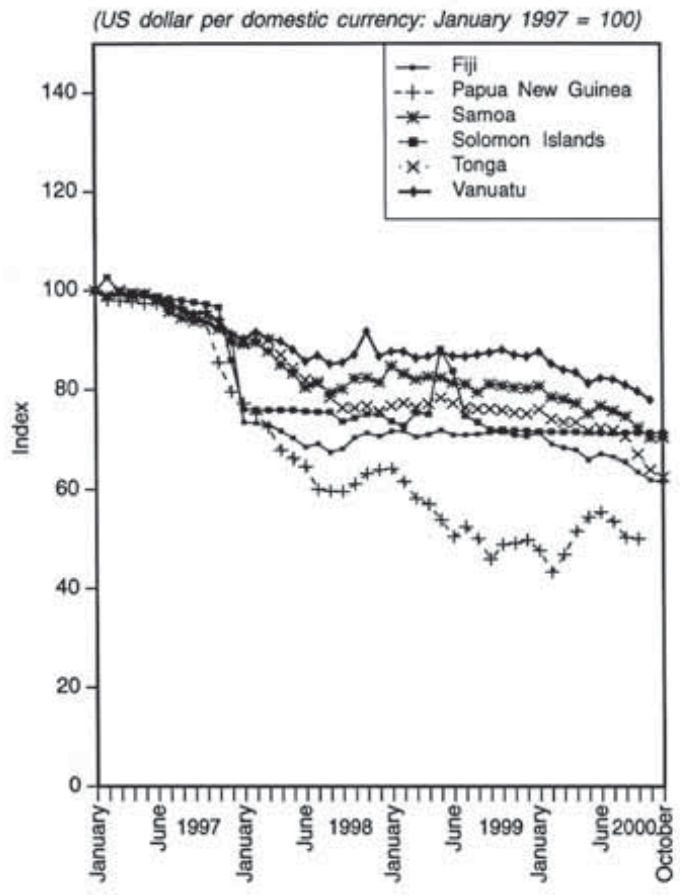
Sources: United Nations, *Monthly Bulletin of Statistics,* October 2000; and national sources.

strength of tourism, the country's biggest foreign exchange earner, lifted service exports to $684 million in 1999, thus contributing to a higher surplus of $306 million on the service accounts. Subsequently, the adverse impact of the political turmoil, particularly a boycott by domestic and overseas trade unions in the handling of non-essential items, made itself felt. There was a small increase of 2 per cent in export earnings relative to a sharper contraction of 5 per cent in import spending, with the trade deficit going down further to $157 million (or about 10 per cent of GDP) in 2000. Interruptions to the supply of raw materials, particularly to the garment manufacturers, and delays in delivery to clients severely affected production and trade flows. In addition, lower imports were caused largely by a fall of 21 per cent in the purchase of investment-type inputs. The slump in tourism will lead to a smaller current account surplus of about $35 million; the same surplus stood at $144 million, or 7.9 per cent of GDP, in 1999.

In Papua New Guinea, merchandise exports increased by 13 per cent to $2 billion (equivalent to 49 per cent of GDP) in 1999 because of higher oil prices; such earnings were projected to rise by another 6.7 per cent to account for 54 per cent of GDP in 2000. In particular, crude oil exports brought in $0.8 billion, or nearly 35 per cent of export receipts, up from an average of 25 per cent over the period 1998-1999. Earnings on gold, the other main export commodity, increased by 16 per cent (to $516 million) during the first nine months of 2000 compared with the corresponding period of 1999. Export value will be boosted significantly, by upwards of $0.6 billion a year, with the completion in 2003 of the gas pipeline project to the north of Australia. On the other hand, largely as a result of adverse weather and bottlenecks in infrastructure and rural extension services, agricultural exports fell by almost 5 per cent to $472 million in 1999, and by another 1 per cent in 2000. The export volume of cocoa and copra remained well below their respective 1997 levels while that of coffee exports has dropped off marginally since 1998, despite a sharp depreciation of the local currency during the same period (figure II.2). A much-anticipated recovery in log exports was tempered by the continuing increase in effective export tax rates, export volumes in 1999 being half those of 1996.

Spending on imports was growing at a much slower rate of just over 3 per cent in 1999 (to $1.1 billion) and 2.2 per cent in 2000, resulting in a trade surplus of almost $1 billion (almost 22 per cent of GDP) in 1999 and $1.1 billion (or 28 per cent of GDP) in 2000. The balance on the trade and service accounts together was much smaller, at $154 million in 1999 and $405 million in 2000, because of large deficits in the service trade. This surplus is

Figure II.2. Index of exchange rates of selected Pacific island economies, 1997-2000



Source: IMF, *International Financial Statistics* (Washington DC), various issues.

expected to contract until 2003 as imports of goods and services are expected to expand in support of the construction of the gas pipeline project and the new nickel mine. In addition, the predominance of large foreign-owned mineral development projects contributes to sizeable deficits in the investment income account; the shortfall amounted to $275 million in 1999 and is expected to rise further in the near term because of high oil prices. The transfer account was in surplus, by $174 million in 1999 mainly owing to ODA receipts, but the current account balance was much smaller, $53 million (or 1.3 per cent of GDP) in 1999. This surplus is expected to reach $259 million (or 6.5 per cent) in 2000.

In Samoa, merchandise exports rose strongly to just over $18 million, while imports reached $115 million, or 56 per cent of GDP, in 1999. As has long been the case, the substantial trade deficit ($96.7 million or 46 per cent of GDP) has been offset in a large part by inward remittances from Samoans living abroad, by external aid, and by tourism receipts. Private remittances, for example, reached $32 million in 1999 and an even higher level is expected for 2000. Meanwhile, tourist spending was estimated at almost $41 million, or 20 per cent of GDP, in 1999. Significantly, overseas Samoans comprised almost one half of the volume of visitor arrivals, while the unrest in Fiji served to divert some of the tourist flows to alternative destinations,

including Samoa. Prospects for the industry are promising with more extensive air links to source nations. As in other Pacific island countries, there exists an acute shortage of hotel rooms (totalling some 700 in current capacity), although this constraint should be somewhat relieved with the coming onstream of new resort projects over the medium term.

Earnings from merchandise exports in Solomon Islands expanded in 1999 at a much slower rate of 6 per cent than earlier expected in view of the first full year of production from the Gold Ridge mine. Gold was the second biggest export item with a relative share of over a quarter. The most important foreign exchange earner, logs, went up in value by 14 per cent in response to revived demand from East Asia, although fishery exports, the third largest item, were hampered by low tuna prices and heavy taxation. Export of palm oil, copra and cocoa also suffered from the civil unrest, which is expected to cause overall earnings to drop by one third in 2000. In particular, palm oil exports were virtually halted, gold exports dropped by 50 per cent and could be nil in 2001, and fishing exports were some 20 per cent lower and were expected to drop further in 2001. Setbacks of various magnitudes were also experienced by cocoa, copra and log exports.

Merchandise imports fell by over 16 per cent in 1999 and by another 27 per cent in 2000. This sharp downward trend in part reflected the completion of the construction phase of the Gold Ridge mine, and in part was the result of the unrest-induced contraction in consumption expenditure, and a fall in the import of inputs because of the closure of mining operations, as well as in capital goods owing to the cancellation of major investment projects. Gold mining helped transform a merchandise deficit of over $18 million in 1998 into a surplus of about $16 million in 1999; a smaller surplus of about $2 million is expected for 2000. Large inflows of aid and investment, among other inward transfers, yielded a current account surplus of almost $43 million (or 11.7 per cent of GDP) in 1999. This surplus is expected to be significantly lower at just under $3 million in 2000 owing to the falling trade surplus, higher income outflows, and a contraction in aid and other transfers.

Tonga registered a sharp increase of over 73 per cent, to $12.5 million, in export earnings in 1999, a reflection of the solid recovery of agricultural production from natural disasters, including droughts and cyclones. Squash exports doubled to $5.6 million in 1999 despite a glut in the market and hence low prices; those of fish and seaweed more than doubled to $3.7 million and should continue to grow strongly in view of government efforts to improve conditions for commercial fishing. The value of other exports such as vanilla, kava and root crops was also higher in 1999. At the same time, there have emerged new opportunities for niche exports following a relaxation of quarantine requirements in New Zealand for certain fruits and vegetables from Tonga, although there was a setback in early 2000 with New Zealand imposing a temporary ban on Tongan papayas. Merchandise exports are expected to rise further to $13 million in 2000.

Merchandise imports were on a slightly declining trend, amounting to $62.6 million in 1999, compared with $63 million a year earlier, and $60.5 million in 2000. The substantial trade deficit of over $50 million (or 33 per cent of GDP) in 1999 and $47.5 million in 2000 was marginally offset by a small surplus on the service account of $3.6 million; tourism receipts provided more than one half of earnings on service exports of almost $18 million. Prospects for the country's tourism sector are reasonably bright in 2000 and 2001 although the crisis in Fiji could be expected to have some negative repercussions for the industry. Meanwhile, inward remittances from overseas Tongans went up from $38 million in 1998 to $43.3 million (or 28 per cent of GDP) in 1999 and are expected to remain at the same level for 2000. Nevertheless, the current account continued to be in deficit although the magnitude of this shortfall declined to $7.6 million (or 5 per cent of GDP) in 1999 from $12.1 million in 1998, and is expected to decline further to $6.6 million in 2000.

Vanuatu's merchandise exports, at $25.3 million in 1999 (or just under 11 per cent of GDP), fell by 17 per cent because of weather-related sharp declines in earnings on copra and kava. Beef exports remained strong at $3.2 million in 1999, and are likely to rise in future years, particularly to the Japanese market. Merchandise imports in 1999 amounted to over $77 million (or 33 per cent of GDP), an increase of 5 per cent over the previous year. The trade deficit has improved somewhat in 2000 with higher earnings on copra, beef, timber and kava, while import spending remained subdued.

Tourism and financial services were among the main foreign exchange earners; tourism brought in $55.5 million (or 24 per cent of GDP) with forecasts for further growth in 2000 as a positive spillover from the civil disturbances in Fiji. Service exports reached $128 million, up 13 per cent, in 1999 but the large surplus on this account was negated by other outflows so that the current account remained in deficit by $10.5 million (or 4.5 per cent of GDP); the shortfall is expected to improve marginally to $7.5 million in 2000.

Capital inflows and outflows

The high level of foreign reserves in Fiji at the time of the coup, at $395 million, was adequate to cover imports for six months. Subsequently, controls on capital outflows to stem capital flight included a reduction in the ceilings on foreign exchange transactions, the introduction of higher interest rates, and a withdrawal of some powers delegated to commercial banks for approving foreign exchange transactions. These measures have been effective in helping to avoid a foreign exchange crisis, although capital inflows have dwindled rapidly. ODA from Australia and New Zealand was suspended in the aftermath of the coup. There was a subsequent, partial relaxation, but new projects remained on hold. Portfolio investment will not resume quickly until the resolution of security of tenure in property, land in particular. Investment projects approved prior to the coup amounted to $300 million, of which some $160 million related to the development of large tourism projects; these are now on hold as well.

Papua New Guinea recorded a current account surplus of 1.3 per cent of GDP in 1999 compared with a deficit of 0.5 per cent of GDP in 1998. As noted earlier, the large surplus on the trade balance combined with a surplus on the transfers account more than offset the deficit in the invisibles account. The marked deterioration in confidence had culminated in substantial capital flight with foreign exchange reserves falling by mid-1999 to just two weeks of import spending. Along with the new government, relationships with bilateral and multinational donors as well as resumed private capital inflows, mostly in the mineral resources sector were restored. Nevertheless, a deficit of $123 million was recorded in the capital account in 1999 although a surplus of $30 million was expected for 2000. External debt servicing has been growing steadily in recent years, reaching 2.7 per cent of GDP in 1999; public-sector debt accounted for around half of the outstanding obligations.

In Samoa, official flows by far dominated capital account transactions. Two major projects to improve the education system and rural water supply, funded respectively by ADB ($7 million) and the EU ($50 million), will boost domestic economic activities, including those from the local providers of goods and services, and revenue prospects in the medium term. On the other hand, money laundering is posing a new and growing threat to financial institutions in many Pacific island countries. A Money Laundering Prevention Act, passed in June 2000, resulted in the seizure of $14 million in September (see box II.2). The balance of payments turned into a deficit equivalent to 3 per cent of GDP in 1999, compared with a surplus of 3.7 per cent in 1998, primarily because of increased private-sector imports in response to a higher level of economic activities. Foreign reserves remained healthy at $65 million in 2000 and were adequate to cover more than six months of import expenditure. At the same time, external debt was manageable at $68 million as of 1998; this amount was about 74 per cent of GDP and some 70 per cent of such obligations were held by the public sector.

Capital flight caused by the ethnic tensions in 1999 transformed a capital account surplus of $18.4 million in Solomon Islands in 1998 into a deficit of $22.3 million in 2000, in spite of higher official inflows in support of the reform programme; a steady deficit of $22 million was expected for 2000. On the other hand, the country had recorded a balance-of-payments surplus for some years so that the level of foreign reserves had gone up from under $17 million in 1994 to almost $57 million (or five months of import cover) by the third quarter of 1999. Reserves have recently been depleted, dropping to $37.5 million in 2000. The outstanding external debt reached $165 million, or 47 per cent of GDP, at the end of 1999 although the burden of debt servicing was about 2.7 per cent of GDP. Almost three quarters of such obligations lies within the public sector with official external arrears, amounting to $10.8 million at the end of 1999. This continued to be a problem. These arrears were reduced early in 2000 as part of the reform programme being supported by multilateral institutions.

Box II.2. Efforts to curb money-laundering activities in Pacific island countries

Money laundering comprises endless variations on a simple theme: taking money earned in illegal activities and moving it through one or more transactions so that it looks legal. Once cleansed, the funds can easily be spent on legitimate deals, such as real estate or stock. The illegal means could be in the form of illegal arms sales, smuggling, and the activities of organized crime syndicates including, for example, drug trafficking and running prostitution rings.

The problem of money laundering began to be taken seriously in the 1980s when organizations such as the United Nations and the Basel Committee on Banking Supervision started looking into the problem. But it was not until the Financial Action Task Force on Money Laundering (FATF) was set up by the Group of Seven (G7) in 1989 that coordinated action really began. One of the first tasks of FATF was to spell out a number of measures, that became known as the "Forty Recommendations" which national governments should take to combat money laundering. They cover the criminal justice system and law enforcement, and the financial system and its regulation. In addition, the European Union and the Organization of American States have also established antimoney-laundering standards for their members while the Caribbean, Asian and Eastern European countries have created regional FATF-type groupings. As a result, some countries have adopted measures against money laundering. However, the problem has by no means been resolved.

FATF announced, in June 2000, a blacklist of 15 countries as " non-cooperative" in the global fight against money laundering. Included on this list are four Pacific island countries, the Cook Islands, the Marshall Islands, Nauru and Niue. Palau, Samoa, Tonga and Vanuatu have also been cited in the past.

Countries blacklisted by FATF have been subjected to sanctions. For example, Western banks, such as Deutsche Bank and Bankers Trust, did not permit any dollar-denominated transactions in Nauru, Palau and Vanuatu in 1999 in the wake of a United States Government investigation into how illicit money was laundered through the Bank of New York and Nauru. Similar sanctions were imposed on Niue by the United States banking system in January 2001 when Niue gave a law firm in Panama the exclusive right to register "international business companies" in the country in return for around $1.6 million a year, which is a substantial portion of Niue's budget. Thus, money laundering can pose significant risks to an economy. The potential macroeconomic consequences of money laundering include inexplicable changes in money demand, prudential risks for banks, contamination effects on legal financial transactions, and volatile capital flows and exchange rates owing to unanticipated cross-border asset transfers. There are social and political dimensions as well; it can lead to the overall weakening of the social fabric and collective ethical standards.

Some Pacific island countries have taken several initiatives in recent years to address this problem. At the national level, several of them, including the Cook Islands, Niue, Samoa and Vanuatu, have recently enacted money-laundering legislation. The recent seizure of $4 million by authorities in Samoa, which was part of a $14 million fund belonging to a group of American Samoan businessmen, partly indicates the success of some Pacific island countries in combating this problem. The Government of Samoa confiscated the funds after the group tried to transfer $4 million to the United States. This followed a joint collaboration between the United States Federal Bureau of Investigation (FBI) and the Attorney General's office in Samoa which proved that the funds were connected to money-laundering activities. At the subregional level, the issue of money laundering has been discussed widely. For example, police chiefs from Pacific island countries met in New Zealand in October 2000 and agreed that the Pacific subregion was being increasingly targeted for money-laundering activities. The meeting among other things, discussed the importance of establishing financial intelligence units, with the aim of monitoring financial and investment schemes to ensure their legality. It also discussed the impact of the Internet on criminal activities in the subregion. The meeting underlined the complexity of electronic crime and the need for governments to interact and create a legislative framework for security purposes.

Pacific island countries are also cooperating with relevant agencies at the global level to combat money-laundering activities. For example, several of them attended the conference jointly organized by OECD and the Commonwealth Secretariat in January 2001 in Barbados to discuss money laundering and related issues. The meeting established a joint working group comprising representatives of the Commonwealth Secretariat, the Caribbean Community, the Pacific Islands Forum and the OECD countries and territories. The working group, which is co-chaired by Australia and

(Continued overleaf)

(Continued from preceding page)

Barbados, has 12 members of which two, the Cook Islands and Vanuatu, are from the Pacific subregion. This group met in London in late January 2001 and identified a number of areas of agreement in relation to the need for dialogue and cooperation. However, the meeting ended with an acknowledgement that further work was needed to achieve a mutually acceptable process and the creation of a truly inclusive global forum. The group will hold its second meeting in Paris in March 2001. Meanwhile, Japan, in cooperation with OECD, hosted another meeting in Tokyo in February 2001 to discuss the harmful tax practice issues. The Tokyo meeting resolved that Pacific island countries would ask OECD to agree to the same level of constructive dialogue with non-OECD members as it had given its own members.

It is of the utmost importance for the international community to work closely with the affected countries as they endeavour to curb money-laundering activities. Apart from raising awareness of the problem within both the government and the private sector, technical and financial assistance should be provided to these countries to establish the necessary legal and regulatory tools and develop administrative competence to combat the problem. It is also important for governments to ensure prudential supervision of the financial sector. One of the major requirements is for financial institutions to know their customers. They should not operate anonymous bank accounts and should take steps to identify the customers when transactions are carried out on behalf of third parties. Financial institutions should also pay particular attention to large, complex or unusual transactions, and report any suspicions to the authorities charged with tackling money laundering. The supervisory authorities should ensure that all financial institutions have adequate programmes in place to guard against money laundering.

Tonga's capital account surplus of $5.2 million in 1999 was expected to reach almost $6 million in 2000. Aid and concessional loans dominate capital account transactions as inward FDI has been comparatively limited. Foreign reserves of $21 million at the end of 1999 were adequate to finance three months of import spending. The large wage increase granted to public servants could put pressure on the balance of payments, and hence on the reserve level, unless efforts are made to contain a budget deficit blow-out. External debt servicing averaged $3.9 million over the period 1999-2000; the amount was equivalent to 2.5 per cent of GDP and 30.5 per cent of earnings on merchandise exports.

Allegations of money laundering against some financial institutions in Vanuatu prompted an outflow of funds from the banks in 1998. Even though the trend was reversed in 1999, some outflows were again recorded in the first half of 2000 as banks placed some of their assets offshore. Vanuatu's traditional capital account surplus reached almost $29 million, or 12 per cent of GDP, in 1999 with virtually the whole amount being the result of net official capital inflows. Foreign reserves, at $43 million or more than six months of import cover, at the end of 1999 remained at a healthy level despite a steady decline in 2000.

Fiscal and financial developments

The fiscal position in Fiji deteriorated considerably, from a surplus of 4.6 per cent of GDP in 1998 to a shortfall of 0.7 and 4 per cent respectively in the following two years as revenue declined along with higher spending on the security forces and on rehabilitation. The falling level of debt (from 58 to 54 per cent of GDP between 1997 and 1999) will again be on an upward trend. Foreign debt accounted for 31 per cent of the total debt in 1999. Among the responsive stabilization measures was an expenditure reduction strategy encompassing a reduction of 12.5 per cent in salaries and wages for public servants, of 20-30 per cent in operating and other grants, and of 30 per cent in capital spending. However, a reversal through ad hoc arbitration of the salary cut is expected to cost an extra F$10 million with the attendant pressure on the fiscal position. Other policy initiatives included budgetary support to indigenous Fijians for increased participation in commerce and government, tax and duty concessions to exporters, and a $2 million grant for inward tourism promotion. Meanwhile, the tight monetary policy stance proved reasonably effective in controlling foreign exchange transactions and restraining capital flight in the aftermath of the coup in the second half of 2000, as was discussed

earlier. Money supply (M2) growth also decelerated sharply to under 7 per cent for the first nine months.

In Papua New Guinea, the budget deficit, which increased significantly in 1998, stabilized at around 2 per cent of GDP over the period 1998-2000, but total debt servicing has become an increasing burden and was equivalent to almost 4 per cent of GDP in 1999. Among the new tax measures were higher excise rates and the introduction in July 1999 of a value-added tax to pay for a reduction in tariff rates in line with WTO and Asia-Pacific Economic Cooperation commitments. However, the lack of capacity to enforce compliance may lead to shortfalls in projected revenue collection from the new measures. At the same time, tighter controls on spending were enforced along with the concerted promotion of domestic competition and a sweeping programme of privatization, with proceeds from the divestiture of the government bank, the national airline and the utilities being used to retire government debt. Monetary policy remained relatively tight to bring down inflation and to stabilize the currency; M2 grew at significantly less than the inflation rate over the period 1998-2000. However, a deterioration in investor confidence to mid-1999 and high interest rates lowered the volume of lending to the private sector as a share of GDP considerably. The trend should be reversed in future years, with nominal interest rates steadily coming down, a stable exchange rate and improved investor confidence from 2000.

Samoa was able to realize a budget surplus for several years, thus maintaining a macroeconomic environment both stable and highly conducive to private investment. The privatization programme, begun in 1999, was on track with further divestiture to take place in 2000. However, there were increased outlays on education and health, together with a higher public-sector wage bill. On the other hand, taxes on exports and dividends were abolished along with a reduction in corporate tax rates (from 35 to 29 per cent), in tariffs (to a maximum of 20 per cent), and in taxes on equipment and raw materials. Largely as a result, the budget surplus of 0.3 per cent of GDP in 1999 was transformed into a comparatively large deficit of 5 per cent in 2000. A cautious monetary stance contributed much to domestic price and financial stability; inflation being 2.2 per cent or lower during the period 1998-2000. M2 has expanded moderately, with private-sector credit going up at a faster rate, for example, by 16 per cent in 1999. The composition of such credit shifted away from personal loans and manufacturing sector credit to the primary sector and to a wide range of services, including construction, trade, transport and communications, and business services.

In Solomon Islands, the large fiscal deficits of the earlier years were significantly reduced to an average of less than 2 per cent of GDP during the period 1998-1999, compared with 4.6 in 1997. Tax revenue increased in 1999 mainly because of improved receipts from import taxes and higher tax revenues from log exports; the improvement owed much to an upgrading and tightening of customs procedures as part of an extensive reform programme. However, with the civil unrest, the budget shortfall was again on an upward trend, reaching an estimated 4.5 per cent of GDP in 2000, despite tighter expenditure controls. Attention is also being focused on the privatization of state-owned enterprises, including those in manufacturing, forestry and agriculture. The financial system, which had been greatly burdened by poorly performing government debt, was considerably strengthened with the reinstatement in early 1999 of the government securities market, while $40 million in frozen treasury bills were successfully converted to medium-term bonds. By and large, M2 was growing relatively slowly, reflecting the improved fiscal position, especially in 1998 (by just 2.5 per cent) and 2000 (by 1 per cent as of September). Indeed, there could be some degree of monetary contraction later in the year in line with the sharp decline in industrial and service sector output, and hence GDP, as a result of the civil unrest in the country.

The fiscal position also improved sharply in Tonga where the budget shortfall had reached 4.3 per cent of GDP in 1998; a surplus of 1 per cent was realized in the following year mainly because of under-spending in the development allocation. A budget deficit of 0.7 per cent of GDP was expected for 2000, but the shortfall could be larger in the next year because of the 20 per cent pay rise granted to civil servants with no changes being made for compensatory revenue-raising measures. Tax revenue, amounting to around 16 per cent of GDP in 1998, is mostly based on import duties. Development expenditure is mainly supported by ODA inflows and government outlays are set to increase if the plan to

develop Tonga's own university is to proceed in place of the currently shared funding of the University of South Pacific in Fiji. Interest rates have remained unchanged over recent years although this may change in 2001, given the moderately rising trend in inflation. The stated policy is to keep real deposit rates positive. M2 grew by almost 12 per cent in 1999 mainly owing to an expansion in private sector credit; lending to agriculture went up strongly but the sector remains a minor recipient in the commercial bank lending portfolio.

Vanuatu also registered a marked improvement in the fiscal position with the budget deficit falling to an average of 1.5 per cent of GDP during the period 1999-2000, compared with 6.7 per cent in 1998. A low level of shortfall was possible in 2000 because a lower tax revenue, 17.8 per cent of GDP (due to a reduction in turnover taxes on financial transactions), was offset by falling current spending to 20.5 per cent. This was largely the result of planned reductions in salaries and transfers. Monetary conditions were eased in response to the slowdown in economic activities in the second half of 1999 so that M2 expanded year-on-year by 1.5 per cent in the first quarter of 2000. This stance was reversed in June, and the money supply contracted by 8.3 per cent by September 2000, compared with a contraction of 9.2 per cent in 1999.

ODA has been comparatively much more important to the fiscal position and, for that matter, to economic activities in the smaller Pacific island economies. In Cook Islands, government finances were strengthened in 1999 through both operating and overall surpluses. The debt-service burden was eased after the restructuring of external debt in September 1998. Interest payments were modest at 12 per cent of tax revenue and the debt stock was equivalent to 78 per cent of GDP. The 2000 budget aimed at a balanced operating account, with revenue to rise by 9 per cent and operating expenditure by 15 per cent.

There were fiscal surpluses in Kiribati in 1995 and 1997-1998 but a deficit, equivalent to 32 per cent of GDP, emerged in the 1999 budget largely because of lower fishing license fees, $A13 million in 1999 compared with $A43 million in 1998. External concessional loans financed about one fourth of the deficit, the remainder being covered by the Consolidated Fund (44 per cent) and the Revenue Equalization Reserve Fund (31 per cent).

In Tuvalu, the projected budget deficit (24 per cent of GDP) became a surplus in 1999 because capital expenditure was 32 per cent below the appropriated level. The 2000 budget provided for an increase of 15 per cent in revenue, mainly from the Tuvalu Trust Fund and external grants, and a substantial rise of 72 per cent in operating expenditure; the rise was to meet projected higher expenditure on personnel, goods and services. Contributions to the Falekaupule Trust Fund, established in late 1999 with ADB loans, community contributions and matching government grants, were expected to reach a capital base of $A14.6 million in 2000, thus generating an annual amount of some $A0.6 million to finance outer island development projects.

Under the Compact of Free Association with the United States, Marshall Islands was provided with an annual block grant during the period 1986-2001, with $40 million a year in the final five years. Public finances have been considerably strengthened through major reforms involving the rationalization of several ministries, a reduction of one third in the number of government employees between late 1995 and March 1999, an extended wage freeze, and a reduction or elimination of subsides to state enterprises. Parallel efforts have also been made to strengthen the tax system. The consequent, large drop in recurrent and capital expenditure contributed to the budget surpluses over the period 1996-1998. However, a deficit of $9 million (or about 9 per cent of GDP) in 1999 resulted from overspending and revenue shortfalls emanating from the reduction in import duty from 12 to 5 per cent.

In the Federated States of Micronesia, grants under the Compact of Free Association with the United States accounted for 47 per cent of total government revenue, while tax collections provided just 14 per cent. Extensive reforms have been carried out in anticipation of reduced Compact funding, including public-service downsizing and public-enterprise rationalization, so that government expenditure went down from 80 per cent of GDP in 1993 to 70 per cent in 1998. The large bulk of operating expenditure (some 85 per cent), however, continued to be accounted for by outlays on wages and travel. Meanwhile, external debt continued to decline to 38 per cent of GDP in 1999, compared with 66 per cent in 1993. The debt-service ratio, at 25 per cent of export earnings in 1999, is projected to reach just 3 per cent by 2002.

Policy issues and responses

As noted earlier, ODA plays a crucial role in sustaining the economic and social development process in many small Pacific island economies, and so does the public sector. The private sector is weak because there is no minimum critical mass for economies of scale and scope, particularly in the so-called "micro-island" economies. Many of these small islands have initiated and implemented forcefully a series of economic, structural and administrative reforms, and liberalization and deregulation measures in recent years, often with the assistance and close collaboration of multilateral agencies and bilateral donors. There have been credible, positive gains from such reform efforts, including improved governance and reduced mismanagement, better public-sector cost-efficiency and productivity, and a larger role for the private sector in domestic economic activities.

It is important that the multidimensional, long-term social consequences arising out of some of these initiatives be given due attention. To begin with, most island countries, both large and small, do not have adequate social safety nets to cater for the large number of employees adversely affected by various downsizing and rationalization measures within the public sector. The informal, but strong, traditional cultural bonds have provided some measure of social protection but this is, at best, a transitory solution. Such bonds are being gradually eroded by cultural changes, overseas migration and urbanization. The high incidence of law and order problems and serious ethnic conflicts and civil unrest in several parts of the Pacific are perhaps symptomatic of the rising social tensions.

Inward remittances from Pacific islanders living and working overseas have been an important source of income and foreign exchange in many island economies, both large and small. These flows will continue for the near future but, again, they cannot be counted on over the longer term. There are increasing difficulties for overseas migration to the traditional recipient countries. Moreover, as the early migrants retire and are replaced by subsequent generations of their children, the initial strong attachment to the old homeland as well as commitment to send large sums of money to the relatives back "home" tend to diminish or disappear. Economic diversification, one of the frequently mentioned options, is easier said than done in most Pacific islands where the wide range of constraints and handicaps, especially those imposed by small size, lack of natural resources and a trained workforce, land tenure and ownership problems, remoteness and high vulnerability to natural disasters, have long remained binding and formidable.

In the above context, the acute and widespread lack of skilled and semi-skilled human resources reflects, among other things, the inadequate resources devoted to education and training and the low priority placed on secondary and tertiary education and on vocational training in several countries. At the same time, the high rates of overseas migration from certain countries, including Fiji (due to the civil disturbances), Samoa and Tonga, have been possible because of the high investment in education made by them. The socio-economic cost of depletion of the already scarce human resources base to local development efforts is high, notwithstanding the large flows of inward private transfers so far received. A related issue in this connection is the need to invest adequate resources in the development and maintenance of ICT infrastructure and related human resources development. In fact, the South Pacific Forum, at its thirtieth meeting held in Palau in 1999, adopted a "Vision for the Pacific Information Economy". Donor countries and agencies are urged to work closely with island countries to enable them to access and use ICT to promote ongoing learning from the global store of knowledge as well as to better exploit global market opportunities for the development of their economies.

Indeed, Tuvalu has gained valuable resources with the leasing of its internet domain ".tv". The country, one of the five least developed countries in the Pacific subregion, has relied almost entirely on external resources, and not trade, for its socio-economic development as the export-oriented agricultural sector is virtually non-existent. Such external resources include principally ODA, inward private remittances, especially from Tuvaluan sailors working on overseas vessels, and rental returns through fishing and fishing licensing. In addition to the Tuvalu Trust Fund, established in 1987, the country has successfully created another innovative financing scheme through the use of its Internet suffix, ".tv", to earn much-needed foreign exchange. In 1998, Tuvalu signed over the rights for its ".tv" Internet

suffix name to a Canadian firm and, in return for permission to use the name, Tuvalu was guaranteed $50 million over a 10-year period plus a 15 per cent stake in the company selling rights to domain names ending with ".tv".

About 170,000 organizations have registered a domain name ending with ".tv", and the additional quarterly income of some one million United States dollars is starting to change the lives of the country's 10,600 inhabitants. The deal has effectively doubled the income of Tuvalu and the extra resources are being used to build infrastructure, including roads, electricity transmission networks in outlying islands and new schools. The airport was also extended to accommodate Boeing 737 aircraft, thus making it possible for Tuvalu to export seafood for the first time. The money earned from the deal has also been used to meet the annual membership obligation of $20,000 of the United Nations; Tuvalu became the 189th member in September 2000.

In addition to ODA and inward private remittances, tourism has long been an important foreign exchange earner for many island economies in the Pacific; the subregion still enjoys a considerable comparative advantage in tourism. Nevertheless, the industry itself is highly susceptible to the contagious ripple effects from negative publicity arising from the political instability and civil unrest in Fiji and Solomon Islands. Around one million tourists visit the various Pacific islands a year but, according to the South Pacific Tourism Organization, the number will fall off considerably as the subregion has been unfairly and indiscriminately painted as unstable. Likewise, many investors and market participants have become nervous about development prospects in the subregion.

It is true that some islands have benefited considerably from the recent diversion of the tourist flows away from the trouble spots. But such a short-term diversion is purely transitory, given the zero-sum nature of this gain. In the long term, growth in inward investment and in tourism hinges largely on stable and sustainable economic growth and social advancement in the subregion as a whole. Meanwhile, however, island economies will have to monitor closely and be well aware of the harmful, long-term impact of certain activities and schemes from fly-by-night investors and from money laundering operations in their concerted pursuit of innovative measures to raise fiscal revenue and investment resources. There are several examples of serious financial damage caused by fly-by-night investors while money laundering is posing a new threat to the financial integrity of many island countries. It is thus encouraging that both issues are being discussed widely at the subregional level and that legislation against money laundering has been put in place in several countries to deal with this new threat (see box II.2).

North and Central Asia

This subregion displayed, by and large, the best economic performance in recent years. The recovery process, which had started in 1999, strengthened further in 2000 thanks to the robust global economy, solid economic growth in the Russian Federation, and the stable demand for and favourable prices of major subregional export products. There are several net exporters of oil and gas in this subregion. They benefited greatly from the significant rise in the price of oil.

The recovery was accompanied by improved fiscal balance. Notable achievements were also recorded in the area of international trade with the subregional economies continuing to unify customs regulations and tariffs to boost intra-trade among members of the Commonwealth of Independent States (CIS), and to adjust trade policy regimes to prepare for admission to WTO. Indeed, Georgia became the 137th WTO member in 2000, being the second country from the subregion to have joined the world trade body. Likewise, the promotion of subregional economic cooperation continued to receive priority attention. In October 2000, for example, the five member countries of the CIS Customs Union (Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan) decided to upgrade the Union status into the Eurasian Economic Community. Meanwhile, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan approved a two-year action programme to expedite the creation of a single economic entity under the Central Asian Economic Union, and a five-year strategy of economic development and integration.

Two other developments promise improved longer-term prospects for subregional economies: improved tax collection and financial sector reform.

The ongoing fiscal reforms appear to have reduced tax evasion and enhanced tax compliance. This has helped to reduce budget deficits. At the same time, financial sector reforms have been pursued in earnest. The mix of fiscal and financial sector reforms has contributed to lower inflationary pressures and provided a sound foundation for future growth.

Growth performance

Most countries of North and Central Asia registered much stronger economic performance in 2000 than in 1999; GDP expansion was particularly robust in Azerbaijan, Kazakhstan, the Russian Federation, Tajikistan and Turkmenistan. While economic expansion in Kazakhstan was backed by the strong performance of the industrial sectors and growing domestic demand, the economy of Turkmenistan benefited significantly from increased commodity prices and improved market access in the Russian Federation. In other countries of North and Central Asia, such as Armenia, Kyrgyzstan and Uzbekistan, GDP growth was estimated to be about 4-5 per cent in 2000 (table II.8). Cotton remained a major export earner in Uzbekistan. The crop, however, was adversely affected by a severe drought, leading to a decline in export revenue.

In 2000 the Russian Federation registered one of the best economic performances of the last 30 years. The fiscal position was stronger, inflation lower, and the current account surplus much larger than earlier expected. Such an outcome owed much to the sharp upturn in oil prices as well as for several other commodities, and to the impact of the steep devaluation of the rouble in 1998. This positive economic environment, combined with more effective tax collection, has led, in 2001, to a balanced budget for the first time. This striking development originated from an impressive shift in the budgetary position of the Russian Federation, from a deficit of 1.6 per cent of GDP in 1999 to a surplus of 2 per cent during the first eight months of 2000. A large surplus of 6 per cent of GDP is expected for 2001.

The 1999 devaluation of the tenge and sound macroeconomic policy helped strengthen economic performance in Kazakhstan in 2000. After declining by 1.9 per cent in 1998, GDP grew by 1.7 per cent in 1999 and was on course to expand by another 10 per cent in 2000. Apart from higher oil prices and industrial output, the recovery process was also underpinned by a clear commitment of the government to the various stabilization and adjustment measures currently under implementation. These measures included a medium-term strategy of fiscal consolidation, a monetary policy stance with a focus on lowering inflation, further structural reforms directed at promoting private-sector-led growth, and strengthening of the social safety net. As envisaged by the government in its programme for medium- and long-term economic development, GDP was to expand by 32 per cent, and industrial production and investment by 42.5 and 75.2 per cent respectively by 2005. Over the same period, however, inflation was expected to be brought down from 13.2 per cent anticipated for 2000 to 3.6 per cent while the budget deficit would be reduced to 1.3 per cent of GDP from approximately 3.5 per cent in 1999.

Armenia, Georgia and Uzbekistan could not meet their planned target of GDP growth in 2000 owing largely to a severe drought. Uzbekistan registered a dramatic slowdown in agricultural output, with a contraction of about 1 per cent in 2000 from a 6 per cent increase a year earlier. The agricultural sectors of Azerbaijan and Tajikistan were also severely affected by drought, resulting in a shortfall in grain supplies. However, oil production plus sizeable foreign investment in this sector enabled the economy of Azerbaijan to continue its strong expansion. Despite the drought and difficult external environment, GDP in Tajikistan increased by 8.3 per cent, an outcome facilitated considerably by a strong surge of 10.3 per cent in industrial production in 2000.

Turkmenistan recorded an outstanding performance in GDP in 2000, driven mostly by the gas and light industries whose output jumped by 83 and 18 per cent respectively in the first nine months of 2000. Agricultural production also grew solidly by 27 per cent during the same period. Kyrgyzstan overcame the consequences of the slowdown of 1998 and the recovery process continued in 2000. GDP rose by 5.1 per cent in 2000, while the national currency lost only 6.7 per cent in exchange value over the first 10 months of the year, compared to 46 per cent during the first 10 months of 1999. The budget deficit, which amounted to 864.6 million soms ($10.8 million), the equivalent of 2.5 per cent of

Table II.8. North and Central Asian economies: growth rates, 1997-2000

(Percentage)

		Rates of growth		
		Gross domestic product	*Gross agricultural output*	*Gross industrial output*
Armenia	1997	3.3	−6.0	8.2
	1998	7.3	13.1	−2.1
	1999	3.3	1.0	5.2
	2000	4.0	..	4.3[a]
Azerbaijan	1997	5.8	−6.0	0.3
	1998	10.0	6.0	2.2
	1999	7.4	7.0	3.6
	2000	11.3[b]	9.0	6.0
Georgia	1997	11.3	6.5	8.2
	1998	2.9	−8.0	−1.8
	1999	2.9	8.0	7.4
	2000	−0.2[c]	..	6.2[a]
Kazakhstan	1997	1.7	−0.8	4.1
	1998	−1.9	−19.0	−2.4
	1999	1.7	28.9	2.7
	2000	10.5[c]	−1.0	14.6
Kyrgyzstan	1997	9.9	12.2	39.7
	1998	2.1	2.9	5.3
	1999	3.6	8.7	−1.7
	2000	5.1	9.6[d]	10.3[b]
Russian Federation	1997	0.9	1.5	2.0
	1998	−4.9	−13.2	−5.2
	1999	3.2	2.4	8.1
	2000	7.6	5.0	9.0
Tajikistan	1997	1.7	3.6	−2.0
	1998	5.3	6.5	8.2
	1999	3.7	4.0	5.6
	2000	8.3	12.4	10.3
Turkmenistan	1997	−11.4	20.6	−32.3
	1998	5.0	24.4	0.2
	1999	16.0	26.0	15.0
	2000	17.6	27.0[c]	18.0[c]
Uzbekistan	1997	5.2	4.0	4.1
	1998	4.4	4.0	3.6
	1999	4.4	6.0	6.1
	2000	5.0	−1.0	6.4[c]

Sources: ESCAP, based on ECE, *Economic Survey of Europe 2000*, No. 1 (United Nations publication, Sales No. E.00.II.E.12) and *Economic Survey of Europe 2000*, No. 2/3 (United Nations publication, Sales No. E.00.II.E.28); and The Economist Intelligence Unit, *Country Reports*, various issues, 2000.

Note: Data for 2000 are estimates.

[a] January-October.
[b] January-November.
[c] January-September.
[d] January-June.

GDP in August 2000, was expected to be eliminated by 2003. Meanwhile, industrial production and foreign trade earnings increased by 10.3 and 10 per cent respectively in the first 11 months of 2000.

At the microeconomic level, industrial output and fixed investment grew in all the economies of North and Central Asia in 2000. Industrial output increased by 9.0 per cent in the Russian Federation in 2000. Among the high performing sectors were light manufacturing, microbiology, printing and ferrous metallurgy industries. Most of the other countries also recorded high industrial growth.

Notwithstanding such achievements in industrial expansion, an issue of ongoing concern is the lack of structural diversification as the degree of reliance on commodities and commodity processing had not changed noticeably in many countries of the subregion. In Kazakhstan, for example, the main sectors registering significantly higher levels of value added were metals and hydrocarbons, and the processing of oil products, ferrous and non-ferrous metals. In particular, output of the mining sector grew by over 21 per cent, that of the iron and steel industry by 25 per cent, and that of the non-ferrous metals sector and the oil and gas sector by around 15-16 per cent in the first nine months of 2000. Aluminium remained one of the main foreign exchange earners for Tajikistan and aluminium production went up from 230,000 tons in 1999 to 300,000 tons in 2000; the planned target being 346,000 tons in 2005.

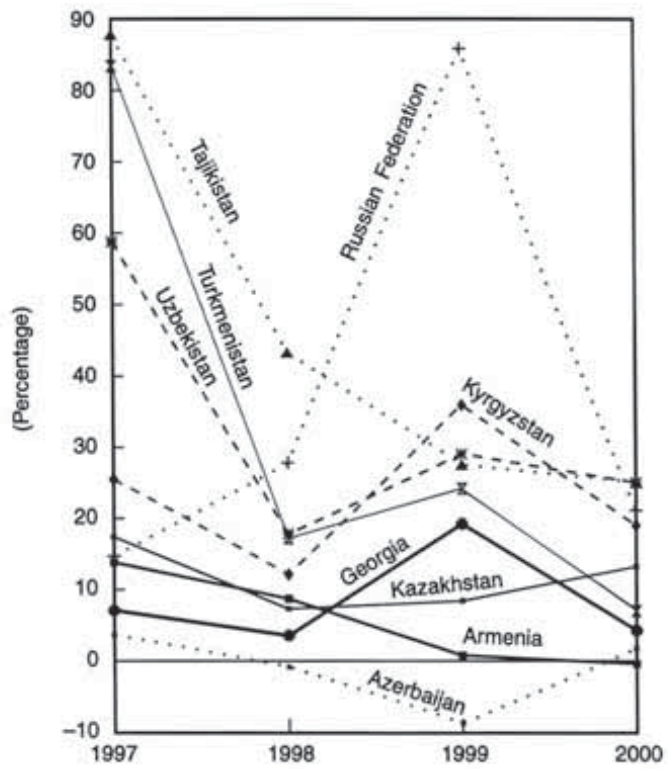
On the other hand, agriculture remained the principal economic engine as well as the major source of employment for most Central Asian countries. Agricultural output was 9.6 per cent higher in Kyrgyzstan during the first half of 2000. As noted earlier, however, agricultural production in several countries was adversely affected by a serious drought that, in particular, destroyed nearly 50,000 hectares of rice field and also resulted in a considerable shortfall in the cotton harvest in Uzbekistan. This was a catastrophe for a country in which agriculture accounted for a major proportion of the economy and a source of export earnings. The drought also led to a grain shortage in Georgia and Tajikistan as their grain harvests in 2000 were estimated about 42-45 per cent lower than in 1999. Other countries of the subregion suffering from the effects of the drought included Turkmenistan, where the cotton crop, at 1.03 million tons in 2000, was about 20 per cent lower than in 1999. The grain harvests in Armenia and Kazakhstan, likewise, were estimated to be lower than their respective levels in 1999. In Tajikistan, the cotton crop of 300,000 tons in 2000 was higher than the 230,000 tons produced in 1999 but was much below the planned target of 500,000 tons. The shortage of fuel and lubricants in Kazakhstan contributed to a somewhat lower grain harvest of about 13 million tons in 2000, compared to 14.2 million tons in 1999. In contrast, the Russian Federation experienced a bumper yield of 72 million tons in 2000, compared to 54.7 million tons in 1999 and 47.8 million tons in 1998.

Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan made further progress in developing their oil and gas sectors in 2000, as reflected in greater output, increased exports, and higher levels of value added in ancillary services such as storage and transportation of crude oil and gas. Oil production grew by 2.8 per cent in Azerbaijan in the first nine months of 2000. Meanwhile, in Kazakhstan the opening of a new export route by the Caspian Pipeline Consortium through the pipeline network of the Russian Federation is expected to raise the country's oil production from the anticipated level of 30 million tons in 2000 to 37-40 million tons in 2001. Similarly, the construction of the Trans-Caspian Pipeline from Turkmenistan to Turkey, via Azerbaijan and Georgia, was expected to increase considerably the gas sales of Turkmenistan. The Russian Federation's oil and gas sector accounted for about 10 per cent of GDP and 40 per cent of export earnings in 2000. Revenue from this booming sector helped fill the state budget through bigger tax returns and higher proceeds from the government equity stake in the sector itself.

Inflation

The economies of North and Central Asia have attempted to control and lower their inflation since 1992; a large number of these economies succeeded during the period 1998-1999 in driving inflation down to a more manageable level and the momentum of improvement is likely to be sustained in the future (figure II.3). In fact, the estimates for 2000 indicate that most of the economies recorded lower inflation rates than in 1999. For example, inflation in the Russian Federation was expected to

Figure II.3. Inflation rates of selected North and Central Asian economies, 1997-2000



Sources: ECE, *Economic Survey of Europe 2000,* No. 2/3 (United Nations publication, Sales No. E.00.II.E.28); and The Economist Intelligence Unit, *Country Reports,* various issues, 2000.

Notes: Data for 2000 are estimates. Inflation rates refer to changes in the consumer price index.

be about 21 per cent, compared to a rate as high as 86 per cent a year earlier (table II.9); it is expected to drop further to 11 per cent in 2001. The declining trend in price pressures was well illustrated by an inflation rate of 16.5 per cent for the first 10 months of 2000, compared to 33.2 per cent for the same period in 1999. Moreover, the prices of a basket of 25 basic food products were only 5.6 per cent higher in October 2000 than in January 2000. In Kazakhstan, year-on-year consumer price inflation slowed from 20.7 per cent in March 2000 to less than 10 per cent in September 2000; it was expected to average 13 per cent for 2000 as a whole.

In Kyrgyzstan, for example, price increases averaged 5.3 per cent for the first seven months of 2000, although inflation was expected to reach 19 per cent by the end of 2000 because of higher prices for food and utility services, especially telecommunications charges. The reduction of fiscal imbalances in Azerbaijan contributed to an expected inflation rate of less than 2 per cent for 2000. In fact, there were some deflationary pressures between May and August 2000, a phenomenon also experienced by several countries in other ESCAP subregions, especially in 1999. The stability of the national currency, the lari, helped slow inflation in Georgia, with price increases totalling only 0.4 per cent during the first eight months of 2000; however, inflation was expected to edge up to 4.3 per cent by the end of 2000 as a result of higher food prices. Year-on-year inflation amounted to about 22 per cent in Tajikistan and Uzbekistan during the first eight months of 2000, and provisionally to around 25 per cent for the year as a whole. In Uzbekistan, inflationary pressure partly originated in a 40 per cent

Table II.9. North and Central Asian economies: budget balance, current-account balance and inflation, 1997-2000

(Percentage)

		Budget balance (percentage of GDP)	*Current account balance (percentage of GDP)*	*Inflation rates*[a]
Armenia	1997	−4.7	−18.8	13.8
	1998	−3.2	−21.3	8.7
	1999	−6.1	−16.6	0.8
	2000	−4.5	−21.0	−0.4
Azerbaijan	1997	−2.8	−23.1	3.7
	1998	−2.0	−30.7	−0.8
	1999	−2.8	−15.0	−8.6
	2000	−2.4	−3.0	1.8
Georgia	1997	..	−7.6	7.1
	1998	..	−11.9	3.6
	1999	..	−7.1	19.2
	2000	..	−3.1	4.3
Kazakhstan	1997	−3.8	−3.6	17.4
	1998	−4.2	−5.5	7.3
	1999	−3.5	−1.1	8.4
	2000	0.0	5.2	13.2
Kyrgyzstan	1997	−5.2	−7.8	25.5
	1998	−3.0	−23.2	12.1
	1999	−2.5	−15.2	35.9
	2000	−2.0	−13.6	19.0
Russian Federation	1997	−7.3	0.6	14.7
	1998	−5.1	0.4	27.8
	1999	−1.6	13.7	85.8
	2000	2.0[c]	17.6	21.1
Tajikistan	1997	−3.3	−6.1	87.8
	1998	−3.3	−8.1	43.3
	1999	−4.8	4.4	27.5
	2000	−2.2	−1.8	25.0
Turkmenistan	1997	0.0	−21.6	83.4
	1998	−2.6	−33.0	17.2
	1999	0.9	−21.4	24.1
	2000	−1.8	2.4[b]	7.0
Uzbekistan	1997	−2.5	−4.0	58.8
	1998	−2.3	−0.3	17.8
	1999	−3.2	−2.5	29.0
	2000	−4.1	−1.3	25.0

Sources: ESCAP, based on ECE, *Economic Survey of Europe 2000*, No. 1 (United Nations publication, Sales No. E.00.II.E.12) and *Economic Survey of Europe 2000*, No. 2/3 (United Nations publication, Sales No. E.00.II.E.28); and The Economist Intelligence Unit, *Country Reports*, various issues.

Note: Data for 2000 are estimates.

[a] Referring to percentage changes in the consumer price index.
[b] January-June.
[c] January-August.

rise in pensions and government wages introduced in August 2000. A stable exchange rate, low food prices and weak consumer demand in Armenia could result in a deflation of 0.4 per cent in 2000. However, the inflation rate in that country was expected to be positive again in 2001 because of higher oil and food prices. Some deflationary tendency was also reported in Turkmenistan in the first seven months of 2000, an outcome attributable to extensive price controls and subsidies maintained by the government. Inflation, however, was expected to be 7 per cent in 2000, owing to the rise in money supply and food imports.

Trade and exchange rates

As indicated previously, the economies of North and Central Asia have made considerable progress towards trade liberalization over the past few years; among the measures involved were the elimination of state monopolies on foreign trade, a relaxation of licensing requirements, and the implementation of significant tariff reforms. However, progress toward trade liberalization has been uneven across the subregion. The progress was more pronounced in Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan, while it was more gradual in Turkmenistan and Uzbekistan. The former group of four countries had been able to establish and maintain a relatively open and liberal trade regime; they had also undertaken measures to abolish state monopoly privileges, to unify exchange rates, and to simplify the regulatory and fiscal frameworks governing foreign trade. Regulatory and fiscal reforms included the removal of non-tariff trade restrictions, export duties, the requirement to surrender export earnings and registration of export contracts.

The trade surplus of the Russian Federation was expected to reach $50 billion in 2000 owing mainly to high energy prices. Export earnings, at $48.4 billion in the first half of 2000, were almost two fifths higher than the level of the corresponding period of the previous year; meanwhile, import spending increased by 6.8 per cent and stood at $15.9 billion over the same period of 2000 (table II.10). There was a significant degree of geographi-

Table II.10. North and Central Asian economies: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					*Imports (c.i.f.)*				
	Value (millions of US dollars)	*Annual rate of growth (percentage)*				*Value (millions of US dollars)*	*Annual rate of growth (percentage)*			
	1999	*1997*	*1998*	*1999*	*2000 Jan-Jun*	*1999*	*1997*	*1998*	*1999*	*2000 Jan-Jun*
Armenia	232	-19.7	-5.2	5.4	18.0[a]	802	4.3	1.1	-11.2	11.0[a]
Azerbaijan	929	23.8	-22.4	53.2	200.0	1 033	-17.3	35.6	-4.1	16.0
Georgia	238	20.6	-19.8	23.8	74.0[b]	602	37.4	-6.3	-31.9	6.0[b]
Kazakhstan	5 592	9.9	-16.3	2.9	105.6	3 683	1.4	1.1	-15.3	28.9
Kyrgyzstan	454	19.5	-14.9	-11.6	4.0	600	-15.3	18.6	-28.7	-6.0
Russian Federation	73 225	-0.3	-15.4	-0.1	38.7	31 329	13.2	-15.3	-31.0	6.8
Tajikistan	689	-3.2	-20.0	15.4	19.0[a]	663	12.3	-5.2	-6.7	2.0[a]
Turkmenistan	1 187	-55.3	-20.9	99.8	69.0	1 478	17.0	-14.8	-50.7	35.0
Uzbekistan	2 800	-4.4	-20.1	-9.0	-2.0	3 000	-11.2	-25.4	-9.0	-1.6

Sources: ESCAP, based on Interstate Statistical Committee of the Commonwealth of Independent States, *Statistical Abstract on External Trade of the CIS Countries,* Moscow 2000; and The Economist Intelligence Unit, *Country Reports,* various issues, 2000.

[a] January-July.
[b] January-May.

cal diversification as exports to countries outside CIS soared to $36.2 billion, compared with $18.9 billion in 1999. Kazakhstan also registered a substantial trade surplus of $1.9 billion, or 18 per cent of GDP, in 1999. Booming trading conditions in 2000 contributed to another trade surplus of $1.3 billion in the first six months of 2000. Export earnings totalled $4.2 billion in the first half of 2000, or over 105 per cent higher than the level of the corresponding period of 1999; the import payment for the first six months, at $1.9 billion, was about 29 per cent higher than the previous year's level. Tajikistan's foreign trade earnings for the first seven months of 2000 amounted to $0.52 billion, an increase of 19 per cent over the corresponding period in 1999; aluminium accounted for more than half of such earnings. Import spending of $0.44 billion, meanwhile, registered a more modest expansion of 2 per cent over the same period in 2000. In contrast, foreign trade remained relatively depressed in Kyrgyzstan owing to the lingering effects of the slowdown in 1998. In the first half of 2000, for example, export receipts (at $233 million) were only 4 per cent higher than in the first half of the previous year, while imports (valued at $252 million) were about 6 per cent lower.

In June 2000, Georgia became the 137th WTO member and was the first economy from the Caucasus countries to join the world trade body. However, the country's foreign trade was adversely affected by a poor agricultural harvest and the consequent depletion of grain reserves caused by the drought in 2000. Nevertheless, year-on-year export receipts increased by 74 per cent and imports by 6 per cent, in the first five months of 2000. The trade deficit amounted to $151 million, or 3 per cent lower than in the first five months of 1999. Armenia also encountered similar problems with the depletion of grain reserves. Import expenditure grew by 11 per cent, with grain remaining one of the main import items, in the first seven months of 2000. Export earnings, however, expanded more sharply at 18 per cent in the same period.

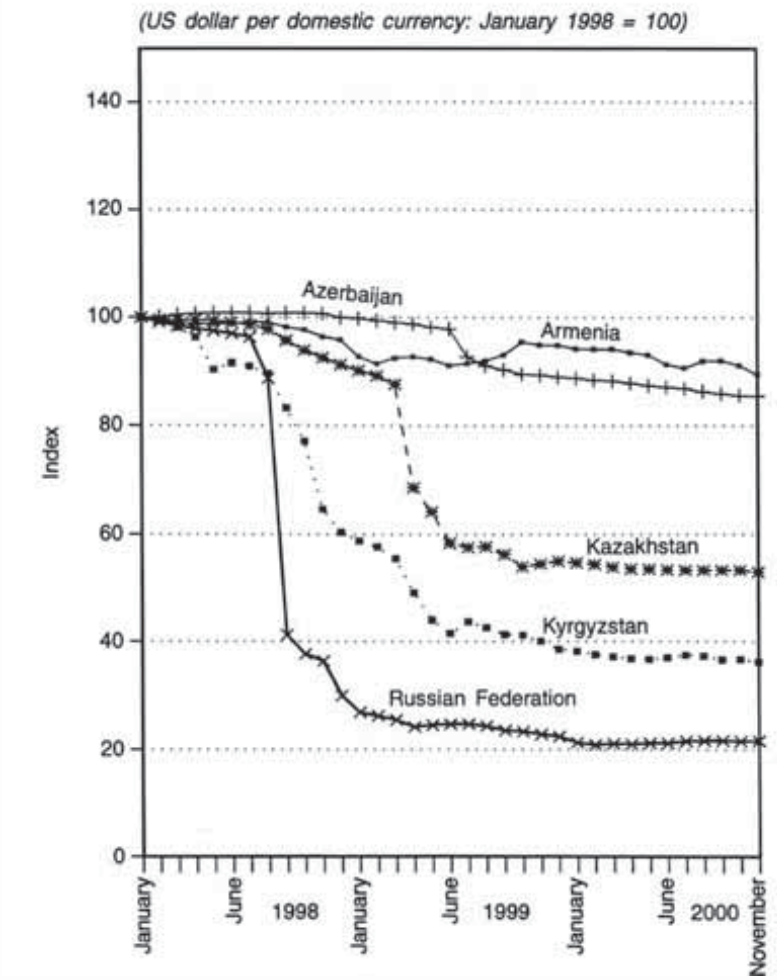
Azerbaijan experienced the most pronounced export boom among the countries of the subregion. Increased volumes and higher prices of the main export commodities, oil and oil products, raised its export receipts by 200 per cent in the first half of 2000, while imports went up by only 16 per cent. Consequently, the current account deficit fell from $485 million in the first six months of 1999 to just $33 million for the first half of 2000. Turkmenistan also registered a larger trade surplus of $227 million in the first half of 2000, up from $2 million for the same period of 1999 owing to higher world prices of gas and the resumption of gas exports to the Russian Federation. Export earnings of $1.12 billion represented an increase of 69 per cent and import expenditure grew by 35 per cent to reach $896 million in the first six months of 2000. The depreciation of the som and higher commodity prices were expected to boost Uzbekistan's export revenue from $2.8 billion in 1999 to $3.1 billion in 2000. However, a poor grain harvest could result in an increase in the imports of grain to meet domestic requirements in 2000.

Oil and gas accounted for almost all the increase in export earnings of Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan in 2000. Oil exports rose 9.5 per cent in the Russian Federation during the first nine months of 2000, compared with the same period of 1999, but fiscal revenue from such exports expanded by 110 per cent in the first nine months of 2000, as a result of rising oil prices and higher export duties on oil products. For example, export duties on fuel oil were raised from 20 to 27 euros per ton, and on oil products (such as gasoline, kerosene and diesel) from 27 to 34 euros ($27.4) per ton in 2000. Export earnings from natural gas, meanwhile, went up by 60 per cent to reach $11.36 billion during the first nine months of 2000, compared with $10.85 billion in 1999. Oil exports from Azerbaijan were expected to double from 4.8 to 9 million tons, yielding more than $1 billion in trade receipts in 2000. Kazakhstan removed the oil export quotas and the limit on production of 22 million tons imposed at the end of 1999 in order to provide local refineries with adequate crude oil, to reiterate its interest in multiple pipeline routes, and to improve the climate for foreign and domestic investment. In 1999, the country produced about 26 million tons of oil, of which over 20 million tons were exported. Oil extraction totalled more than 22 million tons in the first eight months of 2000, an increase of about 15 per cent compared with the same period of the previous year; the production target for the year, however, was 34 million tons of oil and 3 million tons of gas condensate. In Turkmenistan, another resource-rich country in the subregion, natural gas accounted for almost one half of the export earnings in the first five months of 2000.

Trade and economic cooperation continued to feature prominently in the subregion. The five countries of the CIS Customs Union decided to establish a free trade zone with a common tariff, custom and tax policy by 2002. Furthermore, the Union is to become the Eurasian Economic Community with a common currency and broader cooperation among the member countries, including such areas as economic restructuring, the promotion of macroeconomic stabilization, improvements in the investment climate, and adequate food supplies for the community populations. In addition, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan approved a two-year programme of measures to expedite the creation of a single economic entity under the Central Asian Economic Union and a five-year strategy of economic development and integration among themselves.

Rising exports and foreign exchange earnings exerted a stabilizing influence over the exchange values of most currencies within North and Central Asia in 2000 (figure II.4). In Kazakhstan, for example, the exchange rate of the tenge remained stable at around 142 tenges to the United States dollar in the first three quarters of 2000. However, the rate is expected to drift gradually down to 153 tenges to the dollar in 2001. The Russian

Figure II.4. Index of exchange rates of selected North and Central Asian economies, 1998-2000



Source: IMF, *International Financial Statistics*, various issues.

Federation's rouble and the official exchange rate of Turkmenistan's manat held relatively steady against the (appreciating) dollar for the whole of 2000. The average exchange rate of the manat in Azerbaijan was also expected to be stable around the government target of 4,500 manats to the United States dollar in 2000. In Georgia, tight controls over the issue of money helped keep the exchange rate of the lari around 2 lari to the dollar.

On the other hand, the value of the Kyrgyzstan som fell for the first time to more than 50 soms to the United States dollar in 2000 although the exchange value was expected to remain largely the same in the government's economic programme for 2001. The dram in Armenia was also expected to lose about 10 per cent of its value vis-à-vis the dollar in 2000. In Uzbekistan, the unification in May 2000 of the exchange rates of the central bank and the interbank rate meant a de facto devaluation of the som from 150 to 231. However, the so-called "black market" rate of the currency remained approximately three times higher than the unified, official rate. As a response, foreign exchange trading based on market rates was allowed in July 2000.

Capital inflows and outflows

The prospects for larger inflows of external resources, trade-driven FDI, especially into North and Central Asia, became brighter in 2000. Partly as a result, most subregional economies did not resort to IMF loans, which used to be one of the major sources of bridging finance. Only Armenia, Kyrgyzstan and Tajikistan (out of nine countries of the subregion) relied on relatively modest amounts of IMF credit lines which, in a number of instances, represented the conditional disbursement of funds for ongoing programmes. IMF lending to Georgia, for example, was contingent on a cut in government expenditure, the fulfilment of tax collection targets, and structural economic reforms. The release of a $21.5 million tranche from a three-year Poverty Reduction and Growth Facility to Kyrgyzstan was predicated on government efforts to reduce the budget deficit, to rationalize the state investment programme, and to remove obstacles to private-sector development. In the case of Tajikistan, conditions for the final disbursement of a $18 million tranche and a loan worth $51 million under the Growth Facility included continued fiscal and structural reforms and enhanced social protection.

It is noteworthy that Kazakhstan was able to pay off $385 million of the IMF credits drawn over the period 1993-1998 before the due date in 2000; the country also did not make use of a three-year $329 million line of IMF credit arranged in 1999. However, Kazakhstan was expected to receive $850 million from the World Bank in a loan designed to stimulate more broad-based economic growth with the private sector in the leading role; to reform the state sector, including pension, health-care and tax systems; and to ensure better support to the most vulnerable strata of the population by providing an effective social security system. A $20 million line of credit from the World Bank was also extended to Tajikistan in 2000 to modernize agricultural infrastructure, including the development of irrigation systems, and to improve the quality of drinking water. A low-interest loan worth $120 million came from ADB to help finance infrastructure improvements as well as the development of the agriculture, education and health-care sectors for 2001-2003. In 2000, Armenia received a $40 million loan from the World Bank for the upgrading of transport infrastructure, including road and rail bridges, tracks and rolling stock, as well as transport connections with neighbouring Georgia and the Islamic Republic of Iran.

The Russian Federation recorded foreign investment inflows amounting to $12 billion in 2000, compared to about $9 billion received in 1999. FDI was greatly encouraged in the oil and gas sectors through the introduction of new production sharing agreements (PSAs) with leading international oil and gas companies. The new PSAs specified the tax and operating regime for investors; they also simplified considerably the approval of FDI-based project proposals in the oil and gas sectors. Under the existing system, it might take up to eight years to obtain full authorization for a PSA as the process requires the approval of 18 government agencies. For the development of its oil and gas resources, Turkmenistan also relied on the PSA system to promote FDI whose value exceeded $540 million as of July 2000; such investment was expected to reach $7 billion by 2005 and $29 billion five years later. Likewise, the bulk of FDI flows, some 85 per cent, to Kazakhstan was directed to the oil and gas sectors. Such flows had remained sizeable; they amounted to $1.3 billion in 1998, $1.4 billion a year later, and $0.5 billion in the first six months of 2000. Uzbekistan adopted a five-year programme to encourage foreign participation in some 343 joint ventures throughout the various domestic regions. Most

of these joint ventures were in the processing of agricultural products, in light industry and in the manufacture of construction materials.

Reflecting the brightening economic and financial prospects, the stock market of the Russian Federation recovered lost ground to a considerable extent with the return of overseas portfolio investors. The benchmark Russian Trading System (RTS) equity index, which had peaked at 571 in October 1997 and then collapsed to 170 in 1998-1999, went up to 300 in 2000. The volumes of equity trading remained a fraction of the 1997 level, however. In response, the introduction of a corporate governance code was under consideration. It was intended to educate market players on the rules of corporate governance, to provide protection for shareholders' and investors' rights, and to attract additional equity investment. At the same time, government-backed bonds worth $140 million were expected to be sold to foreign investors in order to supplement budget allocations and inject fresh capital into insolvent banks in the Russian Federation in 2000.

More generally, the problem of debt would greatly affect the capabilities of several North and Central Asian economies to implement and sustain programmes of further structural reform and restructuring. The level of Uzbekistan's external debt reached $4.6 billion and the service burden was equivalent to $900 million in 2000. In the case of Turkmenistan, the total debt amounted to 65 per cent of GDP in 1999, but the short-term share of such obligations was three times larger than the value of official reserves. The Russian Federation agreed to be responsible for the foreign debt of the former Soviet Union to the London Club of private sector financial institutions as well as to official bilateral creditors of the so-called Paris Club. In July 2000, $21 billion worth of international bonds were issued as part of a debt restructuring package agreed with the London Club commercial creditors. The new bonds from the Russian Federation were to be exchanged for $32 billion worth of debt owed by the former Soviet Union. The restructured debt was a positive contribution to economic recovery in the Russian Federation. Following this precedent, it is expected that the Paris Club might also provide comparable debt relief. Such relief was important to ensure the success of macroeconomic reform in the Russian Federation, a process which was not only difficult to administer, but also required a massive and long-term commitment of funds.

Fiscal developments

Ongoing, radical reforms designed to raise fiscal receipts and improve the investment climate were implemented in many countries of North and Central Asia in 2000. This has been reflected in a considerable reduction of the budget deficit in most countries of the region (table II.9).

In the Russian Federation, the approved package of tax bills established a flat income tax rate of 13 per cent and eliminated turnover taxes. Lost budget revenue was to be made up through higher excise duties on gasoline and tobacco and through the abolition of numerous tax exemptions granted to companies. A new approach for the reform of tax administration was also undertaken to make it easier for taxpayers to pay. Moreover, certain taxes were combined into a single social welfare tax (of a minimum 5 per cent) to simplify collection and distribution. Budget revenue jumped from 10 per cent of GDP in 1998 to 13.3 per cent in 1999 and further to 17 per cent in the first eight months of 2000; in particular, the tax yields exceeded the estimated target in the third quarter of 2000.

In Kazakhstan, the consolidated budget showed a surplus of $287 million in the first eight months of 2000, largely through a significant rise in tax revenue. Income tax receipts, for example, were 29 per cent higher than the level projected for 2000. The budget deficit for 2000, which was planned to be 3 per cent of GDP, was expected to be considerably less. Rising oil prices and tax receipts boosted budget revenues of Azerbaijan to $395 million in the first seven months of 2000; this amount was $107 million higher than the fiscal receipts for the corresponding period in 1999. In the draft budget for 2001, revenues were envisaged at $900 million, or 17 per cent higher than in 2000, while the expected budget deficit of 2.4 per cent of GDP in 2000 could fall to 2 per cent in 2001. Turkmenistan also recorded a budget surplus of 0.26 per cent of GDP in the first half of 2000 owing to increased tax revenues, particularly in the oil and gas sector. Such receipts were expected to rise further in the second half of the year as a result of new excise duties imposed on alcohol and fuel. However, a high level of government investment and increased salaries for public sector servants could bring about a deficit in the budget to 1.8 per cent of GDP by the end of 2000.

In Georgia, budget expenditure was slashed in June 2000 because of low tax and customs revenue collections; in the first eight months of 2000, fiscal receipts were 10 per cent below the target. Mounting shortfalls in budgeted revenue were also experienced by Armenia; the amount of taxes collected reached only 60 per cent of the planned target in the first nine months of 2000. Compounded by a delay in the release of loans worth $46 million from the World Bank, government spending was expected to slow down by as much as one third in 2000 to curtail the rising budget deficit.

Social programmes accounted for more than half of government expenditure in Kyrgyzstan and, during the first half of 2000, budget expenditure exceeded revenue by 0.5 billion som. The fiscal deficit, equivalent to 2.5 per cent of GDP for the first six months, was expected to be slightly lower at 2 per cent of GDP for 2000 as a whole. Meanwhile, improved tax collections led to an almost balanced budget in Tajikistan in the first six months of 2000. However, the deficit was expected to reach 2.2 per cent of GDP by the end of the year because of additional government spending to relieve the economic hardship caused by the severe drought. Uzbekistan experienced a similar pattern of fiscal outcome; the budget deficit, equivalent to 3.2 per cent of GDP in 1999, is estimated to widen to 4.1 per cent in 2000 as a result of higher wages and pensions provided to public servants to compensate for high levels of inflation.

Money and finance

The Tajik rouble was replaced by a new currency, the somoni, in October 2000. The introduction of the new currency was expected to strengthen the national banking system, to lay the foundation for an independent monetary and fiscal policy, to facilitate the maintenance of macroeconomic stability, to boost economic reform, to develop the real economy, and to raise the quality and competitiveness of industrial and agricultural products. The Tajik rouble had been set at 50 to the United States dollar in 1995 when it was introduced; its exchange value fell to 2,400 in 2000. The new currency was worth 1,000 Tajik roubles. The somoni was expected to lay the foundation for the formation of a national monetary and credit system in Tajikistan.

Large inflows of foreign exchange boosted by more than 40 per cent the monetary base in the Russian Federation during the first nine months of 2000; the money supply (M2) reached the equivalent of 16 per cent of GDP in the fall of 2000. Nevertheless, as discussed earlier, inflation was kept in check, a process considerably facilitated by strong economic growth and the associated higher demand for money. Indeed, the Central Bank cut its refinancing rate from 45 to 25 per cent during the first 10 months of 2000 in order to promote investment and to sustain the recovery and growth process.

The National Bank of Kazakhstan reduced the benchmark refinancing rate from 16 to 14 per cent in June 2000 to encourage lending and investment. However, there was a tighter fiscal policy stance which contributed to low inflation and facilitated the economic recovery process, including higher investment in favour of the non-oil sectors of the country.

Tight monetary policies pursued in Armenia in 1999 were relaxed for 2000; the money supply consequently grew by 15 per cent in the first nine months of the year. Turkmenistan also followed an easier monetary policy stance in 2000 to mobilize and provide resources for the implementation of a long-term strategy for social and economic transformation for 2000-2010. Growth in M2 accelerated from 23.5 per cent in the first quarter of 2000 to almost 74 per cent in the first half of the year, compared with 24 per cent for the whole of 1999. The Central Bank of Uzbekistan kept real interest rates negative in the first half of 2000 but with inflationary pressures on a downward trend, the refinancing rate was reduced from 36 to 24 per cent in order to lower the financing burden on investment, and to underpin further market confidence in som-denominated papers.

Banking systems remained a focus of reform efforts among the countries of North and Central Asia in 2000. Some 19 banks were closed in the Russian Federation. Since the financial crisis in 1998, the total equity and deposits of 1,330 remaining banks went up by 59 and 57 per cent respectively in 1999-2000. However, such equity was equivalent to only 3 per cent of GDP in 1999, compared with 5.6-6 per cent before the financial crisis. Generally, the banking system itself has yet to become a major source of development finance for the economy owing not least to a variety of systemic factors and constraints related to, inter alia,

the investment climate, taxation regime, and corporate governance, including accounting standards. These are among the matters which will be the focus of further financial sector reforms and restructuring in the future.

In Azerbaijan, the three state banks were merged and in July 2000 the country was given its first international credit rating. The banking sector of Kazakhstan, meanwhile, was accorded better ratings from Standard & Poor's, Moody's Investors Service and Thomson BankWatch in 2000. The process of financial intermediation was considerably improved with better legal framework, including the adoption of a law on banking privacy. In addition, the National Bank of Kazakhstan initiated the establishment of a collective insurance fund to protect individuals' short-term savings. Consequently the amount of deposits expanded by 90 per cent and that of lending, by about 40 per cent in the first half of 2000. There was, furthermore, a rising trend of loans denominated in Kazakhstan tenge and/or with a longer maturity, together with a higher share of private deposits in the commercial banks of Kazakhstan. The domestic market for securities was broadened with a wider range of bonds, including municipal bonds and corporate bonds. However, stock market capitalization increased by a modest amount.

The current economic recovery and growing market confidence in its future economic prospects enabled Kazakhstan to place a fourth sovereign eurobond issue worth $350 million and to reimburse $385 million worth of IMF credits ahead of schedule in 2000. Proceeds from the new bonds, with a seven-year maturity, were intended to repay the previous eurobonds falling due. The bond market in the Russian Federation performed well and the main emerging market bond index went up by 60 per cent in 2000. During the year, the ratings on sovereign bonds were steadily raised by various international agencies, and local and foreign banks started buying the short-term treasury bills of the Government of the Russian Federation for the first time since the default in August 1998, despite lower yields which fell from 45-50 to 27 per cent during the period April-July 2000.

On the other hand, the stock market in the Russian Federation was lagging behind the bond market because of concerns over shareholder rights, among other issues. The Central Bank introduced an evening trading session aimed mainly at facilitating greater participation from foreign banks through mitigating the local and international time differences. Given the acute shortage of relatively secure and liquid investment outlets, the local banks bought large amounts of short-term government bonds in 2000. Such investment transactions were expected to be easier with the pending release and trade of the so-called S-accounts (foreigners' rouble-denominated investments in short-term government bonds), which had been frozen in the wake of the financial crisis and default in 1998.

Policy issues and responses

As was apparent from the above analysis, notable progress has been achieved over the past several years by countries of North and Central Asia in resolving fiscal, monetary, structural and other systemic difficulties faced by them in their efforts towards sustainable growth. Nevertheless, the remaining agenda for reform and restructuring is formidable. There is, for example, the ongoing need for further reforms of the tax structure and tax administration to consolidate and extend the gains already made. Such reforms are particularly necessary to ensure greater buoyancy and elasticity in major components of fiscal receipts so as to lower pressure for central bank financing of the deficit and the attendant inflationary implications. These needs have been well and widely recognized across the subregion. An action programme under implementation in the Russian Federation, for example, was aimed at ensuring macroeconomic stability and a balanced budget, improving the business and investment environment, introducing tighter bank regulation, and providing greater transparency and accountability in public finance. A 10-year government plan envisaged the introduction of some crucial steps towards a market-based economic system. Those included private land ownership, elimination of domestic barter trade and encouragement to domestic competition and judicial reform. The plan, which called for a minimum annual expansion of 5 per cent in GDP, also seeks to contain inflation to a maximum of 10 per cent a year.

Further economic liberalization was foreshadowed in a long-term strategy for the economic development of Kazakhstan up to the year 2030. The pertinent policy measures included a tighter fiscal stance, the stabilization of the currency exchange value, a reduction in the budget shortfall, an

improved legal infrastructure and better incentives for investors. The establishment of special areas or zones for economic growth and the promotion of hi-tech business enterprises were also envisaged in the strategy. Another area of concern for government was the pressing need for more broad-based economic growth, not least through structural diversification to reduce Kazakhstan's heavy dependence on the oil sector at present. Toward this objective, further steps in structural reform and privatization were implemented, although revenue from privatization fell from 3.1 per cent of GDP in the first half of 1999 to 0.9 per cent in the first six months of 2000. Up to two fifths of the number of industrial enterprises in the country were making losses; these firms were mostly concentrated in the mining and processing industry, as well as in such public utilities as water, gas and energy production. Another matter of concern was the rising level of inter-enterprises arrears; such massive back debts reached 1,984 billion tenge ($14 billion), a level equivalent to about 90 per cent of annual nominal GDP at the end of April 2000.

The pursuit of broad-based growth and development of the non-oil sectors was also of great concern to Azerbaijan. Greater and faster progress apparently was also needed to improve the transparency and predictability of government economic policies and of the operations of major state enterprises. The maintenance of relatively strong growth with stability and falling current account deficits in recent years should provide a strong platform for reduced state involvement in the economy and for economic diversification. Azerbaijan was expected to cancel the debt of state enterprises and entities that were to be privatized in 2000-2001. Such obligations, which totalled around $3.4 million (including $2 million belonging to industrial firms) in August 2000, had been accumulating for about 30 years and, as such, had frightened off investors interested in taking over the firms slated for privatization.

In Uzbekistan, the final stage in the privatization of enterprises and companies of major strategic importance scheduled to begin in 1999, was postponed until 2001-2002 owing to the lack of experience in privatizing major industries and the underdeveloped stock market in the country. Among other important problems to be managed by government were the restructuring and rationalization of enterprises, regardless of whether they were to be privatized or not. Convertibility of the som was another matter for policy action, as full currency convertibility was one of the main conditions for the disbursement of loans under an IMF stabilization programme in 2000. However, this condition could not be met because of the still significant divergence between the unified and the so-called parallel market exchange rates, despite a variety of measures being undertaken to unify the exchange rates of the central bank and interbank.

The pace of restructuring and privatization of state-owned enterprises was relatively more moderate in several other economies of North and Central Asia. Armenia, for example, was expected to privatize the four power distribution networks, with a 29 per cent share to be retained by government, through international tender in 2000. However, the privatization process was delayed because of concerns about the possible increases in electricity prices that would adversely affect domestic industries and service sectors. Two thirds of the economy was to be transferred to the private sector in Turkmenistan by 2010. However, privatization efforts in 2000 involved mostly SMEs, with the important enterprises in the industrial and transport sectors, as well as oil and gas sectors, remaining outside the process. Tajikistan had to sell 265 state-owned enterprises in the first half of 2000 because the available funds were simply inadequate for continued subsidies to those companies. The Russian Federation had a large number of state enterprises that produced goods of limited demand and little value, and their indebtedness continued to soar in 2000. A system of barter transactions and subsidies kept those inefficient companies operating, although the percentage of barter trade among them fell from 29 per cent of production volume in April of 2000 to 26 per cent in June 2000. In this context, the promotion of SME sector development would be critical for broad-based economic growth and as an important, alternative source of employment for potentially redundant workers in those enterprises as and when they are privatized or closed down.

By and large, there remained a variety of obstacles to strong and sustained economic expansion and structural diversification in many countries of the subregion. Among the pertinent examples are the persistence of low levels of bank lending to the real sectors, of large-scale capital flight, and of extensive non-monetary settlements. Meanwhile, the

main constraints on investment include fears of an excessive and unpredictable tax burden, the great difficulties in enforcing contracts through the courts, corruption and overbearing state regulation of business, poor corporate governance, inadequate corporate financial reporting, and weak protection of shareholders and creditors. Now that a large measure of stability has been achieved and the process of recovery appears to have taken firm root in most countries, they are better poised and would be well advised to seriously address these institutional constraints to long-term development.

South and South-West Asia

The fiscal year 2000, by and large, was a good year for the South and South-West Asian economies with GDP growth rates ranging from 4.5 to 6 per cent (table II.11). Notwithstanding the hike in oil prices, consumer prices were kept well under control even in economies where inflation had been a problem, such as the Islamic Republic of Iran and Turkey. The expansion in output was driven by a variety of factors. Agricultural production improved in

Table II.11. Selected South and South-West Asian economies of the ESCAP region: growth rates, 1997-2000

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
India	1997	5.0	−1.9	5.9	9.0
	1998	6.8	7.2	4.0	8.3
	1999	6.4	1.3	7.8	8.6
	2000	5.9	2.0	5.5	8.3
Iran (Islamic Republic of)[a,b]	1997	3.4	3.5	5.4	5.0
	1998	1.6	8.1	2.1	−0.9
	1999	2.4	−0.3	2.3	4.3
	2000	4.5	4.3	3.4	6.1
Pakistan[a]	1997	1.9	0.1	0.6	3.6
	1998	2.0	4.5	0.3	1.6
	1999	3.1	1.9	2.5	4.1
	2000	4.5	5.5	3.3	4.5
Sri Lanka	1997	6.3	3.0	7.7	7.1
	1998	4.7	2.5	5.9	5.1
	1999	4.3	4.5	4.8	4.0
	2000	5.7	2.6	7.7	6.0
Turkey	1997	7.6	−2.3	9.5	9.0
	1998	3.2	8.4	1.8	2.6
	1999	−5.1	−4.6	−6.3	−4.3
	2000	6.0	2.5	5.5	7.9

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); The Economist Intelligence Unit, *Country Report: Turkey*, October 2000; and *Country Profile: Turkey*, 2000; and national sources.

Notes: Data for 2000 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.
[b] Industry comprises oil; mining and manufacturing; water, power and gas; and construction.

all the economies with the exception of Sri Lanka, as did industrial production with the exception of India. The service sector remained buoyant across the subregion. Export performance was noticeably better, aided by robust international demand. However, this did not translate into major improvements in the current account balance because of high import growth in several economies. Besides, the fiscal balance remained fragile in most economies except notably in the Islamic Republic of Iran where the budget deficit has been usually low. High levels of public debt, and hence the service burden, will continue to pose a formidable challenge to governments of many countries of the subregion for some time to come.

Growth performance

In India, fiscal year 2000/01 started with an optimistic note. The core infrastructure industries continued to do well as a result of both higher public and private investment, while good weather conditions boosted agricultural performance considerably. The service sector remained vibrant, with its share in GDP rising from 36 per cent in the 1980s to 48 per cent in 2000/01. Industrial production decelerated somewhat, a reflection of the inherent lags in adjustment to restructuring, higher oil prices, inadequate domestic consumption and lower inventory demand for capital goods. GDP growth was estimated at 5.9 per cent for the fiscal year as a whole, somewhat lower than in the preceding year.

The slowdown in overall industrial growth was due to the poor performance of both capital goods and consumer goods industries (for example, commercial vehicles, jute textiles, wood products, paper products, leather and chemical products, machinery and equipment, beverage and tobacco). However, the core infrastructure industries (except crude oil and cement) continued to perform well; in particular, telecommunications output (net connections) went up by 50 per cent over the previous year. Overall industrial growth of 5.5 per cent was driven largely by an expansion of some 5 per cent in manufacturing, 6 per cent in electricity generation, and 3.5 per cent in mining and quarrying. In 2000/01, the service sector was estimated to have expanded robustly by 8.3 per cent. Among the causal factors were a rapid increase in public expenditure (for example, on public administration, social services, rural extension services and defence), complemented by a higher level of government procurement and other trade-related activities on account of bumper food grain crops.

Assuming no serious external shocks, both natural and human-made, and ongoing (second-generation) economic reforms (especially in the infrastructure, insurance, financial and public sectors), India is expected to sustain GDP growth rates in the neighbourhood of 7 per cent during the period 2001-2003. Such expansion would be underpinned by the projected growth of 3-3.5 per cent in agriculture, 7-8 per cent in industry and 8-10 per cent in services.

India has been able to maintain an upward trend in domestic savings during the past three years. This has been mirrored in a similar trend in investment. Domestic investment has been financed mainly by internal resources in India. The rate of private savings was approaching those achieved by high-performing Asian countries. However, the public-sector savings rate continued to be low and constrained efforts to increase the investment rate further. Efforts are under way to rationalize public expenditure with a view to fostering public savings and releasing more resources for physical and social infrastructure development.

In the Islamic Republic of Iran, GDP growth was estimated at 2.4 per cent in 1999/2000, up from 1.6 per cent in the previous year. Unfavourable weather conditions contributed to poor agricultural performance with output falling marginally compared to a robust growth of over 8 per cent in the previous year. Production of wheat, barley and pulses each fell by some 14 per cent, and of rice and cotton by 1-2 per cent. However, the output of sugar beets and potatoes grew by almost 17 and over 4 per cent respectively. Adherence to the production quota from OPEC led to a negative growth of 1.0 per cent in the oil sector in fiscal year 1999; but non-oil GDP expanded by 3.2 per cent. Following the completion of a number of development projects, the manufacturing and mining value added grew by 2.5 per cent. Two large petrochemical and metal melting factories also started operating in the year. Industrial growth (at 2.3 per cent) was also driven by the production of 107.1 billion kilowatt of electricity, a level almost 10 per cent higher than the previous year. As a whole the service sector grew by 4.3 per cent, a rate underpinned by a vigorous expansion in banking services (by over 30 per cent in terms of value added), and in building and construction (by some 12 per cent, the highest rate in recent years).

On the expenditure side, private consumption went up by just over 3 per cent in 1999/2000 while fixed capital formation rose by 8 per cent. Consequently, gross investment increased to 14.2 per cent of GDP from 13.5 per cent during the previous year; on the other hand, savings rates stabilized at around 18.4 per cent over 1998/99 and 1999/2000. Both the investment and savings rates were expected to be about one percentage point higher, along with much stronger GDP growth at 4.5 per cent in 2000/01. Sectorally, agriculture and industry were expected to expand by 3-4 per cent, while service sector growth would be higher at 6.1 per cent.

The economy of Pakistan recovered considerably in 1999/2000 with GDP growing by 4.5 per cent, compared to 3.1 per cent in the previous year. Agricultural output in particular recorded a steep increase to 5.5 per cent. The bumper cotton crop (up from 8.8 million bales in the preceding year to 11.2 million bales) and wheat crops (from 17.9 to 21.0 million tons) were complemented by a substantial increase of over 10 per cent in rice production. On the other hand, sugar cane output fell by 16 per cent. Excluding sugar, the value added in large-scale manufacturing grew by 6.4 per cent, with cotton textiles being leading contributors. As a whole, industrial output (manufacturing and electricity combined) went up by 3.3 per cent.

The services sector continued to show a healthy expansion of 4.5 per cent in 1999/2000, a rate marginally higher than that of the previous year. The construction sector, which had contracted previously, grew by 6.2 per cent, a turnaround driven largely by higher investment in land improvements plus the construction of residential and non-residential buildings, highways and bridges. The upward trend in value added from electricity generation and gas distribution continued; the expansion reached almost 8 per cent. Other service subsectors registering high growth included finance and insurance, and transport and communications.

Notwithstanding the significant improvements achieved in 1999/2000, the economy of Pakistan continues to be vulnerable to the vagaries of the weather. Agriculture remains an important activity, the sector constituting 26 per cent of GDP over the period 1997-2000. Large segments of the manufacturing sector also rely heavily on domestic agricultural inputs (such as cotton and sugar cane). In addition, there is the relatively low level of domestic investment (some 15 per cent of GDP) and a still lower level of domestic savings, a condition not entirely conducive to the emergence of a dynamic industrial sector. There was also a change in the patterns of private sector investment; such investment declined sharply (by almost 50 per cent) in electricity generation and gas distribution, the main recipients of private investment in the recent past. This could have an adverse impact on their future expansion. Meanwhile, public sector investment went up by just under 10 per cent in 1999/2000 with transportation and agriculture being the main target. Gross domestic savings increased to 14 per cent of GDP, considerably short of the target of 18 per cent.

In Sri Lanka, GDP growth for the year 2000 was estimated at 5.7 per cent, considerably better than during the previous two years. The improved performance was led primarily by the industry and service sectors, while there was a deceleration in agricultural growth.

Rice production during the 1999 *Maha* and *Yala* seasons[3] peaked at 2.9 million tons, a level even higher (by 2 per cent) than the previous record in 1995; the main paddy harvest was projected to rise by another 1.5 per cent in 2000. The same year also witnessed a record level of tea production with output rising by 11.1 per cent on a year-on-year basis during January-August. Meanwhile, favourable weather conditions for three consecutive years and higher prices in 1999 boosted coconut production with output being over 11 per cent higher in the first seven months of 2000. Rubber production, however, fell by just over 4 per cent in the same period. As a whole, the agricultural sector was estimated to expand by 2.6 per cent in 2000, compared to a higher rate of 4.5 per cent a year earlier.

Manufacturing growth was robust, rising from 10.6 per cent in the first three months of 2000 to 11.4 per cent in the second quarter of the year. A sustained improvement was registered in all industrial categories, with the output of textiles, wearing apparel and leather products rising (year-on-year) by over 18.3 per cent between January and July 2000, in part as a response to higher demand from the United States and the EU. Increased domestic consumption and higher exports of rubber products lifted the value added in the chemical, rubber, plastic and petroleum

[3] *Maha* is the main rainy season; *Yala* is the winter season.

product subsectors by almost 11 per cent between January and July. Overall, industrial growth was projected to reach 7.7 per cent, a rate substantially higher than the 4.8 per cent achieved in 1999.

As regards services, the high growth subsectors included trade, transport and communications which together posted an output increase of just over 8 per cent in 1999, with a still higher volume of activities expected in 2000. The construction subsector was expanding modestly at 4.8 per cent while the number of tourist arrivals declined moderately as a result of negative perceptions about the country's security situation. This trend was likely to be reversed through concerted efforts at image-building at the start of the new tourist season. The service sector as a whole was expected to perform reasonably well with growth estimated at 6 per cent in 2000, compared with 4 per cent in the previous year.

Investment activities in Sri Lanka, though comparable to or better than in other economies of the subregion, have not been buoyant in recent years. The ratio of investment to GDP, at 25 per cent in 2000, was somewhat lower than the rate of just over 27 per cent in 1999. Gross domestic savings have shown a tendency to decline so that the resource gap, which had been equivalent to 3 per cent of GDP in 1997, went up almost continuously to around 8 per cent in 2000.

Economic activities in Turkey had contracted for five successive quarters in the wake of the Russian rouble crisis and the devastating earthquake of 1999. GDP then recovered strongly in the first half of 2000, growing by over 5 per cent (year-on-year) in both the first and second quarters. Private consumption was expanding at a high rate of about 7 per cent in the second quarter, a development led by strong demand for durable goods, a fall in interest rates in late 1999 and early 2000 along with a reduction in inflation. Likewise, gross fixed capital formation was also accelerating and overall GDP growth was estimated at 6 per cent in fiscal year 2000, compared to a contraction of over 5 per cent in the previous year. In this context, private-sector investment accounted for about three quarters of total investment spending and continued to rise, by over 18 and almost 12 per cent (year-on-year) in the second and first quarters respectively. Public-sector investment was also on the rise because of the post-earthquake rebuilding and rehabilitation needs.

Agricultural output was estimated to grow by 2.5 per cent for 2000, a remarkable recovery from a contraction of 4.6 per cent in the preceding year; the upward trend accelerated from a marginal agricultural growth of just 0.4 per cent in the first quarter of 2000 to 2.3 per cent in the second quarter. Industrial production also went up rapidly, along with buoyant demand, by 5.5 per cent for 2000 against a contraction of 6.3 per cent in 1999. In particular, motor vehicle production increased by 50 per cent (year-on-year) in the second quarter, while the combined output of radios, televisions and communications equipment was 35 per cent higher. An expansion of almost 22 per cent was recorded by the food processing industry according to the production index for July 2000. Despite the stiff competition from Asian producers, the output volumes of textiles and clothing rose by 12.3 and 9.2 per cent respectively. However, damage to the refineries caused by the 1999 earthquake kept the production of petroleum products depressed. Meanwhile, the service sector emerged as another engine of growth with an expansion of nearly 8 per cent expected for 2000. The volume of wholesale and retail trade, for example, went up by around 10 per cent in the first half of 2000, and the number of tourist arrivals by almost 36 per cent in the first eight months of the year.

Inflation

The effects of higher international oil prices and depreciation of the local currency exerted an upward push to prices in India in 2000/01. In particular, the administered prices of petrol were raised by 8 to 10 per cent, of diesel and liquid petroleum gas by 17 to 20 per cent, and of kerosene by 50 per cent with effect from October 2000. However, inflation remained at a single-digit 6.5 per cent in 2000/01 (compared to 3.4 per cent in the previous year) owing to an ample supply of agricultural goods (especially food) and excess capacity in manufacturing as a result of sluggish domestic demand. There was, moreover, better management of the supply of essential consumer goods and raw materials, partly through liberal imports and a strengthening of the public distribution system for food grains, sugar and kerosene oil. Inflation is forecast at around 5 per cent on average during the period 2001-2003 in line with the current commitment to the maintenance of price stability.

Consumer prices in the Islamic Republic of Iran went up by over 20 per cent in 1999/2000, marginally higher than the previous year (table II.12). Higher prices were observed in a wide range of goods, especially food, beverage and tobacco, services (in particular transportation, communications and health and medical care), housing, fuel and lighting. A rapid expansion in the money supply (M2) was considered to be a major reason behind the persistence of high inflation. The need to

Table II.12. Selected South and South-West Asian economies: summary of macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*
India	Savings/GDP	24.7	22.4	24.0	25.0
	Investment/GDP	26.2	23.4	24.9	26.6
	Budget balance/GDP	−4.7	−5.1	−5.6	−5.4
	Current account balance/GDP	−1.3	−0.9	−1.0	− 1.7
	Money supply growth (M2)	17.7	18.2	17.2	13.7[a]
	Inflation rate	6.8	13.1	3.4	6.5
Iran (Islamic Republic of)	Savings/GDP	20.7	18.4	18.3	19.4
	Investment/GDP	16.2	13.5	14.2	14.5
	Budget balance/GDP[b]	−1.0	−2.2	−0.2	−0.2
	Current account balance/GDP	1.4	−1.1	9.1	12.1
	Money supply growth (M2)	15.2	19.4	20.1	..
	Inflation rate[c]	17.3	20.0	21.1	19.9
Pakistan	Savings/GDP	12.8	15.7	12.3	14.0
	Investment/GDP	17.7	17.1	15.0	15.0
	Budget balance/GDP	−6.4	−7.7	−6.1	−6.1
	Current account balance/GDP	−7.0	−2.8	−3.9	−1.8
	Money supply growth (M2)	19.9	7.9	6.2	9.4
	Inflation rate[c]	11.8	7.8	5.7	3.6
Sri Lanka	Savings/GDP	21.4	19.1	19.8	17.1
	Investment/GDP	24.4	25.1	27.1	25.0
	Budget balance/GDP	−7.8	−9.2	−7.5	−7.6
	Current account balance/GDP	−2.6	−1.4	−3.3	−3.5
	Money supply growth (M2)	13.8	9.6	12.4	11.6
	Inflation rate[c]	9.6	9.4	4.7	5.7
Turkey	Savings/GDP	21.8	22.9	19.8	..
	Investment/GDP	25.7	23.6	22.7	..
	Budget balance/GDP[d]	−7.8	−7.1	−10.9	−12.0
	Current account balance/GDP	−1.4	1.0	−0.7	−4.8
	Money supply growth (M2)	97.5	89.7	98.3	66.1[a]
	Inflation rate[c]	85.8	84.6	64.9	54.2

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); IMF, *International Financial Statistics*, vol. LIII, No. 9 (September 2000) and *International Financial Statistics*, vol. LIII, No. 12 (December 2000); and The Economist Intelligence Unit, *Country Profile: Turkey*, 2000; and national sources.

Notes: Data for 2000 are estimates. Savings/GDP refers to gross domestic savings/GDP; and investment/GDP refers to gross domestic investment/GDP.

[a] January-August.
[b] Excluding grants.
[c] Referring to changes in the consumer price index.
[d] Including transfers.

reduce double-digit inflation had been among the priority areas for policy attention. Inflation was targeted at just under 20 per cent in 2000/01 and for this purpose, commercial banks were accorded greater independence in allocating credit, including the evaluation of loan proposals on market-based criteria. As a complementary measure, the prudential supervision of banks has been intensified and administrative control curtailed.

Inflation continued on a downward trend in Pakistan over recent years, reaching 3.6 per cent in 1999/2000 against the initial projection of 6 per cent and considerably less than the previous year's level of 5.7 per cent. Among other containing factors was modest M2 growth. There was, in addition, improved food supplies owing to a strong recovery in agriculture. Food price inflation decelerated sharply to 2 per cent in the first 10 months of 1999/2000 compared with an average of 10.5 per cent recorded during the period 1994-1999. Increases in non-food prices were also modest, averaging just under 5 per cent, compared with about 10 per cent observed during the period 1994-1999. Such relative price stability was maintained despite upward adjustments in gas and petroleum prices which then pushed up the prices for the transport and communications subgroups. Institutionally, the promotion of special market places in cities, where growers could sell their products directly to customers without the middlemen, also helped check consumer price inflation. There was, moreover, better coordination through the regular weekly meetings of the Economic Coordination Committee of the Cabinet to monitor the prices of essential food items and recommend remedial and timely measures in case of shortages.

Inflation fell to the lowest level (4.7 per cent) for over a decade in Sri Lanka in 1999, an outcome attributable to higher agricultural output, favourable adjustments in taxes and import tariffs on several imported items, and lower prices on several key imports. Prices edged upwards in 2000, with inflation just over 5 per cent up to September. Higher fuel costs led to a cascading effect on both domestic and imported prices, including those on fertilizer, chemicals, transport and electrical equipment, steel, cement and building materials. Nevertheless, the continuation of good agricultural performance and effective demand management policies (including lower M2 growth) helped keep inflation in check at 5.7 per cent in 2000.

In Turkey, inflation came down significantly from 70 per cent at the beginning of the year to 49 per cent in September 2000 on a year-on-year basis. The continuous slowdown in wage increases in the manufacturing industries, a reduction in petrol taxes to counter higher fuel prices, lower monetary expansion, and the policy of keeping nominal depreciation below the ongoing inflation rate helped contain price increases and inflation expectations. Overall, inflation was estimated to be just over 54 per cent in 2000, compared with almost 65 per cent during the previous year.

Trade and exchange rates

India experienced a significant expansion of both exports and imports in 1999/2000 and 2000/01. In April-August 2000, for example, exports reached $17.4 billion, or almost 24 per cent higher, year-on-year. Earnings on rice, oil meals, marine products, ore and minerals, chemical and related products, engineering goods, textiles, carpets, leather and gems and jewellery went up by 10 per cent or over. The relative share of primary products declined from 24 per cent in 1996/97 to 17 per cent in 1999 and further to 15 per cent in 2000/01. This was due largely to the falling share of agricultural exports and to higher earnings on manufactured items. India's major export markets were the United States; the United Kingdom; Germany; Hong Kong, China; the United Arab Emirates; and Japan. For 2000/01 as a whole, merchandise exports were estimated to grow at 15 per cent compared with less than 12 per cent in the previous year (table II.13).

The value of merchandise imports, estimated at $21.7 billion in April-June 2000, was 20.5 per cent higher year-on-year, a major part of the increase attributable to higher oil prices. The import bill was likely to be 17.5 per cent larger for 2000/01 as a whole. Meanwhile, the relative share of bulk imports (crude oil, petroleum products, consumer goods, and some key raw materials and intermediate goods) went down considerably, from 42 per cent in 1996 to 31 per cent in 1998. This trend was reversed somewhat to around 38 per cent in 1999/2000 owing partly to the relatively higher international price of oil. Non-bulk items (capital goods, precious stones, chemicals and chemical products, textiles, plastics, scientific instruments and medicines) constituted 62 per cent of the total import value in 1999, compared with 64 per cent in 1997 and 69 per cent in 1998. Notably, the relative share of capital goods declined

Table II.13. Selected South and South-West Asian economies: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					Imports (c.i.f.)				
	Value (millions of US dollars)	Annual rate of growth (percentage)				Value (millions of US dollars)	Annual rate of growth (percentage)			
	1999	1997	1998	1999	2000	1999	1997	1998	1999	2000
India	36 310	5.7	−4.4	11.6	15.0	44 889	9.2	3.8	16.5	17.5
Iran (Islamic Republic of)	19 726	−17.4	−29.3	50.4	29.3	13 511	0.0	−3.6	−5.4	14.8
Pakistan	7 528	−6.6	4.2	−10.7	8.4	9 613	−4.5	−8.4	−6.7	−0.2
Sri Lanka	4 593	13.1	3.4	−4.1	20.4	5 884	8.1	0.4	0.2	17.8
Turkey	26 588	13.1	2.7	−1.4	4.5	40 692	11.3	−5.4	−11.4	36.0

Sources: United Nations, *Monthly Bulletin of Statistics*, September 2000; The Economist Intelligence Unit, *Country Report: Turkey*, October 2000; and national sources.

continuously from 25 per cent in 1996 to 10 per cent in 2000, while those of other non-bulk items (such as gold and silver, plastics, scientific instruments, coal and coke, medicines and drugs, chemicals and non-metallic mineral products) went up from 17 to 34 per cent respectively in the same years.

Notwithstanding the improved export performance, the external trade sector remained under pressure, with the trade deficit widening to an estimated 4.4 per cent in 2000/01. The invisible surplus, on the other hand, was expected to be substantial, with private transfers and software exports exhibiting continued vibrancy. Nevertheless, the current account deficit increased to 1.7 per cent of GDP in 2000/01. This partly contributed to a depreciation of the currency by about 5.5 per cent (from 43.33 to 45.75 rupees per dollar) between 1999/2000 and 2000/01 despite interventions by the Reserve Bank of India. Notably, the country persisted with further trade and tariff liberalization in the 2000/01 budget as well as with other policy reforms. The measures included a reduction of peak customs duty from 40 to 35 per cent, significant cuts in duties on telecommunications and other infrastructure imports, and a higher ceiling on external portfolio investment by institutional investors (from 30 to 40 per cent of the paid-up capital of any Indian company). In addition, quantitative restrictions on imports were removed for 714 tariff lines, including 58 items reserved for the small-scale sector. Special Economic Zones were permitted to retain their entire foreign exchange earnings and to engage in the manufacture of items reserved for the small-scale sectors. The Indian rupee was fully convertible for current account transactions and almost fully convertible on non-resident capital accounts.

In the Islamic Republic of Iran, higher prices on oil and gas boosted export earnings by over 50 per cent (to $19.7 billion) in 1999/2000, with oil and gas bringing in $16.3 billion; there was an increase of 8.5 per cent (to $3.5 billion) in the value of other export categories. Meanwhile, import spending amounted to $13.5 billion, equivalent to a decrease of 5.4 per cent over the previous year. In consequence, the trade balance was turned from a deficit of $1.2 billion to a surplus of $6.2 billion in 1999/2000. There was, however, a decline in net transfers (mainly through lower workers' remittances) from $497 million in 1998/99 to $344 million in the following year, while the deficit in the services account stood at $1.8 billion. The current account surplus thus reached $4.7 billion (or just over 9 per cent of GDP) in 1999/2000. This surplus was expected to exceed 12 per cent of GDP in 2000/01 on account of higher earnings from exports (by about 29 per cent), while growth in import expenditure would be under 15 per cent.

A multiple exchange rate system was in operation in the Islamic Republic of Iran. The various steps taken to allow a greater role for market forces

in determining the exchange rate were considerably facilitated by the export boom. Importers holding a valid import licence were assured of an unrestricted access to the foreign exchange market while the share of imports transacted at the market rate (which stood at 8,200 rials for one dollar on 1 September 2000) was to increase from 30 per cent in 1998/99 to over 60 per cent in 2000/01. On the other hand, the volume of transactions at the official export exchange rate of 3,000 rials for one dollar was substantially reduced from the beginning of 2000. Beginning in 2005/06, foreign transactions at the other official export rate of 1,750 rials for one dollar would be discontinued. These measures were expected to improve export competitiveness and discourage domestic consumption of both importables and exportables, especially that of petroleum. Indeed, increased domestic consumption of petroleum has been undermining the country's net export position, one that is fixed by the OPEC quota. Per capita petroleum consumption in the Islamic Republic of Iran was found to be 10 times higher than that of other countries at a comparable level of development.

In Pakistan, exports exhibited a strong rebound of 8.4 per cent in 1999/2000 as against a decline of 10.7 per cent in the previous year. A bumper cotton crop raised the supply of raw materials at reasonable prices, while the (exportable) textile sector was buoyant. Almost four fifths of the gains in export earnings were accounted for by textile products; raw cotton, fish and fish products also registered significant growth. In addition, a good rice crop and an upturn in manufacturing output (except sugar) improved their export availability. The sharp exchange rate depreciation in the previous year also helped increase the competitiveness of exports. By and large, however, Pakistan's export base remains narrow; manufactured products are heavily dominated by labour-intensive goods, especially textiles and clothing. There was also a heavy concentration of export markets (United States; Germany; Japan; United Kingdom; Hong Kong, China; Dubai and Saudi Arabia). The share of Pakistan's exports to the United States has been rising continuously.

Import spending declined marginally by 0.2 per cent in Pakistan in 1999/2000, compared to a sharper fall-off of almost 7 per cent in the previous year. However, the value of imported petroleum products and crude oil increased by over 73 per cent and almost 89 per cent respectively. Among the non-oil groups, food imports went down by one third because of higher domestic production; in particular, there was a massive fall in both the quantity and value of imported wheat and to a lesser extent of soybeans, palm oil and tea. The trade balance of Pakistan remained in deficit during the 1990s; the shortfall was as high as $3.54 billion (or 5.7 per cent of GDP) in 1996/97. Better export performance and some compression of imports helped ease the trade deficit, which was estimated at $1.4 billion (2.3 per cent of GDP) in 2000, down from $2.1 billion (3.3 per cent of GDP) in the previous year. Workers' remittances continued to be an important source of foreign exchange receipts; the inflows, estimated at $984 million in 1999/2000, were slightly less than the previous year's inward transfer of $1,066 million.

Under the unified floating exchange rate system, introduced in May 1999, the value of the rupee was governed by the floating inter-bank rate; this exchange rate against the dollar remained stable in both the inter-bank foreign exchange market and the open market in 1999/2000. Since July 2000, however, the exchange rate has come under constant downward pressure and, as of 6 October, the dollar reached 60 rupees at the inter-bank rate and 64 rupees in the open market. On 29 November 2000, an IMF stand-by agreement of $596 million was approved so as to help stabilize the rupee exchange rate.

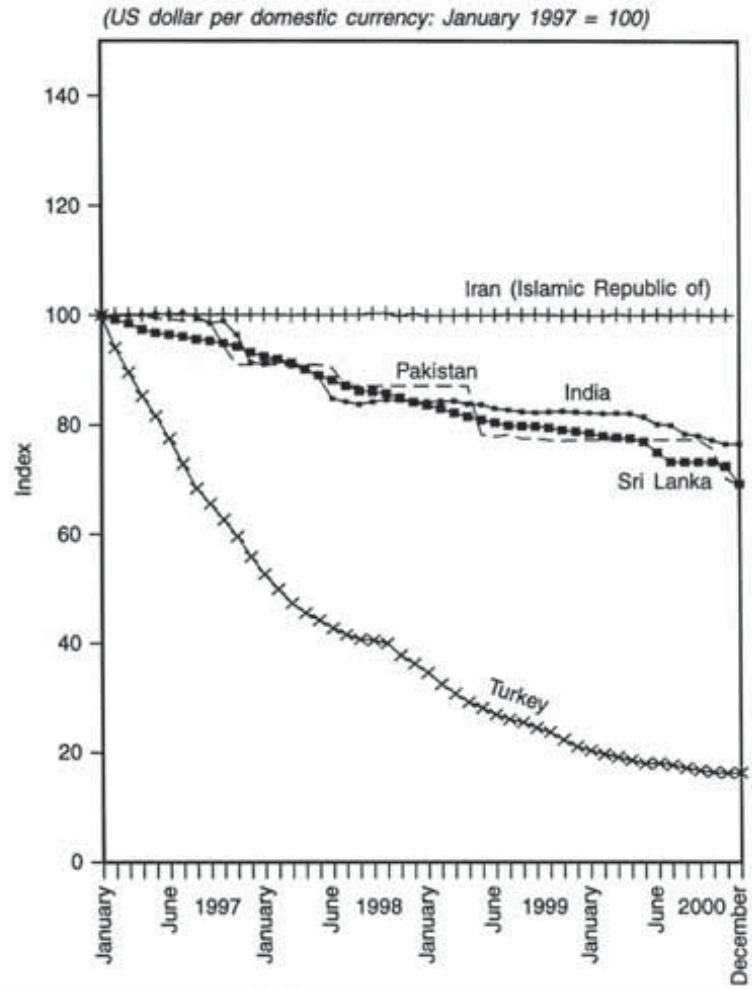
In Sri Lanka, exports entered into an upswing phase from about mid-1999 and earnings on industrial exports went up by over 22 per cent during the first seven months of 2000, compared with the same period in 1999. The value of mineral exports was up by over 50 per cent, while that of agricultural products grew by less than 10 per cent. The overall growth of merchandise exports was estimated at 20.4 per cent in 2000. Meanwhile, capital goods imports expanded by some 60 per cent during the first seven months of the year, with the growth rates of intermediate goods being 30 per cent and consumer goods, 15 per cent. It appeared that such an upswing in import spending was part of a catching-up process as imports had hardly grown in the previous two years. The upswing was also the result of higher oil prices and increased imports for military purposes. Import value was estimated to grow by almost 18 per cent in 2000 as a whole.

Buoyant exports helped stabilize the merchandise trade deficit to around 8 per cent of GDP in 2000. Regarding services, the higher number of

tourist arrivals in 1999 (by about 14.5 per cent over the previous year) did not continue in 2000 when the volume of arrivals, and, by implication, the associated earnings, fell off by almost 3 per cent year-on-year during the first seven months of the year. In contrast, private transfers remained on an upward trend, with gross inflows reaching $587 million during the first half of 2000, an increase of 16 per cent over the previous year. Generally, service exports in 2000 were estimated to grow by almost 2 per cent, compared with 0.3 per cent in the previous year. Meanwhile, expenditure on imported services, including marine insurance, also remained at a high level, expanding by 7 per cent in 2000, or marginally faster than the previous year's 6.4 per cent. The current account deficit was estimated to have worsened slightly in the year 2000, to 3.5 per cent of GDP from 3.3 per cent in 1999.

The Sri Lankan rupee had depreciated at an annual average rate of just over 7 per cent during the period 1995-1999. In May 2000, the Central Bank of Sri Lanka made a further downward adjustment in the exchange rate by about 5 per cent relative to the United States dollar. The value of the rupee stood at 78.5 per dollar on 15 September 2000, compared with an average of 72.1 observed in September 1999 (figure II.5).

Figure II.5. Index of exchange rates of selected South and South-West Asian economies, 1997-2000



Sources: IMF, *International Financial Statistics*, various issues; *Far Eastern Economic Review*, various issues; and *The Economist*, various issues.

Turkey experienced a modest increase of 4.5 per cent year-on-year in merchandise export earnings (of $13.4 billion) in the first half of 2000. The principal contributors included automobiles, electrical equipment (for example, television sets), clothing and finished textile products (accounting for 25 per cent of all exports), and of iron and steel. There was, however, a decline in export earnings from agricultural produce and foodstuffs. By broad categories, exports of capital goods expanded by some 23 per cent, whereas export receipts from intermediate products and consumer goods went up modestly (by 4.6 and 2 per cent respectively). Almost 54 per cent of the export flow was to EU countries, with Germany remaining Turkey's single largest export destination. The United States accounted for just 11 per cent of exports, although it has become the fastest growing market given the durable strength of the American economy and the United States dollar. During the first half of 2000, import spending soared by 36 per cent year-on-year. Intermediate goods imports (including oil and gas), with a relative share of 67 per cent, went up steeply by 38 per cent; the corresponding rates of expansion in the import value of consumer products and capital goods being 43 and 29 per cent respectively.

Higher income from tourism was offset by a sharp fall (by over 40 per cent year-on-year) in workers' remittances in the first two quarters, yielding only a modest improvement in the invisible accounts balance. The overall current account balance deteriorated sharply; the shortfall was estimated at 4.8 per cent of GDP for the year 2000, as compared to less than 1.0 per cent a year earlier. This widening gap, together with the high, albeit declining, rates of inflation, exerted considerable downward pressure on the local currency, whose exchange value relative to the United States dollar depreciated by about 40 per cent between March 1999 and March 2000.

Capital inflows and outflows

Despite a higher inflow of FDI and some $2.5 billion raised through the India Millennium Bonds, there was a decline in net capital inflows to India from $10.7 billion in 1999/2000 to $8.7 billion in 2000/01. Foreign investment, which had fallen from $5.38 billion in 1997/98 to $2.31 billion in 1998/99, surged to $5.12 billion in 1999/2000, some 42 per cent (or $2.17 billion) coming from FDI. This sharp turnaround was attributable to the relative stability of the domestic currency, broad-based industrial growth, and the easing of economic sanctions on India by developed countries. There was also greater recourse to the international financial markets by the Indian corporate sector. The flow of external investment capital was estimated to be slightly higher at $5.50 billion in 2000/01, FDI accounting for just over one half (or $2.85 billion).

India's foreign currency reserves continued to rise substantially, by some $9.8 billion over the years 1998-2000, and by $2.04 billion in 2000/01. They were equivalent to 7.5 months of imports at the end of 2000. There are other indicators of the remarkable improvement in the country's external position. About 45 per cent of the total debt stock, which stood at $97.7 billion as of March 1999 and $98.4 billion 12 months later, was of a concessionary nature. In particular, the share of short-term liabilities, at 4.1 per cent at the end of March 2000, represented a substantial decline in recent years while nearly two thirds of long-term external debt incurred since 1991 had been sourced from multilateral institutions. Furthermore, the debt-to-GDP ratio continued to fall to an average of 21.5 per cent over the period 1999-2001 and the debt-service ratio (that is, the ratio of total debt-service payments to gross receipts on the current accounts), from 35 per cent in 1990/91 to just over 15 per cent during the period 1999-2001.

A sharp improvement in the current account balance, with a surplus of over 9 per cent of GDP in 1999/2000, helped the stock of foreign reserves in the Islamic Republic of Iran by $1.8 billion; the reserve level had fallen somewhat in the previous two years. There was little FDI in 1999/2000 and portfolio investment, at $800 million, was more or less at the same level as in the preceding year. There was, however, an increase of $600 million in commercial borrowings which totalled around one billion dollars. The year 1999/2000 also witnessed further success in reducing the outstanding stock of external debt from a peak of $23.2 billion in 1993/94 to $10.3 billion; external arrears were virtually eliminated. Meanwhile, the maturity structure of external obligations improved noticeably. In particular, short-term debt dropped substantially from a peak of $6.7 billion in 1994/95 to $3.62 billion at the end of 1999/2000. Medium- and long-term debts, which had surged to $17.3 billion in 1995/96, declined to $6.06 billion in 1999/2000 through repayments and refinancing.

The issuance of short-term letters of credit as a means of import financing was replaced by short-term bank credit with a substantial drop in interest charges from an average annual level of 20 per cent on letters of credit to the London Interbank Offered Rate (LIBOR) plus 0.75 per cent for bank credit. The crucial contribution of FDI to the economic development of the Islamic Republic of Iran has been well recognized, especially in relation to efforts to raise productivity levels through the transfer of modern technology and management practices. Steps have been taken to address various deficiencies in the existing FDI laws and regulations to reduce administrative delays and other transaction costs, especially those in such areas as visas and work permits, customs clearance and taxation. In addition, the recent approval of new legislation for the protection of FDI was expected to attract a greater flow of FDI in new areas. Indeed, investment projects under buy-back and build-operate-transfer (BOT) arrangements have been undertaken in the oil sector. Such modalities were scheduled to be extended to other sectors.

Despite an improvement in the trade balance, capital inflow in the form of private transfers, workers' remittances and long-term capital declined somewhat in Pakistan in 1999/2000. Net private transfers increased to $3.19 trillion from $2.27 trillion in the previous year. This upsurge, however, was offset by lower inflows of workers' remittances and net long-term capital, from $1.06 billion and $1.81 billion to $0.98 and $0.21 billion respectively. There was, moreover, a decrease in ODA commitments to $1.67 billion in 1999/2000, compared to $2.12 billion in the previous year, a direct result of the economic sanctions imposed on the country. Foreign exchange reserves, at $1.35 billion (equivalent to seven weeks of import spending) as of June 2000, were down from the stock of $1.73 billion a year earlier. On the debt-servicing side, however, Pakistan was the recipient of much debt relief from both the Paris Club and Non-Paris Club donors. Debt-servicing liabilities dropped to $1.53 billion in 1998/99, or about 35 per cent lower than the previous year's level; such liabilities were estimated to decline further to $1.4 billion (or just below 17 per cent of export earnings) in 1999/2000.

Net capital inflows have been on a downward trend in Sri Lanka since 1993, reaching a historical low of $398 million in 1999. Gross ODA, for example, declined to about $450 million in 1999 from an average of $565 million during the previous five years. Foreign portfolio investment was negative in net terms, although the amount involved was quite small. In addition, there was a widening of deficits in both the current account and overall payments balance in 1999. The stock of external reserves stood at an estimated $1.64 billion, compared to $1.98 billion in 1998. The current account shortfall was expected to persist through 2000, with the amount of external reserves falling by another 16 per cent between the end of December 1999 and the end of June 2000 so that gross reserves stood at $1.3 billion, or about 4.2 months of import spending, as of August 2000.

Turkey experienced a sharp upswing in the inflow of external resources in the first two quarters of fiscal year 2000. Net capital inflows amounted to $4.4 billion in the second quarter, compared to $3.3 billion in the first quarter. The bulk of such resources, however, consisted of receipts from government bond issues and other public sector borrowings; net FDI flows, in comparison, increased by only $170 million. The stock of foreign reserves went up by $1.65 billion at the end of the second quarter of 2000, and the accumulation was expected to continue through the year with the total reserves being $24.3 billion at the end of September 2000.

Fiscal and financial developments

India's central government budget was formulated with a target deficit of 5.1 per cent of GDP for 2000/01. The major policy thrusts included the promotion of industrial and infrastructure development through fiscal and other incentives, including the rationalization of customs and excise duties, and a reduction of the maximum tariff rate from 40 to 35 per cent. Direct taxes were left unchanged while provisions were made for higher public expenditure on agriculture, infrastructure and rural development. There were also measures designed to stimulate corporate restructuring; strengthen research and development efforts; foster the construction, information technology, and knowledge-based industries; and promote the development of social sectors to ensure distributive justice.

Among the major expenditure-control measures were a redeployment of surplus government staff coupled with the creation of no new jobs; the introduction of a voluntary retirement scheme in the

public sector banks; a cut in the foreign travel budget and non-salary current expenditure; the implementation of zero-based budgeting techniques in existing projects; and a reduction of subsidies through the reliance on cost-based user charges for publicly supplied goods and services. Moreover, an institutional mechanism for better medium-term management of the fiscal deficit was introduced in the form of a Fiscal Responsibility Act for both central and state governments. On the other hand, the main elements of government policy towards the public sector itself were to restructure and revive potentially viable public sector units and close down those which were chronically sick. Market resources were to be raised against the security of assets of the closed public sector units to provide adequate safety nets to the affected workers. A fresh impetus to disinvestment and privatization programmes was also proposed.

Despite these developments, revenue shortfalls and expenditure overruns meant that the central government deficit for 2000/01 was likely to be higher than the target, amounting to 5.4 per cent of GDP or marginally lower than that of 1999/2000. Although both direct tax and non-tax receipts were buoyant, sluggish industrial production adversely affected indirect tax collections. There was also a shortfall in the realization of disinvestment targets. The high level of central-government fiscal deficits has led to a steady accumulation of public debt, with the debt-to-GDP ratio going up from 51 to 53 per cent during the 12-month period ending March 2000; the ratio was projected to rise further to 54 per cent at the end of March 2001. A high level of domestic debt overhang could lead to higher interest rates, crowd out private investment, and pose debt refinancing and servicing problems.

Monetary policy in India had been directed toward moderating the downward pressures on the exchange rate in the wake of the regional financial and economic crisis in 1997-1998. The focus of monetary policy in early 2000/01 shifted toward supporting a recovery in the industrial sector. In particular, the Reserve Bank of India lowered by one percentage point the interest (to 7 per cent) and the fixed repurchase rate (to 5 per cent). The cash reserve ratio was also reduced by one percentage point (to 8 per cent) and the savings deposit rate by 0.5 percentage point (to 4 per cent). These measures were intended to boost private sector credit off-take as well as to reduce the cost of bank funds. However, the monetary stance was reversed with the rupee weakening further against the United States dollar in the latter part of 2000; the Bank rate was raised to 8 per cent and the cash reserve ratio to 8.5 per cent in July 2000. There were also interventions in the spot and forward markets, coupled with a reduction (by 25 per cent) of the refinance limits available to the banks and financial institutions.

In the monetary policy announcement made by the Reserve Bank of India in early October 2000, the bank rate and cash reserve ratios were kept unchanged; the policy focus was on the twin objectives of consolidating financial reforms in the long run and ensuring sufficient domestic liquidity in the short run. In 2000, there was a strong growth in bank deposits because of high real interest rates, in particular the longer-term rates. The liquidity position in the banking system was, by and large, comfortable and there was a substantial increase of investments by commercial banks in government securities and bonds, debentures, and shares of the corporate sector. At the end of September 2000, aggregate deposits of the banks increased by 14 per cent and the investments made by them, by 15 per cent. Bank credit expanded by 22.6 per cent but the amount of net bank credit to the government sector, by only 12 per cent.

In the Islamic Republic of Iran, a balanced budget was designed for 1999/2000 with a major focus on poverty alleviation, the cornerstones of which included the development of deprived regions, the implementation of self-employment projects, and a strengthening of institutions for fiscal decentralization. In view of the unprecedented rise in oil export revenue, a budget revision was made in February 2000 to allocate the windfall gains to both current and capital expenditure. General revenue shot up by almost 47 per cent in 1999/2000. Fiscal receipts from oil and gas, at 44,170.4 billion rials, represented an increase of 27 per cent over the expected target. Non-oil revenue was also on an upward trend, increasing some 39 per cent. Over one half of such revenue came from tax receipts, which in 1999/2000 were about 38 per cent higher than the previous year's level. Corporation taxes provided almost two fifths of tax revenue, income taxes about 21 per cent, wealth taxes 4.5 per cent, import duties 22.5 per cent, and consumption and sales taxes just over 13 per cent. The share of direct taxes in the total tax revenues fell to 64 per cent in 1999/2000, against almost 68 per cent in the previous year.

As a whole, the ratio of tax revenue to GDP went up from 5.7 per cent in 1998/99 to 6.4 per cent a year later. Total expenditure expanded by about one third, with the bulk (over 71 per cent) going to recurrent expenditure which, in turn, showed an increase of 26.4 per cent. Capital expenditure, however, was growing at a much faster rate of 54 per cent, its relative share in total expenditure increasing from 27.4 per cent in 1998/99 to 28.6 per cent in the following year. It is worth noting in this connection that the deficit-to-GDP ratio went down from 2.2 per cent in 1998/99 to just 0.2 per cent in the following year.

Higher export earnings boosted the level of foreign assets within the banking system by about 54 per cent in 1999/2000. There were modestly higher claims, by 6.5 per cent, on the government owing largely to increased obligations incurred by public corporations and institutions. Credit to the private sector, on the other hand, went up significantly, by over 29 per cent. Among the major sources of demand were construction and housing (35 per cent of the total), and manufacturing and mining (with a relative share of 22 per cent). Growth in M2 of some 20 per cent in 1999/2000 was more or less at the same rate as the previous year, notwithstanding a relatively restrictive monetary policy stance to contain monetary expansion. A ceiling on credit facilities extended by the Central Bank and other banks to the public, private and cooperative sectors was set at 6,000 billion rials over the level of credit outstanding at the end of 1998/99. Furthermore, the private sector was to be allocated at least 55 per cent of the increase in credit extension. Banks were also obliged to channel 25 per cent of the incremental (non-public sector) credit to the agricultural sector, about 33 per cent to the manufacturing and mining sector, 29 per cent to the construction and housing sector and 8 per cent to exports and domestic trade.

Efforts have been made in Pakistan to lower the large fiscal deficits, which have persisted over several years, through both revenue-raising and expenditure-restraining measures. The federal budget of 1999/2000 provided for higher revenue, by about 11.6 per cent, with some 68 per cent of all fiscal receipts to be raised from taxes. However, shortfalls in capital receipts, including those from external sources, contributed to a decline of 8.5 per cent in revenue (compared to the previous year's level) while expenditure went up by over 8 per cent. There were several measures to address the large budgetary gap (of just over 6 per cent of GDP) contained in the economic revival agenda announced in December 1999. Among those were the introduction of an agricultural income tax, the provision of incentives for the disclosure and minimization of tax evasion, and a simplification of tax rules together with a reduction in the multiplicity of taxes. Tax administration was to be strengthened and various tariff reforms instituted.

Pakistan's budget for 2000/01, presented in June 2000, was one oriented towards both fiscal relief and investment promotion through, most notably, a decrease in the allocation for (domestic) debt servicing, a significant cut in the relative share of defence spending, and higher allocation (by over 19 per cent) for development expenditure. The budget deficit was to be contained to a much lower level of 4.6 per cent of GDP through a large increase, projected at 24 per cent, in revenue whereas expenditure would expand by only 2 per cent. New tax proposals consisted of a higher withholding tax on imports, a presumptive tax on exports and customs duties on cars and televisions. On the other hand, the wealth tax was abolished and there was a reduction in the number of other taxes as well as in some rates. Survey and registration procedures were to be strengthened to improve the income and sales tax base. For the next three years, average GDP growth was projected at 5 per cent a year, inflation at 4.5 per cent, investment rate at 18 per cent of GDP, and a budgetary deficit in the third year at 3.2 per cent of GDP.

The persistence of relatively large fiscal deficits pushed up the volume of domestic debt from just under 49 per cent of GDP in 1997/98 to 51.5 per cent in 1999/2000. Interest payments became the single largest item in government expenditure, absorbing 58 per cent of the tax revenue. Almost two thirds of the increase in net domestic assets of the banking system was due to higher government borrowings; in comparison, credit to the private sector (excluding public-sector enterprises) was expanding at a slower rate and amounted to 15 billion rupees in 1999/2000 compared with 60 billion in the previous year, despite lower lending rates from the banks.

Sri Lanka has also faced a fragile budgetary situation characterized by high ratios of budget deficits and domestic borrowings to GDP for most of the 1990s. Budget revenue for the fiscal year 2000 was

estimated at just over 18 per cent of GDP, or marginally higher than the provisional estimate of 17.6 per cent in 1999. Current expenditure, projected at 18 per cent of GDP, was lower than the provisional estimate of 18.7 per cent in 1999. The estimated deficit remained almost at the same level of 7.6 per cent of GDP for 1999 and 2000. There were no significant changes in the extent of revenue mobilization or expenditure allocation, although new expenditure commitments made on the eve of parliamentary elections (in October 2000), coupled with the escalation of defence expenditure, would likely lead to considerable deviations from the budget estimates, with a higher deficit expected for 2000. Indeed, provisional data showed faster increases in both recurrent and capital expenditure for the first seven months of the year.

Public debt (both domestic and foreign) stood at 1,051 billion rupees, or 95 per cent of GDP, at the end of 1999 with the relative shares of domestic obligations and foreign debt being largely of the same magnitude. Debt servicing took up more than 50 per cent of government revenue; the bulk was related to domestic debt as some 97-98 per cent of foreign borrowings were on concessionary terms. In this context, proceeds from privatization would be used to reduce the level of domestic debt. The money supply was expanding in 1999 at 12.4 per cent, a slightly higher rate than during the previous year (9.6 per cent), in part because of an easier monetary policy stance. The statutory reserve ratio, for example, was reduced from 12 to 11 per cent in August 1999 while the bank rate was reduced from 17 to 16 per cent. Credit to the private sector went up by 14 per cent. However, interest rates started to rise during the first half of 2000, partly in response to the expected increase in government borrowings to meet new expenditure commitments. At the same time, credit extended to the private sector was declining, a trend reflecting higher interest rates and the prevailing uncertainties owing to the elections and the worsened military conflict. The combined effect of all these factors served to reduce M2 growth to an estimated 11.6 per cent in fiscal year 2000.

In Turkey, fiscal and financial developments reflected the context of the three-year IMF stabilization programme signed in December 1999. In general, the programme for 2000 remained on track with monetary and exchange rate outcomes being in line with the targets while there were improvements in the fiscal area. In the first eight months of 2000, for example, both total revenue and tax revenue were twice the amounts realized in 1999. Receipts from the emergency taxes, which had been put in place after the 1999 earthquake, accounted for about 15 per cent of the tax revenue. At the same time, non-interest expenditure went up by around 50 per cent, the same rate as targeted in the 2000 budget. While there was a significant rise (of almost 47 per cent) in personnel costs (including wages and salaries of government employees), subsidies fell in real terms during the same eight months of 2000. Government price support for agriculture, an important component of public expenditure in the past, was reduced, as was the amount of procurement of agricultural crops. Notwithstanding such fiscal improvements, the budget shortfall continued to deteriorate to 12 per cent of GDP from just below 11 per cent in 1999, largely as a result of substantial interest payments on domestic debt. The deficit was projected at 30 per cent lower in the draft budget for 2001.

The Central Bank adhered to monetary approaches and targets as agreed with IMF whereby lira liquidity could not be altered by any means other than through the sale and purchase of foreign exchange; on the other hand, the domestic asset position of the Bank was to remain under a predetermined ceiling. There was in consequence a sharp contraction in M2 growth, which at some 66 per cent (year-on-year) for the first eight months of 2000, was much lower than an expansion of over 98 per cent for 1999 as a whole. Interest rates charged by banks during the year were adjusted through changing the repurchase rates to keep to the liquidity targets. However, important developments in the financial sector took place towards the end of 2000. A financial crisis was triggered when some banks which over-invested (gambled) in treasury bills turned to the interbank credit market to finance their purchases. The credit was refused and interest rates began soaring. The market rushed to dollars and the Central Bank funds were drained as the government tried to improve liquidity. To remedy the situation the government signed a $10 billion rescue package in December 2000 with IMF. The package comprised $7.5 billion assistance under a special IMF short-term loan facility for countries in crisis and $2.9 billion from a current standby arrangement. The move gave an immediate boost to the country's deteriorating financial market.

Policy issues and responses

Sustaining high rates of economic growth, macroeconomic balance and price stability continued to be among the major objectives of economic policy in South and South-West Asia. In addition to several recent policy initiatives discussed earlier, a number of other measures deserve a brief note. Concerted efforts were made in India in 1999/2000 to strengthen the banking system and increase its operational efficiency, and to improve the functioning of money and capital markets, both primary and secondary. The Prevention of Money-Laundering Bill and the Foreign Exchange Management Act (replacing the outdated and rigid Foreign Exchange Regulation Act of 1973) were introduced to liberalize and modernize the foreign exchange regulatory environment. The partial utilization of provident funds for investing in private sector bonds and securities was also allowed, while domestic national funds were allowed to invest in overseas securities. At the same time, competition within the insurance sector was to be fostered by making entry easier for private firms. Prudential norms for financial institutions were tightened through the imposition of a higher capital adequacy ratio (9 per cent), the introduction of minimum provisions for standard assets, a shortening of the period for loans to be classified as doubtful assets, and the introduction of a market risk weight of 2.5 per cent on all bank investments plus a 100 per cent risk weight on open foreign exchange positions. Debt recovery tribunals were strengthened and the scope of their mandate was expanded.

While capital account transactions were partially liberalized, several indirect measures were introduced by the Reserve Bank of India to discourage foreign exchange outflows. In particular, a surcharge of 50 per cent on the lending rate for the financing of imports (except for those of an essential nature) was imposed as a temporary measure. At the same time, banks were to charge an annual interest of 25 per cent on export earnings not remitted or deposited so as to discourage delays and speculation. In addition, a reduction of 50 per cent was made on the retained portion of foreign exchange earned under the Exchange Earner's Foreign Currency Account Scheme. A similar reduction was also introduced regarding the limits available to banks for all refinance facilities, including collateral-based lending.

The policy focus in the Islamic Republic of Iran has been on, among other areas, the creation and expansion of employment opportunities, improved security and confidence for investment, a reduction of the government role in domestic economic activities through privatization, and the full enforcement of interest-free banking opportunities and practices. Priorities were also accorded to ensuring social justice and to encouraging greater participation by all stakeholders. Some specific steps recently taken in this regard were discussed earlier. The country's heavy dependence on oil export revenue is another issue of policy concern as this has contributed to substantial instability in the budgetary and foreign exchange positions, and hence in the domestic monetary base. Structural diversification has been promoted, including the encouragement of foreign investment in the non-oil, export-oriented sectors, and of reciprocal purchases of goods and services. Measures were also being adopted to strengthen the coordination and cooperation among institutions which oversee foreign investment.

Financial sector reforms have been implemented by Pakistan as part of the overall policy efforts to improve the effectiveness of monetary policy by shifting from direct to indirect intervention and by ensuring greater reliance on market forces. Among the pertinent initiatives was the gradual liberalization of interest rates (with a view to their further reduction) and of controls on credit. In 1999/2000, for example, substantial cuts were made to the lending rates by the leading commercial banks following downward adjustments of the repurchase rate at the State Bank of Pakistan. The deposit rates on national savings schemes were also on a downward path. In addition, there has been a greater use of treasury bills for the financing of budget deficits along with a strengthening of the supervisory framework of the State Bank. The maturity periods of the bills were made more flexible, a fixed schedule of auctions was introduced to ensure transparency, detailed tender notices were advertised in both newspapers and the Reuters pages, and bill auction results were made available on the same day. Measures taken to increase bank profitability included the closure of loss-making outlets, involving so far some 788 branches and booths. Requests for the opening of new bank branches would be considered on the basis of strict commercial viability and of the parameters under the current branch licensing policy. All these measures

were expected to improve market and investor confidence, leading to higher levels of investment activities; in addition they would help lower inflation expectations, thus creating a congenial environment for sustained, higher rates of economic growth.

In Sri Lanka, the wider use of information and communication technology (ICT) has been recognized as crucial to ensuring greater efficiency, productivity, and hence competitiveness in various areas of the economy. At present, there are two government institutions producing annually fewer than 100 graduates in ICT, with another 150 graduates coming from private institutions. On the other hand, the requirement for ICT professionals was estimated at over 10,000 persons by 2004 and some 20,000 by 2010. Recognizing this critical weakness, a big programme has been launched under the Board of Investment fast-track approach for the development of every aspect of the ICT industry, including capacity-building through training activities. A variety of incentives were also provided under the 2000 budget for private sector investment in 50 ICT training centres, to be set up in various schools and to be linked to a central hub. These centres were to produce ICT professionals at the low and medium levels of the scale, thus helping to reduce youth unemployment. Their initial establishment costs were to be met by the Board of Investment.

As discussed earlier, an ambitious three-year stabilization programme was launched by Turkey toward the end of 1999 with IMF support. It had three major policy objectives: a rapid reduction of the fiscal deficit; the implementation of structural reforms, including privatization; and the introduction of an effective exchange rate regime complemented by a forward-looking wage policy. Programme outcomes were expected to lower the continuing high inflation rates by reducing inflationary expectations, to improve economic efficiency and export competitiveness, to foster greater private investment, and thus to enhance and sustain economic growth. In the fiscal area, there were various measures aimed at cutting losses by the state enterprises, those in the energy sector especially, as such losses had been a burden on public finance. A surcharge of 50 per cent was imposed on electricity consumption of over 150 kh per month both to raise revenue and to conserve energy. Likewise, the explosion in domestic demand for liquefied petroleum gas (LPG), was mainly a result of large price subsidies; in response, the valued-added tax on gas used in motor vehicles was raised from 17 to 40 per cent and the charge for mandatory testing of motor vehicles converted to LPG was increased from 7.4 million lira to 156.7 million lira. In addition, a cut was made in direct subsidies on LPG prices.

South-East Asia

There were signs of an economic slowdown in this subregion, especially in the second half of 2000, after the crisp "V-shaped" recovery of the past two years. Nevertheless, GDP expanded by an average of nearly 6 per cent for the year, compared with 3.4 per cent in 1999, with Malaysia and Singapore growing by 8 to 10 per cent. Another bright note was the significant decline in inflation, despite rising oil prices and currency depreciation and hence higher cost pressures in several countries. In addition, there was a surplus on the external current accounts in all countries in the subregion. However, the persistence of higher energy costs and large fiscal deficits in several economies could be a constraint on continuing growth with price stability. Moreover, South-East Asian stock markets performed poorly in 2000, following last year's stunning rebound until well into the first quarter of the year. Among the causal factors behind this outcome were the volatility and weakness in the American stock markets, domestic political uncertainties that were perceived as having negative implications for sustained progress in the corporate and financial sector reforms, and concerns about a slowdown in world economic growth.

Growth performance

GDP in Brunei Darussalam expanded rather strongly, by an estimated 3 per cent in 2000, relative to the preceding two years (table II.14). The improvement owed much to higher oil revenues. Growth in the domestic non-energy sectors did not gain much momentum as these remained dependent on government spending. The promotion of SMEs in the private sector and the further development of public ICT systems and facilities were progressing steadily, although not as rapidly as expected; an upgrading of the ICT infrastructure is essential to boost the country's non-oil GDP growth both directly and indirectly.

Table II.14. Selected South-East Asian economies of the ESCAP region: growth rates, 1997-2000

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Brunei Darussalam	1997	3.6	2.8	4.5	2.3
	1998	−4.0	2.4	−11.2	6.8
	1999	2.5	−0.1	3.2	1.7
	2000	3.0	2.2	3.4	2.5
Indonesia	1997	4.7	1.0	5.8	5.6
	1998	−13.2	0.8	−15.6	−16.2
	1999	0.2	0.7	1.7	−1.5
	2000	4.4	−2.0	7.0	5.1
Malaysia	1997	7.5	0.4	7.9	8.7
	1998	−7.5	−4.5	−11.0	−4.6
	1999	5.4	3.9	7.8	3.6
	2000	8.2	2.4	12.7	5.9
Philippines	1997	5.2	2.9	6.2	5.4
	1998	−0.6	−6.3	−2.1	3.4
	1999	3.3	6.0	0.9	4.1
	2000	3.7	3.0	3.6	4.6
Singapore	1997	8.4	0.1	7.4	9.0
	1998	0.4	−6.9	1.0	0.1
	1999	5.4	−3.0	6.5	4.8
	2000	10.1	−0.5	9.2	10.6
Thailand	1997	−1.7	0.4	−2.5	−1.4
	1998	−10.2	−1.4	−13.2	−9.5
	1999	4.2	−8.6	12.4	0.4
	2000	4.5	2.0	8.6	2.1
Viet Nam	1997	8.2	4.3	12.6	7.1
	1998	5.8	3.5	8.3	5.1
	1999	4.8	5.2	7.7	2.3
	2000	6.7	4.0	9.9	5.5

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000), and national sources.

Notes: Data for 2000 are estimates. Industry comprises mining and quarrying, manufacturing; electricity, gas and power; and construction.

The pace of recovery in Indonesia picked up significantly in 2000, assisted by the rise in oil prices; GDP had remained virtually flat in 1999, but went up by 4.4 per cent in 2000. Industrial production expanded by 7 per cent, signifying a reversal of the large contraction experienced by this sector during the crisis. Buoyant export growth, especially in electronics, underpinned the sharp upturn in manufacturing and, to a considerable extent, in transport and communications as well. There was, comparatively, some weakness in construction, finance and banking, and overall services; the latter was partly a reflection of a halting revival of the tourism sector. The service sector expanded by just over 5 per cent in 2000, compared with an average annual decline of almost 9 per cent during the years 1998-1999. Meanwhile, rice production in 2000 amounted to 50 million tons, making Indonesia self-sufficient in rice

again after a decade-long slump in production. The overall agricultural sector, however, faced significant structural problems that are related to the squeeze on agricultural credit and disruptions to estate and forestry production caused by social unrest in the outer islands. Agricultural output is estimated to have contracted by about 2 per cent in 2000.

The upswing in export earnings and some initial progress with the ongoing restructuring of the banking system were behind the relative stability of the rupiah in 1999 and in the first quarter of 2000. This, along with a good rice crop, served to reduce both inflation and interest rates. However, the currency was weakened in the latter part of 2000 owing to continuing political problems; interest rates have risen as well, with adverse implications for credit extension and, consequently, for the prospects of investment expansion. Notwithstanding higher export income, the economic recovery depended considerably on fiscal stimulus and, hence, remained fragile. Government spending over the next two years will be constrained by the ballooning in debt-servicing obligations; the budget deficit already reached some 5 per cent of GDP in 2000. All these factors could combine with a comparatively less favourable external economic environment to constrain output growth in the months ahead.

GDP growth, at 8.2 per cent in Malaysia in 2000, exceeded the 1999 performance by nearly 3 percentage points. Higher prices for oil and several other commodity exports were among the driving forces behind this boom. There was an impressive upswing in industrial production which expanded by 12.7 per cent in 2000 on top of strong growth of almost 8 per cent in the previous year. On the other hand, agricultural growth slowed from almost 4 per cent in 1999 to 2.4 per cent in 2000, largely on account of lower production of crude palm oil and rubber. Meanwhile, the positive spillover effects from a robust expansion in manufacturing production and from higher earnings from oil manifested themselves in building, construction and infrastructure development activities. However, growth in transport, storage, communications and utilities moderated during the year. Value added in the service sector as a whole rose by 5.9 per cent in 2000, compared with 3.6 per cent in 1999.

It is noteworthy that GDP growth was achieved, as in 1999, in an environment of low inflation, although the budget deficit increased by one percentage point as a ratio of GDP. The strong growth performance contributed much to the solvency of the financial sector and facilitated efforts in restructuring the corporate sector. Progress in banking reforms and corporate restructuring and the improved employment prospects strengthened domestic demand. The marked fall in investment as a proportion of GDP experienced in the recent past was reversed through new investment in IT, as well as through the expansion of existing production capacity to meet higher demand. Growth prospects for the near term remained reasonably bright, not least because energy exports could significantly counter a slowdown in manufactured exports in 2001.

GDP growth was relatively modest in the Philippines at 3.3 and 3.7 per cent for 1999 and 2000 respectively. Agriculture accounted for one fifth of GDP and growth of this sector slowed from 6 per cent in 1999 to 3 per cent in 2000 largely because of political unrest in the important crop-producing area of Mindanao; this region accounts for one third of rice and two thirds of corn output. Industrial production also expanded modestly at 3.6 per cent in 2000. Food processing displayed an improved performance, but other manufacturing activities, such as chemicals, basic metals, textiles, electrical machinery, wood products and beverages, recorded low growth. The services grew at relatively stable rates of 4.1 and 4.6 per cent respectively for 1999 and 2000.

The Philippine economy suffered significantly from rising energy prices, relatively high levels of unemployment, a weak exchange rate and poor business confidence, in part, the result of the prolonged hostage crisis in the early part of 2000, and then the political turmoil during the second half. All these dampened overall prospects for economic growth in the near term. Meanwhile, a sharp fall in the peso exchange rate contributed to the price pressures that were further aggravated by rising energy prices. Plans to cut the excise tax for petroleum products had to be shelved since this action would have caused a deterioration in the fiscal position; the budget deficit target had already been exceeded by the end of August 2000.

Singapore achieved the fastest GDP expansion, just over 10 per cent, among the economies of the subregion in 2000, twice as much as registered in the previous year. Growth was broad-based with

output from both industry and services rising at similar rates. A major engine of growth in Singapore continued to be the manufacturing sector, although trade and tourism activities showed renewed buoyancy. Private construction activities, however, registered a sharp drop, reflecting excess supplies in both the residential and non-residential segments of the sector. Notwithstanding this remarkable performance, Singapore is currently in a state of transition to a knowledge-based and service-oriented economy from its present strengths in electronics and petrochemicals. In consequence, skilled workers would need to be redeployed or attracted to the ICT sector with some unavoidable restructuring and rationalization of traditional companies and business activities. A possible negative side effect of this process could be that structural unemployment may rise in the short term as the transition will require relatively new and different kinds of skills and human resources.

Thailand's marginally higher growth in GDP, some 4.5 per cent in 2000 compared with 4.2 per cent in the previous year, was largely underpinned by robust industrial output, especially of electronics and electrical products, steel, and automobiles and parts. However, several other products (for example, food and beverages, cement, textiles and garments) did not perform as well, a reflection of large debt exposure, excess capacity and low-capacity utilization. Agriculture grew modestly at 2 per cent, after two successive years of contraction averaging 5 per cent annually over the years 1998-1999. The growth of this sector remained constrained by several factors, including low prices and worldwide oversupplies of some key commodities and slowing demand for agricultural exports in the second half of 2000. Other factors included higher costs of such important inputs as chemical fertilizers and pesticides, and rising oil prices. Deep-seated problems in banking and finance, plus the relatively modest GDP growth over the past several years, were some of the main factors behind the subdued rate of expansion in the service sector of just over 2 per cent in 2000; this sector had been shrinking by an annual average of some 3.5 per cent over the period 1997-1999.

A positive aspect of economic growth in Thailand in 2000 was that it was accompanied by a recovery in investment. The investment rate recovered from around 20 per cent of GDP annually during the years 1998-1999 to 23.5 per cent in 2000. Nevertheless, economic growth began to stall somewhat from the latter part of 2000 because of the ripple effects of high oil prices, the depreciation of the baht, and political uncertainties. The progress in corporate and financial sector reform has been rather fitful. Some of the largest corporations have not yet been fully successful in restructuring their balance sheets, a factor that has created a new class of "strategic" defaulters. This has made the banking system even more reluctant to lend, thus adding to the overall credit crunch problem. By and large, NPLs continue to affect both banks and their corporate customers, while the continuing weaknesses of domestic bank balance sheets potentially pose a risk to sustained, stronger economic growth in the short and medium terms.

Economic performance in Viet Nam was robust in 2000, with GDP growth at 6.7 per cent compared with the rate of 4.8 per cent in 1999. Growth was particularly strong in the industrial and, to a lesser extent, service sectors. Exports remained vibrant, aided by higher regional demand as the neighbouring countries rebounded from the crisis. Despite a slowdown in FDI inflows, industrial value added went up by almost 10 per cent. This upswing was largely underpinned by buoyant activities in both the non-traditional private sector, mainly garments, and the more traditional state sector, mostly heavy industries. On the other hand, agricultural output expanded at a more moderate, but still strong, pace at about 4 per cent in 2000, compared with 5.2 per cent during the previous year. The sector accounted for about two thirds of domestic employment. Serious flooding across the Mekong delta adversely affected production, transportation and marketing during the year. There were also low or falling prices for several important cash and export crops, notably rice and coffee.

The investment rate increased modestly to 29.3 per cent of GDP in 2000. Unresolved difficulties (including not least NPL problems) in the banking sector acted as a constraint on domestic investment in both the industrial and service sectors; the industrial sector remained dominated by state companies, whereas the private sector now plays a major role in several service areas. Meanwhile, planned capital expenditure had been rolled back in view of the shortfall in revenue collections and slowdown in ODA in 1999.

Inflation

A bright note across most parts of South-East Asia in 2000 was the subdued pressure on consumer prices, despite rising oil prices, a considerable depreciation in the exchange rates and larger fiscal deficits in several countries. The available estimates for Brunei Darussalam indicate an inflation rate of just 2.7 per cent in 2000. As a net oil exporter, the country enjoyed much improved terms of trade during the year, giving rise to both gains in real income and a more stable exchange rate than in several other economies in the subregion.

The most drastic fall in inflation was registered by Indonesia where the rate of increase in consumer prices was less than 4 per cent for 2000, compared with an annual average of nearly 39 per cent during the previous two years (table II.15). A good rice crop, easier transport and marketing conditions, the continuing weakness of domestic demand and government subsidies were among the factors that dampened local prices. Another helpful element was the strengthening of the local currency from the latter part of 1999, although the subsequent weakening of the rupiah, especially in the second half of 2000, along with higher energy costs, partially countered the favourable impact on consumer prices. In particular, the rising short-term interest rates (by over 2 percentage points) would help contain inflationary pressures, but they could also adversely affect the recovery process and add to the already heavy debt-servicing burden. The inflation outlook is mixed. While good weather conditions should guarantee an adequate supply of rice in 2001, social unrest in different parts of the country could have a negative influence on the planting and sowing of crops. In addition, the larger budget deficit and higher M2 growth in 2000 could exert pressure on consumer prices in the coming months.

Despite robust economic growth, inflation fell further in Malaysia, from 2.8 to 1.8 per cent between 1999 and 2000. The fixed exchange parity of the ringgit with the United States dollar adopted since September 1998 meant some appreciation in the country's exchange rate vis-à-vis other countries and this moderated somewhat the pressures of imported inflation. This is particularly significant because the country relies considerably on food imports; foodstuffs command a weight of some 30 per cent in the consumer price index. At the same time, movements in the prices of other major items (such as clothing and footwear, rent and manufactured household goods) remained muted and those of certain industrial raw materials actually eased during the year. The inflationary outlook continues to be benign, even after taking into account possible increases in the prices of petroleum products and a higher rate of M2 growth in 2000.

In the Philippines, the downward trend in inflation continued with consumer prices rising by about 4.3 per cent in 2000, the rates being almost 10 per cent in 1998 and about 7 per cent in the following year. There were price increases in such major components of household expenditure as food, beverages and tobacco. The other contributory factors were the depreciation of the currency and higher oil prices, although the impact of rising energy costs has yet to filter fully through to consumer prices. On the other hand, in attempting to maintain the stability of the peso, short-term interest rates had to rise from 10 to over 16 per cent between January and December 2000, thus sharply constraining the rate of M2 growth during the year with a moderating impact on inflation.

Singapore was another economy experiencing very strong growth with a remarkably long history of price stability within the subregion. Indeed, over the last seven years, inflation averaged no more than 1.5 per cent a year, despite an annual GDP expansion of some 7 per cent. In 2000, consumer prices went up by only 1.5 per cent and much of this increase was due to slightly higher costs of food items and petrol; other major components of the price index showed little change. As regards cost factors, the Singapore dollar depreciated marginally against the United States dollar during the year, and its upward push on prices was thus slight. M2 growth was negligible at less than 1 per cent upto June. Given this background, the outlook for continuing price stability remains positive in the near term.

Consumer price stability was also remarkable in Thailand, with an inflation rate of only 1.7 per cent in 2000, despite the weakening of the baht and higher oil prices. This was primarily due to stable food prices and low prices for consumer durables because of keen retail competition. Public transport and housing costs remained, by and large, steady. Core inflation (excluding food and energy) of 0 to 3.5 per cent is being targeted as a policy objective for the period 2000-2002. Short-term interest rates eased from 4.4 per cent to just over 3 per cent between the

Table II.15. Selected South-East Asian economies: summary of macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*
Indonesia	Savings/GDP	31.5	28.4	19.5	22.4
	Investment/GDP	31.8	19.1	11.6	13.0
	Budget balance/GDP[a]	0.0	−3.7	−2.3	−5.0
	Current account balance/GDP	−2.3	3.3	4.1	4.8
	Money supply growth (M2)	23.2	62.3	11.9	13.0
	Inflation rate[b]	6.7	57.7	20.5	3.7
Malaysia	Savings/GDP	43.8	48.5	47.0	44.1
	Investment/GDP	42.9	26.7	22.3	22.7
	Budget balance/GDP[a]	2.4	−1.8	−3.2	−4.2
	Current account balance/GDP	−5.9	12.9	16.0	10.8
	Money supply growth (M2)	22.7	1.5	11.6	16.8
	Inflation rate[b]	2.7	5.3	2.8	1.8
Philippines	Savings/GDP	14.2	12.8	14.9	15.1
	Investment/GDP	24.8	20.2	18.6	19.5
	Budget balance/GDP	0.1	−1.9	−3.7	−2.8
	Current account balance/GDP	−5.3	2.4	10.3	11.8
	Money supply growth (M2)	26.1	8.5	16.1	9.2[c]
	Inflation rate[b]	5.1	9.7	6.7	4.3
Singapore	Savings/GDP	50.4	50.6	49.9	50.7
	Investment/GDP	39.3	32.8	32.8	34.3
	Budget balance/GDP[a]	9.6	1.6	2.5	3.0
	Current account balance/GDP	17.9	25.4	25.0	21.0
	Money supply growth (M2)	10.3	30.2	8.5	0.4[d]
	Inflation rate[b]	2.0	−0.3	0.1	1.5
Thailand	Savings/GDP	34.9	35.1	32.8	32.8
	Investment/GDP	32.9	20.3	20.7	23.5
	Budget balance/GDP[a]	−0.3	−2.8	−3.3	−2.9
	Current account balance/GDP	−2.0	12.5	8.9	6.7
	Money supply growth (M2)	16.5	9.7	5.4	4.5[e]
	Inflation rate[b]	5.7	8.1	0.3	1.7
Viet Nam	Savings/GDP	20.1	21.5	24.6	26.6
	Investment/GDP	28.3	29.0	27.3	29.3
	Budget balance/GDP[f]	−4.8	−2.6	−2.8	−3.2
	Current account balance/GDP	−6.2	−3.9	0.6	1.1
	Money supply growth (M2)	26.1	24.3	17.0	20.5
	Inflation rate[b]	3.1	8.8	4.3	−1.5

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000), and *Asian Development Outlook 2000* (Oxford University Press, 2000); IMF, *International Financial* Statistics, vol. LIII, No. 9 (September 2000) and *International Financial* Statistics, vol. LIII, No. 12 (December 2000); and national sources.

Note: Data for 2000 are estimates.

[a] Excluding grants.
[b] Referring to changes in the consumer price index.
[c] January-August.
[d] January-June.
[e] January-September.
[f] Excluding grants and including onlending.

beginning and end of 2000 while M2 growth had moderated somewhat from 5.4 per cent in 1999 to 4.5 per cent by mid-2000. The near-term outlook for low levels of inflation is thus positive, especially given the slack in the economy and the strong likelihood of a slowdown in economic growth in 2001.

Uniquely within the subregion, Viet Nam experienced some measure of deflation, with consumer prices falling by 1.5 per cent in 2000, despite a strong rebound in domestic economic activities. The incidence of deflation, however, had made itself felt earlier in several other economies in East Asia and South-East Asia (China; Hong Kong, China; Japan; Republic of Korea; and Singapore) in 1998 and/or 1999. Rice has a large weight in the price index of Viet Nam and lower rice prices, on account of bumper harvests, more than offset increases in the prices of other items in the consumption basket. Consumer prices are likely to move upward in the near future owing to the impact of high oil prices, substantial growth of M2 and a larger budget deficit in 2000.

Trade and exchange rates

Strong economic performance in South-East Asia was driven, to a considerable extent, by robust export growth in 1999 and 2000. Although the external balance remained mostly comfortable despite higher import bills, the exchange rates of most currencies came under some pressure during the year. This was, by and large, a reflection of negative market perceptions regarding political developments in the subregion, the speed of progress in corporate and financial sector restructuring, and the strength of the United States dollar, rather than any sharp deterioration in the economic fundamentals as such.

Crude oil and liquefied natural gas are the main exchange earners of Brunei Darussalam, and both export categories benefited considerably from higher prices in 2000. The economy remains vulnerable to global developments in oil prices, and their possible volatility, despite concerted efforts and some progress made in the diversification of the domestic economic structure.

Indonesia is a net oil exporter and also major exporter of a wide range of agro-based and manufactured goods, including textiles and garments, electronics, seafood, palm oil, coffee and wood products. After a slight decline in 1999, export momentum was built up in 2000 and the consequent acceleration of GDP growth also led to a sharp upswing in imports (table II.16). Earnings on merchandise exports increased by nearly 36 per cent in 2000 on a year-on-year basis up to April. Imports, which had contracted by over 12 per cent in 1999,

Table II.16. Selected South-East Asian economies: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					*Imports (c.i.f.)*				
	Value (millions of US dollars)	*Annual rates of growth (percentage)*				*Value (millions of US dollars)*	*Annual rates of growth (percentage)*			
	1999	*1997*	*1998*	*1999*	*2000 Jan-Aug*	*1999*	*1997*	*1998*	*1999*	*2000 Jan-Aug*
Indonesia	48 665	7.3	−8.6	−0.4	35.9[a]	24 004	−2.9	−34.4	−12.2	15.8[a]
Malaysia	84 455	0.5	−6.9	15.2	19.2[a]	64 966	0.8	−26.2	11.4	31.3[a]
Philippines	36 576	21.9	18.2	24.3	15.1	32 568	13.2	−18.5	3.4	2.5
Singapore	114 689	0.0	−12.1	4.4	22.7	111 060	0.8	−20.9	6.1	22.5
Thailand	58 440	3.0	−5.1	7.3	21.5	50 342	−13.1	−31.6	17.2	26.2
Viet Nam	10 434	26.6	0.4	13.2	19.6	13 198	4.0	8.2	5.2	16.6

Sources: United Nations, *Monthly Bulletin of Statistics*, September 2000; IMF, *International Financial Statistics*, CD-ROM, October 2000.

[a] January-April.

expanded strongly by nearly 16 per cent year-on-year in 2000 up to April as industries strove to build up inventories of raw materials and spares. There were, in addition, some emergency fuel imports in response to the inadequate domestic production of certain categories of petroleum products.

The trade surplus of $24 billion in the first 11 months of 1999 rose to over $30 billion in the first 10 months of the following year. This upswing more than offset a large increase in net outflows on the service, income and transfers accounts. The capital account, however, moved into deficit with lower official inflows, higher debt repayments and net outflows of foreign investment, which showed a very sharp increase from $232 million in the first quarter of 1999 to $1,474 million in the corresponding period of 2000. Overall, the current account in Indonesia has been in comfortable surplus since 1998, when it stood at 3.3 per cent of GDP; the surplus widened to over 4 and almost 5 per cent of GDP in the following two years. However, there were adverse market perceptions as regards political instability, continuing social unrest, uncertainties concerning the future course of economic policy, and possible delays in IMF disbursements. In addition to declining investor interest, all these issues combined to generate a downward drift in the exchange rate of the rupiah for a large part of 2000. In a related development, Bank Indonesia switched from May 2000 to the measure of "usable reserves", a change increasingly coming into vogue in many countries following the 1997 financial crisis. Under the new measure, the level of international reserves went up from $26.2 to $27.3 billion between August 1999 and August 2000. This compares with about $19 billion in August 1998.

Export earnings in Malaysia recovered impressively, after contracting in 1998, to expand by over 15 per cent in 1999. Exports continued to grow strongly in the first four months of 2000, showing a 19 per cent increase over the corresponding period in 1999. Electronic equipment and electrical machinery were by far the largest exchange earners, accounting for 60 per cent of exports in 1999. There was simultaneously considerable buoyancy in imports, which rose by 11 per cent after a contraction of over 26 per cent in the previous year. Imports increased more strongly in the first four months of 2000, by 31 per cent compared with the same period of 1999, an upswing driven by vibrant domestic economic activities during the year. Capital goods imports rose sharply, constituting nearly 60 per cent of total imports in both 1999 and 2000; other major categories of merchandise imports included basic manufactures, chemicals and food.

Malaysia has operated a pegged exchange rate regime since September 1998, and the ringgit has strengthened along with the appreciation of the dollar against most foreign currencies, particularly those in East Asia and South-East Asia, over the course of 1999-2000. The strength of the local currency contributed, in part, to the buoyancy shown by imports and the consequent narrowing of the trade surplus from $18.5 billion in the first 11 months of 1999 to $16.7 billion in the first 10 months of 2000. Despite higher debt repayments and some outflows of portfolio capital, international reserves were largely unchanged at $30.1 billion at the end of October 2000, compared with the level prevailing 12 months earlier. Such reserves were adequate to cover 5.5 months of import expenditure and were 6.4 times larger than the level of short-term external debt.

In the Philippines, export earnings continued at a high rate through the crisis years, an exceptional pattern within the subregion. In fact, the growth rate of exports increased from 18 to 24 per cent between 1998 and 1999, total exports reaching $36.6 billion in the latter part of the year. Export growth was somewhat less buoyant during the first eight months of 2000 with export receipts 15 per cent greater than in the corresponding period in the previous year. About one third of the country's exports go to the United States and the robust strength of this economy together with some depreciation of the peso helped sustain the expansion in export receipts in 2000. Export growth has been underpinned by new manufacturing activities, such as electronics which now account for over 30 per cent of total exports, having doubled over the last five years. Traditional export products, consisting of mainly food and basic manufactures, together accounted for 40 per cent of total exports.

During the period 1998-1999, import growth was muted. Imports had actually contracted sharply, by over 18 per cent, in 1998 to rise marginally by just over 3 per cent, to $32.5 billion in 1999. In 2000, import growth slowed to 2.5 per cent although there were higher imports of capital goods, especially telecommunications and electrical equipment

and of crude oil, chemicals and transport equipment. The trade balance widened from $4 billion in the first 10 months of 1999 to $5.8 billion in the same period of 2000 and contributed to a higher current-account surplus, which rose from 10.3 to 11.8 per cent of GDP between 1999 and 2000. Foreign exchange reserves rose marginally to $13 billion in September 2000 from $12.7 billion in September 1999, despite a lower inflow of portfolio and other types of foreign investment. Despite the improved current-account position, the peso depreciated considerably against the dollar in the latter part of 2000, after remaining stable for much of 1999 and into early 2000, a reflection of adverse market perceptions of political problems in the country.

Merchandise exports from Singapore recovered from the decline in 1998 to rise 4.4 per cent in 1999. In the first eight months of 2000, export earnings went up by nearly 23 per cent compared with the corresponding period of 1999. The improvement in export performance was accounted for by petroleum products and telecommunications equipment, which continue to be the main foreign exchange earners for Singapore. However, export shares for a number of items, for example, electronic products, declined in 2000 relative to those of its subregional neighbours. This phenomenon could be attributable, in part, to the relative appreciation of the Singapore dollar compared with the currencies of its subregional economies, with the exception of the Malaysian ringgit. The loss of market share indicates the need to promote the development of higher quality, higher value added and knowledge-based products to ensure a rising share for Singapore in world trade in this rapidly developing activity.

Imports have risen broadly in tandem with exports in 1999-2000. Imports were practically stagnant in 1997; they then contracted by almost 21 per cent in the following year. There was subsequently a recovery with merchandise imports going up by 6 per cent (to $111.1 billion) in 1999. In 2000, however, imports expanded by over 22 per cent, an upswing driven by the exceptionally fast pace of growth in GDP, by renewed consumer confidence and by the need to rebuild inventories.

The trade surplus in Singapore has stabilized around its 1999 level. However, the service-account surplus widened in 1999, after registering a decline in 1998, as earnings from tourism and shipping services became buoyant because of the faster regional economic growth and the higher volume of intraregional trade. In addition, there was a higher level of financial-service exports along with increased activities from brokerage services in the stock market for non-resident investors. The current-account surpluses have remained substantial, averaging 25 per cent of GDP for 1998-1999 and, due in part to strong GDP growth, declining to 21 per cent in 2000. Notwithstanding this strong external position, the Singapore dollar depreciated slightly against the United States dollar, from S$1.67 in December 1999 to S$1.74 in December 2000, a movement which was less than that of other currencies in the subregion. The customary high level of foreign reserves remained stable at nearly $78 billion in September 2000 compared with $76 billion 12 months earlier.

Thailand is another country in the subregion which recorded an impressive export performance in 2000. Earnings from merchandise exports, which had gone up by over 7 per cent in 1999 (to $58.4 billion), expanded further by over 21 per cent in the following year. Export earnings on semiconductors are estimated to have jumped by 37 per cent to approximately $20 billion in 2000, the highest level ever reached, with roughly three quarters of such receipts coming from the United States market. Thailand's principal exports hitherto have been textiles, rice, rubber and jewellery, with transport equipment having risen rapidly in importance in recent years.

Reflecting stronger economic activities and exports, imports also rose by over 17 per cent (to $50.3 billion) in 1999 and by a further 26 per cent during the following year. Part of the increase was accounted for by the higher oil import bill but other import categories, particularly of raw materials and capital goods, also expanded significantly, for example chemicals (by 10 per cent) and machinery (by 4 per cent). In consequence of these trends, the trade surplus came down from $9.7 billion in 1999 to $5.8 billion in 2000. The surplus on services, having risen in 1998, declined in 1999 and again in 2000. This was mainly on account of higher expenditure on transport, freight and commercial fees. These developments combined with some diminution in the pace of economic growth in the second half of 2000 and the pending general election to weaken the baht exchange rate relative to the dollar, from 38 to 43 baht between December 1999 and December 2000.

The faster pace of growth in Viet Nam during the period 1999 to 2000 took place along with a much higher rate of both export and import growth. Export earnings had been stagnant in 1998 but recovered strongly to rise by over 13 per cent (to $10.4 billion) in 1999; they expanded further by nearly 20 per cent in 2000. Rapid growth was registered in the export of seafood, garments and footwear, as well as of the newer light manufactured goods, such as electronics and computer components. Rice and coffee exports declined somewhat. Imports also expanded strongly, by almost 17 per cent in 2000, compared with an annual average rate of less than 6 per cent during the previous three years. Imports stood at $13.2 billion in 1999. Reflecting, in part, a more robust overall economic performance, the value of imported raw materials and capital goods went up significantly. Both the trade and service deficits widened in 2000, despite higher receipts from tourism. However, the current-account surplus went up modestly, from 0.6 to 1.1 per cent of GDP between 1999 and 2000.

The bilateral trade agreement with the United States, if ratified, is due to be implemented in early 2001. The most-favoured-nation trading status gained by Viet Nam might, however, be followed by the imposition of quota restrictions on Vietnamese textile and garment exports to the United States market. Meanwhile, economic integration with ASEAN is proceeding on schedule as Viet Nam has continued to lower tariff barriers as part of its commitments to the ASEAN Free Trade Area. Against this backdrop, the local currency remained largely stable against most leading currencies; full convertibility for current-account transactions was one of the policy objectives, although a target date has not been definitely set for this.

Capital inflows and outflows

Given the prevailing current-account surpluses and efforts to reduce external indebtedness, capital was flowing out from most of the countries of South-East Asia on a net basis in 1999 and 2000. Foreign exchange reserves were also built up in 1998 and 1999, but have thereafter tended to stabilize. Substantial inflows of portfolio investment in early 2000 brought about an upward movement in stock market indices, but the trend was reversed in the latter part of the year following the declines in United States stock markets.

In the context of external indebtedness, Indonesia's debt profile has shifted away from short-term private to longer-term public debt, much of which has also been rescheduled since 1998. Large borrowings to finance bank recapitalization and to compensate Bank Indonesia for the liquidity injected into the banking system in 1997 raised sovereign debt to $68.2 billion (or 91 per cent of GDP) by the end of 2000, from $53 billion as of June 1997. This level of sovereign debt was much higher than those of the neighbouring countries, including, for example, the Philippines (37 per cent of GDP) and Thailand (23 per cent). Recent depreciation of the local currency posed another challenge for debt management as the new debt is denominated in foreign currencies; thus, servicing obligations in local currency change with changes in the rupiah-yen and rupiah-United States dollar exchange rates. The value of approved FDI rose in the first half of 2000 in the wake of large disinvestments in 1999, but was still considerably below the pre-crisis levels. Political uncertainties, economic and financial problems, and social unrest are the main reasons behind fragile investor confidence. All these have persisted despite a variety of policy measures introduced to improve market sentiment, including better tax incentives and the opening up of sectors previously off limits to foreign companies.

The negative impact of FDI on Malaysia in the wake of the imposition of selective capital controls in September 1998 appears to have dissipated. Foreign investment applications picked up considerably in late 1999 and early 2000, a rebound partly reflecting the high approvals for manufacturing investment made in the earlier years as well as the continued investment in the oil and gas sectors and in services. The net outflow of funds for overseas investment also increased in 1999, as did portfolio net outflows. However, these outflows were more than offset by the strong trade surplus, net FDI inflows, and the revaluation gains arising from the strengthening of the ringgit against most major foreign currencies. Gross external debt, which stood at $45 billion in 1998, has now largely stabilized at that level, while the proportion of long-term debt increased from 68 to 80 per cent between 1997 and 1999.

In the Philippines, the total outstanding external debt stood at $52.2 billion (or about two thirds of GDP) as of June 2000. This represented a drop of

some $0.3 billion from the end of March level as a result of net repayments on loans and increased investments by residents in debt instruments issued by Philippine borrowers outside the country. The banking sector was also opened up for further foreign participation from May 2000. A foreign bank would now be able to own up to 100 per cent of one local bank within seven years from the enactment of the law; a foreign bank acquiring up to 60 per cent equity in a local bank prior to the passage of the law could raise its stake to 100 per cent within the same period. However, the central banking authorities must ensure that 70 per cent of the entire banking sector's assets are held by Filipino-controlled banks. There was a considerable decline in FDI inflows in 1999. Its revival would require improved market sentiments and investor confidence which, in turn, are contingent on the restoration of political stability.

Singapore has no official external debt and private companies, although free to raise equity or debt finance externally, have not often done so. The country is an important investor in overseas projects in its own right, facilitated by the enormous current-account surplus and foreign-exchange reserves accumulated over the years. At the same time, the patterns and size of capital-account transactions (both inflows and outflows) are also influenced by the government, via its large holdings (including through Temasek Holdings) in government-linked companies.

Along with the relatively large surpluses on the external current account over the last three years, the debt profile has improved substantially in Thailand. As of October 2000, foreign debt totalled $83 billion or about 14 per cent less than in 1999. The proportion of long-term debt had risen from 60 to 82 per cent between 1997 and October 2000, while that of short-term debt had fallen sharply to 18 per cent over the same period. FDI inflows in 2000 were substantially lower than the 1999 level, a decline attributable to the general loss of interest on the part of investors in greenfield investment projects coupled with the difficulties experienced by some investors in consummating merger and acquisition projects. On the other hand, portfolio investment had been relatively buoyant until stock market weakness set in from the early part of 2000.

Gross external debt in Viet Nam, at $22.4 billion (equivalent to 82 per cent of GDP) in 1999, is either publicly owned or publicly guaranteed. The country is classified as a heavily indebted poor country and the low debt-service ratio of just over 6 per cent of exports reflects debt rescheduling arrangements made in 1998. Meanwhile, concerted efforts have been carried out to attract external private capital, particularly FDI inflows. In 2000, most of the approved investment projects originated from such newer investors as Australia, Japan and Taiwan Province of China. Historically, the top foreign investors were from Singapore; Hong Kong, China; and the Republic of Korea who together contributed some two fifths of the total FDI in the country. In addition, the bilateral trade agreement with the United States should have a positive impact on FDI inflows in the years ahead.

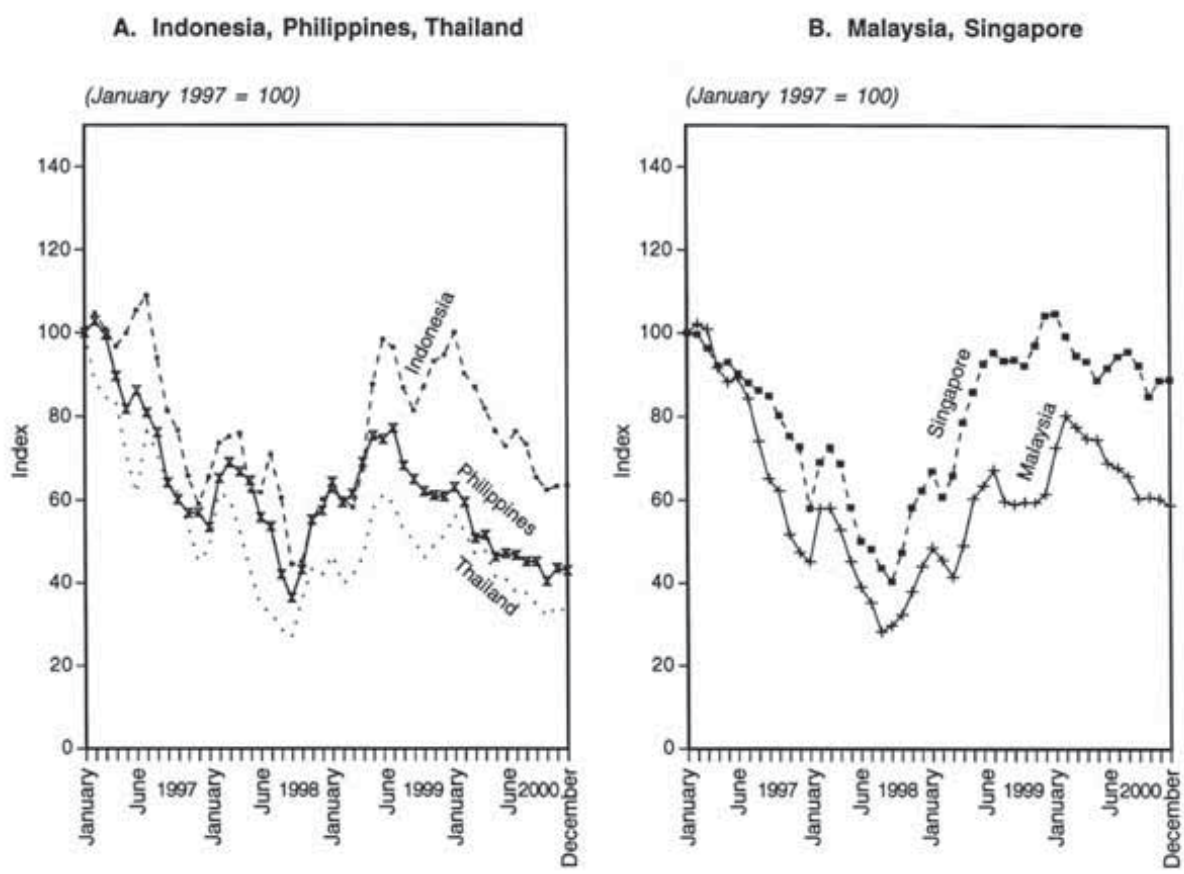
Financial sector developments

The strong economic recovery in the subregion has not been accompanied by commensurate achievements in financial and corporate sector restructuring. The resolution of NPLs made only gradual progress and there were few signs of a tangible recovery of credit flows to the real sectors of the economy. In tandem with the markets of the United States during the year, subregional capital markets entered a bearish phase, a movement which became intensified in the latter part of the year (figure II.6). Given the scarcity of venture capital support, it became virtually impossible for companies to raise finance from the capital market, a weakness that hit ICT companies particularly hard.

Efforts are under way in Brunei Darussalam to set up a regional financial centre focusing on Islamic financial services; the pertinent legislation is being updated. Currently, the nine foreign banks in the country are providing conventional banking services. The country faces competitive pressures in Islamic banking from Malaysia, while for more conventional financial services, such as loan syndication and structured finance, Singapore is a more established regional financial centre of considerable size and sophistication. The proposed regional financial centre in Brunei Darrussalam might thus offer services similar to an offshore financial centre with a mix of Islamic and conventional financial products available to both residents and non-residents.

In Indonesia, the process of financial-sector restructuring remains beset by difficulties and only limited headway has been made by the Indonesian

Figure II.6. Index of stock markets of selected South-East Asian economies, 1997-2000



Source: *The Economist,* various issues.

Bank Restructuring Agency (IBRA). The progress in corporate debt workouts has been slower than expected. This is also the case with institutional reform, most notably of the legal system and the bureaucracy. Besides, bank lending is still constrained by rising interest rates as well as the cautious stance of banks about lending to the still weak corporate sector despite the planned completion of the bank recapitalization programme by the end of the year. The closure of 16 private banks was an essential element of the overall resolution of the banking crisis in 1997. Given the understandable lack of experience with multiple bank closures, no institutional arrangements were in existence for effective follow-up after closure. The surviving assets of these banks were not properly secured, thus rendering the process of their liquidation more difficult and complicated. IBRA had disposed of only 2.5 per cent of the assets on its books by September 2000, a level far less than the amount sold by similar agencies set up to revive the financial and corporate sectors in other crisis-hit Asian countries. In Malaysia, the National Asset Management Company (Danaharta) had sold 40 per cent of the distressed assets it once controlled and in Thailand, the Financial Sector Restructuring Agency had disposed of 78 per cent of its assets over the comparable period.

An Ombudsman Commission, established in May 2000 to prevent political interference in IBRA, joined the other existing committees with financial responsibilities, including the Financial Sector Action Committee, the Independent Review Committee and most recently, the Oversight Committee. Most of

these committees have overlapping functions and remits and as such might have complicated further the process of financial-sector reform. The Jakarta stock market, which had hit a low in May 2000 in response to reports of civil unrest, showed little sign of improving subsequently. Trading was relatively weak and at the end of 2000 the stock market index had declined by over 38 per cent in rupiah terms and by nearly 53 per cent in United States dollar terms, compared with the levels prevailing at the beginning of the year.

The Malaysian Government is adhering to its year-end target date for banking-sector consolidation, a process considerably facilitated by a strong performance of the real sector. The banking system became stronger with a risk-weighted capital ratio of 12.9 per cent as of the end of June 2000, well above international norms. Danaharta made further progress in rehabilitating and restructuring viable loans; a total of RM 27.5 billion of loans and assets had been restructured or disposed of, with an average recovery rate of 75 per cent, by September 2000. The amount of capital injection in the banking sector by Danamodal (established as a special purpose vehicle in August 1998 to recapitalize banking institutions) also declined following the repayment of RM 340 million, bringing the total capital injection to RM 4.9 billion in five banking institutions at the end of June 2000. Similarly, the Corporate Debt Restructuring Committee (established in August 2000 under the auspices of the Bank Negara Malaysia) had restructured some RM 23.6 billion of corporate debt in 27 cases as of July 2000. However, the stock market became generally weaker from the second quarter of 2000 onward in line with similar outcomes elsewhere in the subregion. It is noteworthy, however, that the stock market index had fallen by only 12.5 per cent, one of the lowest declines in the region, during the year from January to November 2000.

In the Philippines, the supervisory powers of the central bank were further strengthened. Greater competition from foreign banks can be expected following amendments to the banking legislation. Financial-sector consolidation is also moving rapidly. The process is largely market-driven, in part as a response to heightened competition. Some four or five major local banks are expected to emerge at the completion of the process. The ratio of NPLs slightly increased from 14.7 to 15.3 per cent of the total loan portfolio at the end of July 2000 owing to stricter restructuring guidelines that took effect on June 1; banks can no longer conceal NPLs through restructuring arrangements to make these loans appear to be current. Nevertheless, the NPL ratio was considerably lower than in other crisis-hit countries, such as Indonesia and Thailand. In 1998, a Small Investors Program had been introduced to encourage Philippine citizens to hold (and trade) treasury (or government) securities in small sums and by means of an efficient (electronic trading) and low-cost (scripless) system to streamline the settlement procedures. Plans were made to have treasury issues listed on a newly established Bond Exchange in 2000 to promote the Small Investors Program further to secure broader investor participation in the capital market and to raise the pool of savings available for investment.

The Monetary Authority of Singapore has decided on a package of reforms aimed at shifting the emphasis from regulation to supervision, and from a rules-based to a risk-management approach. Entry barriers to the financial industry have been largely removed, while the liquid fixed-income and equity markets are being widened and deepened along with the promotion of asset management activities. This would enable Singapore to better cope with the challenges posed by global finance as these markets and activities are less developed than its banking and foreign exchange industries. Moreover, the use of the Singapore dollar by non-residents is being gradually liberalized. Meanwhile, banks are required to separate financial and non-financial businesses by the end of 2003 so as to reduce their exposure to cyclical downturns in particular areas, for example in property development. Non-financial activities must be segregated from the banking group and divested. They can be sold to third parties or to the bank's principal shareholders who will own them directly. Reflecting the trends elsewhere, stock market prices fell by around 21 per cent in 2000; the decline would be higher if measured in United States dollars.

Financial-sector restructuring continues to pose a major challenge to the recovery process in Thailand. Problem loans were down from their peak of nearly 49 per cent in mid-1999 to under 25 per cent in October 2000 and short-term interest rates fell to just over 3 per cent in the latter part of 2000. Nevertheless, credit growth remained constrained as

banks tried to protect their capital base and were wary of acquiring new assets with economic growth slowing down in the latter part of 2000. It was noted recently by the rating agency Standard and Poor's that local banks remained in need of as much as 1.2 trillion baht (or about $28 billion) in new capital. Some of the larger banks were able to return to the capital markets through securities and equity issues, although the appropriate levels of risk-weighted capital remained a difficult issue in the current financial environment, given the continuing high levels of gearing in Thai companies and their consequent vulnerability to a new downturn. Rural debt has also been an area of concern.

Meanwhile, the planned privatization of both Siam City Bank and Bangkok Metropolitan Bank remained uncompleted, in part as a result of the failure to find new strategic owners for these banks. The current approach in dealing with the impaired assets of the banks is largely market-based, but the process will need to be speeded up to revitalize credit growth and to improve investor confidence in the financial-sector restructuring and consolidation process and, by implication, in corporate-sector restructuring as well. The National Real Estate Information Centre was set up as a response to problems in the financial sector. It had been argued that over-exposure by the banking sector to the property market occurred because bankers did not have enough information on the market. At around 290 billion baht (or 18.3 per cent of the total NPLs of banks) at the end of July 2000, NPLs in the property sector were a major factor in the persistent NPL problems. The Thai stock market also declined sharply during the year, by 44 per cent between the beginning of the year and the end of December 2000, and by nearly 51 per cent in United States dollar terms.

Viet Nam was one of the few countries in the subregion which experienced a relatively limited impact from the crisis, but its financial sector has not been free from weaknesses. Because of the underdeveloped capital markets, both state and private sector enterprises have been heavily dependent upon banks for investment and working capital. It is thus essential to ensure stability of the banking system and to reduce the likelihood of NPLs building up. The central bank has pursued a tighter overall policy regime, including direct central bank controls on credit expansion, by imposing credit ceilings on bank lending. The weaker joint stock banks will be closed or merged with stronger banks. Movements in interest rates will be made to reflect better the influence of market forces and arm's length scrutiny of bank loan applications will be encouraged. So far, the progress has been slow in the recapitalization of state-owned banks. A better balance between equity and debt in the state enterprises will be difficult to achieve without a functioning capital market. A stock market had been planned for several years but its launching had been delayed because of, among other reasons, an inadequate number of companies willing to list and concerns that the market would expose the financial system to unnecessary risks. It was finally opened in July 2000 with only two companies listed. The main instruments available for trading on the exchange floor will be government, bank and project bonds until such time as an adequate volume of listed equities is available for trading on the stock exchange.

Policy issues and responses

The continuing overhang of private-sector debt and the rapidly rising levels of public-sector indebtedness are among the major policy concerns in South-East Asia. The growing public debt burden in most economies is highly correlated with the restructuring of the financial and corporate sectors. The problem might be further aggravated if growth in the region were to falter as a spillover effect from a sharp slowdown in the global economy. In other words, a debt trap could be possible whereby public or publicly guaranteed debt would grow faster than revenue available for servicing. Measured by the debt stock to GDP ratio, the burden ranges from a relatively modest 25 per cent in Thailand to a high of 91 per cent in Indonesia. Debt-service payments in Indonesia also soaked up 36 per cent of government tax revenue in the fiscal year 1999, compared with 24 per cent before the financial crisis. Such payments clearly could act as a constraint on public spending for socio-economic development. Efforts to widen and deepen the tax base should also be complemented by greater streamlining and rationalization of government expenditure allocations.

It is also critically important to ensure the resolution of NPLs in a time-bound and orderly manner; these loans remained substantial in several

countries despite two years of financial restructuring and the economic turn-around. A solid recovery will be hard to sustain without overcoming the banks' reluctance to lend and without a significant pickup in private investment. However, the continuing lack of demand for financial assets seemed to be reflected in recent declines in bank deposit rates and the comparatively modest M2 growth. In this context, the relatively undeveloped capital markets have made it more difficult for impaired assets to be efficiently priced and disposed off. There are also obvious political difficulties in selling distressed assets in the face of determined resistance from their legal owners. The bad debt problems apparently have been aggravated by the current bouts of political unrest and uncertainties in several countries of the subregion.

It cannot be overemphasized that market sentiment and investor confidence, and hence the overall growth prospects in the subregion, depend heavily on the success of the bank and corporate restructuring programmes. The slow pace of post-crisis corporate restructuring, or any noticeable back-tracking in the process, would have an adverse impact on the stock markets, and could threaten to smother economic recovery with higher short-term interest rates and tighter liquidity.

An over-dependence on certain sectors for exports or for employment is a vulnerability for several countries in the subregion. Brunei Darussalam, for example, is heavily dependent on oil and gas revenues, while the agricultural sector accounts for one half and two thirds of the employment respectively in Thailand and Viet Nam. Prices of several agricultural commodities have remained weak for several years and have, over the last two years, been instrumental in persistent rural poverty. Electronics (and especially semiconductors) constitute a major source of export earnings in several countries, while the United States economy is the destination of a quarter or more of the exports. Such structural concentration and vulnerabilities cannot be attenuated in the short term. It is also not clear what direct role governments could or should play in countering them. One obvious role relates to the provision of better information for investors, business people and traders on markets, technologies, standards regarding quality assurance and control, input and financing sources etc. More generally, governments and the private sector need to act in concert to reduce structural vulnerabilities.

Following the 1997 crisis, governments in the subregion have embarked on a process of reform that included improved public and corporate governance. Prior to the collapse in 1997, there was no real or adequate penalty for a country or company operating in a non-transparent manner. However, market sentiment and investor confidence are currently much more sensitive to certain minimum standards of transparency, disclosure and accountability. There is a perception that the appetite for reform appears to be waning three years after the crisis. There is an urgency to remove such a perception with demonstrable improvements in the regulatory and supervisory frameworks and enforcement of appropriate penalties in the event of non-compliance.

Finally, all countries in the subregion need to enhance their competitiveness through, among other channels, increased spending on education, distance learning, retraining and greater reliance on ICT in production and marketing. Indeed, rising labour costs have blunted the competitive edge of most economies in the subregion in labour-intensive activities. The process of transition to acquire competitiveness in increasingly knowledge- and technology-based activities needs to be more vigorously pursued.

East and North-East Asia

Within the subregion, China and Hong Kong, China registered robust growth with virtually no inflation pressures in 2000; economic expansion was remarkably vibrant in Hong Kong, China. The Republic of Korea continued to show strong growth with only moderate inflation, although economic activities appeared to cool off somewhat in the later part of the year. Mongolia maintained, by and large, its recent economic performance. Expansionary government policies and increased external demand played a key role in the high GDP growth rates within the subregion in 2000 although the immediate economic prospects would not appear as favourable, especially in relation to the persistence of high oil prices and the slowing United States economy. Financial sector fragility, the underlying uncertainties regarding the progress of financial and corporate sector reforms and restructuring, and rising government debt remained matters for policy concern and attention in several subregional economies.

Growth performance

GDP in China was estimated to grow by around 8 per cent in 2000, reversing the deceleration observed over the years since 1992-1993 when the economy achieved a record rate of annual expansion of some 13 per cent. In money terms, GDP in China amounted to $991 billion in 1999 and is expected to exceed $1 trillion in 2000 for the first time in its history. Hong Kong, China put up a highly robust performance, with GDP expanding almost 10 per cent in 2000, after a spectacular growth of 14.3 per cent achieved in the first quarter. This contrasted sharply with a contraction of 5 per cent in 1998 and a modest expansion of 3 per cent a year later. Meanwhile, there were signs of a slight slowdown in the Republic of Korea after posting year-on-year a GDP growth rate of 12.7 per cent in the first quarter and 9.6 per cent in the second quarter of 2000. Recent data on economic growth are not yet available for Mongolia, a landlocked country. GDP in this country is expected to grow at 4 per cent in 2000, a rate not remarkably different from that registered since 1997.

GDP in China has consistently displayed a very fast rate of growth over the 1990s. This remarkable expansion in output has been achieved within an environment of sustained price stability. For the period 1996-2000, for example, the annual rate of GDP growth averaged 8.3 per cent a year; it is projected to be between 7.7 and 8.7 per cent in the medium-term period of 2001 through 2003. Sectorally, the value added of primary industry in China increased 2.8 per cent in 1999, and that of secondary and tertiary industries by 8.5 and 7.5 per cent respectively. For 2000, the corresponding figures were estimated at 2.5, 10.5 and 8.3 per cent.

Agriculture has always been considered as vital to China. With some 7 per cent of the world's arable land, the country has to produce commodities to meet the needs of some 22 per cent of the world population. Reform in the last two decades has greatly increased agricultural productivity. Grain production per capita, for example, rose from 300 kilograms at the beginning of the reform period to more than 400 kilograms by the end of 1999, resulting in an excess supply of several products. At the same time, however, agricultural output continues to be subject to the vagaries of weather conditions. In 2000, the country experienced a widespread drought that reduced the summer grain harvest and, in consequence, the value added of agriculture went up by only 1.5 per cent in the first half of the year. The autumn grain production, which constitutes about three quarters of the total agricultural production, is forecast to be bountiful so that the total value added of the agricultural sector will be 2.5 per cent higher for 2000 as a whole.

The levels of industrial sector value added in China have been expanding at a relatively high, albeit slightly declining rate; annual growth in industrial output decelerated from 14 per cent in 1995 to an average of 12 per cent over 1996-1997, and then to about 9 per cent in 1998 and 1999. This trend was, in part, reflected in the marginal deceleration in GDP growth patterns since 1993, as noted earlier. In the first three quarters of 2000, however, industrial growth reached almost 10 per cent, and it is estimated to be about 10.5 per cent for the year as a whole (table II.17). Among the contributing factors to this upward trend was the production of communications equipment, personal computers and integrated circuits; their outputs increased significantly in the first half of the year. The growth rate of the industrial sector is expected to hover around 10 per cent in the next three years.

The service industry expanded by just over 8 per cent in the first half of 2000, a rate slightly lower than the annual average of about 10.5 per cent registered during the two decades of reform. Expansion in this sector has tended to be faster than the growth rate of GDP, a trend projected to remain in the next three years. However, the relative weight of services in GDP is still rather low, amounting to only 33 per cent in 1999, although the share will rise with the economy becoming more open, deregulated and market-oriented. There will be fast-growing demands for services, such as legal, financial, health-care, education, advertising and transportation services, and retail trade.

On the demand side, China has pursued active policies to stimulate the expansion of the domestic consumption of goods and services over the past two years, including, for example, lowering interest rates, raising civil service salaries, and extending public holidays for shopping. Domestic demand had been constrained by relatively high unemployment, fear of further job losses, and reduced levels of labour earnings in consequence of the ongoing process of restructuring state-owned enterprises. In addition, public investment is planned in about 5,100

Table II.17. Selected East and North-East Asian economies of the ESCAP region: growth rates, 1997-2000

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
China	1997	8.8	3.5	10.8	8.2
	1998	7.8	3.5	9.2	7.7
	1999	7.1	2.8	8.5	7.5
	2000	8.0	2.5	10.5	8.3
Hong Kong, China	1997	5.0	..	..	..
	1998	−5.1	..	..	..
	1999	3.0	..	..	..
	2000	9.7	..	..	..
Mongolia	1997	4.0	4.3	−3.6	9.0
	1998	3.5	6.4	3.9	0.3
	1999	3.0	3.0	1.8	3.8
	2000	4.0	..	..	..
Republic of Korea	1997	5.0	4.6	5.4	4.7
	1998	−6.7	−6.6	−7.5	−6.0
	1999	10.7	4.7	13.0	9.4
	2000	9.2	−1.5	10.9	8.3

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000), and *Asian Development Outlook 2000* (Oxford University Press, 2000); *OECD Economic Outlook 2000*, No. 68 (November 2000); and national sources.

Notes: Data for 2000 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

projects, using the funds raised during the past two years through the issue of long-term treasury bills worth some 250 billion yuan renminbi.

The economy of Hong Kong, China has continued to recover strongly since the second half of 1999, with GDP expected to rise by almost 10 per cent in 2000. In particular, exports of goods and services were estimated to grow by over 13 per cent, a performance driven by strong import demand in all major markets. Trading activities also surged and this, together with a further leap in inbound tourism, helped spur the rise in services exports. Domestically, consumer spending became relatively more buoyant, along with increased overall incomes and sustained improvements in the labour market. The volume of investment spending in the second quarter of the year also expanded further, following the rebound in the first quarter. The building and construction sector remained sluggish, but there was a sharp increase in machinery and equipment acquisitions. The overall output from building and construction activities contracted by 6 per cent in the first quarter, and by another 11 per cent in the second quarter of 2000.

Many manufacturers in Hong Kong, China have set up production facilities in the mainland since the country's implementation of its open-door policy in 1979. This has greatly facilitated and increased trade between Hong Kong, China and the mainland. During the first quarter of 2000, for example, the total export value to the Chinese mainland for outward processing purposes went up by 23 per cent; this contrasted with an expansion of about 6 per cent in 1999. Out of the total export value to the mainland in the first quarter, domestic exports based on outward processing increased by 7 per cent, while re-exports for outward processing expanded significantly by 26 per cent. Furthermore, the value of imports from the mainland following outward processing were up markedly from 2 per cent in 1999 to 15 per cent in the first quarter of 2000.

Inbound tourism remained robust. The total number of incoming visitors surged by a further 18 per cent in the second quarter of 2000 over a year earlier, having leaped by 13 per cent in the first quarter. These growth rates were higher than the 12 per cent rise in the second half of 1999 as well as for 1999 as a whole. For the first half of 2000, there were some 6.2 million visitors, with the number of visitors from East Asian countries showing a particularly strong recovery. This upward trend was underpinned by the reasonably robust economic turnaround in the region and the appreciation of some of the regional currencies over the past year.

GDP in Mongolia is estimated to grow by 4 per cent in 2000. Industrial output in the first eight months of 2000 amounted to 140.1 billion tugrik ($137 million), or about 29 per cent more than the level in the same period in 1999. Outputs in electricity, minerals, coal, clothing, wood products and printing increased, but outputs in manufactured textiles decreased. Outdated technology has been a drawback in ensuring higher quality and productivity, especially in some major industries where government still has a large stake.

There has been some public controversy in Mongolia over certain implications of FDI. Nevertheless, the crucial importance of such investment, as a source of development finance and technology transfer, is well appreciated by the new government in its efforts to support and attract additional capital inflows. There were hopeful signs for the renovation of some coal mines following a recent agreement between Mongolia and the Russian Federation. Of Mongolia's estimated 150 million tons of total coal reserves, 20 million have been mined, leaving 130 million. Gold production in the first six months of 2000 reached almost 3.5 tons, an increase of under 7 per cent year-on-year. In the agriculture sector, on the other hand, the break up of state farms in 1991 has led to reduced grain production, making food security and nutrition serious issues. The main factors behind this downward trend in production included inadequate financial resources, managerial skills and experience. Except for the central and western regions, the availability of electricity is minimal and this is another major obstacle to development in Mongolia. However, two agreements securing external aid for the construction of hydroelectric stations, reached early in 2000, would help to alleviate the problem. More recently, a soft loan worth $0.8 million was provided by the Economic Development Cooperation Fund of the Republic of Korea for a thermal power station in Dalanzadgad.

In the Republic of Korea, GDP went up by about 9 per cent in 2000, a marginal slowdown from the heady expansion of the previous year. Growth was led by a sustained increase in fixed investment (by almost 13 per cent) and exports; there was also higher private consumption, with expenditure on final consumption being almost 8 per cent higher. It was notable that there was a rise of over 41 per cent in equipment investment, reflecting a sharp rise in domestic capital formation in machinery and transportation equipment. Construction investment meanwhile decreased by almost 5 per cent during the second quarter, although the scale of such contraction was smaller than that of the previous quarter. Exports of goods and services shot up by almost 24 per cent in real terms, a result of a substantial increase in the shipment of computers, semiconductors, and wireless communications equipment. The significant growth in import spending on goods and services, at almost 20 per cent, was a reflection of the higher domestic purchase of capital goods and raw materials necessitated by the business boom earlier in the year.

As regards the sectoral sources of growth, the levels of value added in agriculture, forestry and fishery are estimated to have slightly declined in 2000. This was attributable, in part, to the poor performance of inshore fisheries and marine aquaculture which more than offset the ongoing growth in the livestock industry. Meanwhile, construction activities are likely to remain, by and large, stagnant owing to over-supply and credit constraints. In sharp contrast, however, manufacturing and services are estimated to register high growth rates, with the former registering year-on-year a 16.8 per cent first-quarter growth in 2000, thus driving the overall rate of economic expansion in the Republic of Korea. Growth was notably high in such subsectors as electric and electronics equipment (especially computers, semiconductors, and telecommunications equipment). The industrial machinery subsector continued to expand in response to robust demand at home and abroad. The service industry expanded by over 8 per cent, underpinned largely by higher output, totalling some 20 per cent, in the transportation, storage, and communication sectors. The growth of communications largely centred around mobile phones and the Internet.

Inflation

The rate of increases in consumer prices among economies in East and North-East Asia remained largely subdued or on a downward trend. Indeed, there was a deflationary pressure, of around 3 per cent, in Hong Kong, China in 2000 while in Mongolia consumer prices went up by about 5.5 per cent. Elsewhere in the subregion, inflation was, by and large, stable with China registering a marginal rise in inflation of just 0.5 per cent, while it rose from less than 1 per cent in 1999 to 2.3 per cent in the Republic of Korea for 2000.

China has experienced deflationary pressures since 1998, when consumer prices fell by almost 1 per cent; this downward force became stronger in 1999 so that there was a deflation of 1.4 per cent. However, prices began to increase in May and inflation was projected to be about 0.5 per cent in 2000 as a whole (table II.18). Excess capacity in many industries, ample supplies and lower consumer confidence were among the major factors behind this subdued pattern of price behaviour. In particular, there was some evidence that among more than 600 kinds of industrial products, only 12 were in short supply. Food prices were also on a downward trend

Table II.18. Selected East and North-East Asian economies: summary of macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*
China	Savings/GDP	41.4	41.3	39.7	39.5
	Investment/GDP	38.1	38.8	38.3	37.8
	Budget balance/GDP[a]	−0.8	−1.2	−2.1	−3.1
	Current account balance/GDP	4.1	3.3	1.6	1.7
	Money supply growth (M2)	18.8	14.9	14.7	14.2[b]
	Inflation rate[c]	2.8	−0.8	−1.4	0.5
Hong Kong, China	Savings/GDP	31.1	30.2	29.9	30.7
	Investment/GDP	34.5	29.7	25.4	27.3
	Budget balance/GDP[a]	6.6	−1.8	−0.1	1.0
	Current account balance/GDP	−3.9	1.8	5.8	4.1
	Money supply growth (M2)	8.3	11.8	8.1	12.0
	Inflation rate[c]	5.8	2.8	−4.0	−3.2
Mongolia	Savings/GDP	21.9	27.0	20.0	..
	Investment/GDP	26.0	25.8	26.0	..
	Budget balance/GDP	−8.5	−11.9	−9.7	..
	Current account balance/GDP	5.7	−12.3	−11.8	..
	Money supply growth (M2)	32.5	−1.7	31.6	14.8
	Inflation rate[c]	36.6	9.4	7.6	5.5
Republic of Korea	Savings/GDP	33.7	34.2	34.2	32.0
	Investment/GDP	34.2	21.2	26.8	28.5
	Budget balance/GDP[a]	−1.5	−4.2	−5.1	−2.8
	Current account balance/GDP	−1.7	12.9	6.1	1.9
	Money supply growth (M2)	14.1	27.0	27.4	24.8
	Inflation rate[c]	4.5	7.5	0.8	2.3

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2000* (Oxford University Press, 2000) and *Asian Development Outlook 2000* (Oxford University Press, 2000); IMF, *International Financial Statistics*, vol. LIII, No. 9 (September 2000) and *International Financial Statistics*, vol. LIII, No. 12 (December 2000); and The Economist Intelligence Unit, *Country Forecast: South Korea*, December 2000; and national sources.

Note: Data for 2000 are estimates.

[a] Excluding grants.
[b] January-March.
[c] Referring to changes in the consumer price index.

as the prices of grains were decreasing every year after four consecutive years of bumper grain harvests. Another set of indirect factors behind the price deflationary tendency emanated from the comparatively poorer export performance of China during the past two years (1998-1999) after the financial and economic crisis among East Asian economies. The annual export growth rate averaged over 3.3 per cent, significantly lower than the (pre-crisis) rate recorded during the period 1996-1997, and this had a dampening effect on the price level.

In Hong Kong, China consumer prices continued downward and deflation persisted at around 3 per cent in 2000, 1 percentage point less than the previous year's rate. Retailers continued to promote sales of their goods and services through significant discounts on ticket prices, more a result of keen competition in the retail business, increased price sensitivity of consumers and lingering feelings of job insecurity and uncertainties. The prices of consumer electrical and electronic products fell significantly, by some 8 per cent, while those of wearing apparel and plastic products were flat. Cost pressures from domestic sources also remained subdued, as borne out by lower property prices and rentals carried over from the earlier periods. There were, in addition, stagnant labour wages as well as a continued freeze in government fees and in a number of public utility charges. On the other hand, price pressures from external sources firmed up somewhat owing to a sharp rebound in the world price of commodities and oil. There was also a pickup in inflation in some of the major suppliers to Hong Kong, China although this was offset somewhat by the appreciating United States dollar, to which the local currency is tied at a fixed parity. The net effect has been to keep a firm lid on the prices of retained imports of foodstuffs and consumer goods.

In Mongolia, inflation has maintained a consistently downward trend since 1997 when it reached as much as 36.6 per cent. Detailed data on various categories of consumer prices are not available as yet, but there are indications that the downward trend in inflation might be reversed in 2001. Among other causal factors were the steep increases in oil prices and higher prices of domestic foodstuffs, especially those of meat.

Consumer prices in the Republic of Korea began to edge upwards in June 2000 with inflation estimated to reach over 2 per cent for the year as a whole. In particular, the costs of agricultural, livestock and marine products had been stable until July when reduced shipments from the main producing areas pushed prices higher; supply shortfalls, in turn, were due to poorer harvests as a result of torrential rain. At the same time, the prices of manufacturing products in the Republic of Korea have been on a strong upward trend since June, a trend driven by rises in the prices of petrochemicals, pulp and paper, and primary metal products. Higher prices for petroleum products and, to a lesser extent, for other imported raw materials also contributed to this rising trend. In addition, the charges for various services have gone up since July. The hike was caused by increased fees and levies for such public services as medical and motor insurance premiums, transport fares and house rentals.

Trade and exchange rates

The volume and value of foreign trade expanded rapidly in China in 2000. The contributory factors were the strong international economy, the ongoing recovery of the regional economy and the government policy of encouraging exports (including an increase in the rebate rate for exported goods). Earnings on merchandise trade, for example, had risen by just over 6 per cent (to $195.1 billion) in 1999; they jumped by about 33 per cent in January-September 2000 compared with the level during the same period a year earlier. Mechanical and electronics products accounted for 41 per cent of merchandise export receipts during the first half of 2000, having expanded by some 42 per cent in value in the same period. Other major export groups included garments and clothing, and high-technology goods with a relative share of just under 14 per cent each.

A large proportion of China's export depends considerably on imported inputs. Import spending remained strong; it went up by over 18 per cent (to $165.8 billion) in 1999 and expanded year-on-year by a further 39 per cent during the first nine months of 2000. In particular, the import of mechanical and electronic equipment, which constituted some 45 per cent of total import spending, grew by about 32 per cent during the first half of 2000. It is noteworthy that it was the first time both import and export values in China had exceeded $100 billion in a half-year period. However, the rate of export growth is expected to ease slightly in the second half of 2000 partly because of the impending slowdown of the

United States economy, higher oil prices, and the very high rate of export expansion in the first half of the year. The total value of exports is expected to be about $249 billion, representing a growth rate of 28 per cent for the year. Import spending is expected to grow marginally faster at 29 per cent in 2000 to reach about $213 billion. The overall trade surplus would thus increase to almost $36 billion in 2000. Meanwhile, there was a moderate deficit on the service account and a larger shortfall in the income account owing to a high level of outward remittances of interest and dividend overseas.

International trade is widely expected to expand further with China's membership in WTO. The net impact of entry on the trade account and exchange rate is difficult to gauge at present. Large segments of the export-oriented industry in China are heavily dependent on a variety of hard and soft imported inputs. Thus, changes in exchange rate are a double-edged instrument for export competitiveness. The current exchange rate of 8.3 yuan renminbi per $1 is expected to be retained throughout 2000-2001 although currency trading may be permitted in wider bands. Indeed, the rapid growth of merchandise export earnings in 2000 has lessened the need for the authorities to devalue the renminbi in order to enhance the competitiveness of domestic firms.

In Hong Kong, China the value of merchandise exports was virtually unchanged at almost $174 billion in 1998 and 1999 (table II.19). The sustained recovery among East Asian economies and some rebound in the value of East and South-East Asian currencies, together with strong import intake from the traditional markets, served to buoy export earnings. Exports of goods and services are expected to increase by over 13 per cent in 2000. Such a robust performance was also attributable to the improved competitiveness of exports following the cost/price adjustments in the local economy over the past years. Earnings on the two main domestic export categories, apparel and clothing, and electronic equipment and machinery, went up by 7 and 27 per cent respectively in value in the first nine months of 2000. Meanwhile, the value of re-exports of electrical machinery and equipment, and of telecommunications and sound equipment, jumped by 47 and 31 per cent respectively.

Exports from Hong Kong, China are expected to be buoyant over the medium term of 2000-2002. Nevertheless, recent developments appear to indicate that the external environment is not likely to be that favourable in the short to medium term. The reverberations from high oil prices and slower global growth will constrain external demand for goods and services from Hong Kong, China. Its currency is expected to remain fixed at 7.8 Hong Kong dollars to the United States dollar. It is not expected that there will be a reoccurrence of the threat to the fixed currency link that resulted from the financial market volatility and speculation in 1997/98. The Hong Kong Monetary Authority has undertaken a series of financial-sector reform measures to strengthen the

Table II.19. Selected East and North-East Asian economies: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					*Imports (c.i.f.)*				
	Value (millions of US dollars)	*Annual rates of growth (percentage)*				*Value (millions of US dollars)*	*Annual rates of growth (percentage)*			
	1999	*1997*	*1998*	*1999*	*2000 Jan-Sep*	*1999*	*1997*	*1998*	*1999*	*2000 Jan-Sep*
China	195 150	21.0	0.4	6.3	32.9	165 788	2.3	−1.3	18.2	38.7
Hong Kong, China	173 885	4.0	−7.5	−0.1	17.6	179 520	5.1	−11.6	−2.7	1.0
Mongolia	233	6.4	−23.5	−32.4	..	426	3.9	7.5	−15.4	..
Republic of Korea	144 745	5.0	−2.8	9.4	26.2	119 750	−3.8	−35.5	28.4	41.5

Source: IMF, *International Financial Statistics*, CD-ROM, January 2001.

linked exchange system, including the introduction of a discount window facility to reduce interest rate volatility in the inter-bank market and a United States dollar clearing system.

The value of exports from Mongolia, which had been stagnant in 1997 and sharply down by about 24 per cent in the following year, fell by over 32 per cent (to $233 million) in 1999. The downward trend reversed with increasing export earnings in the first four months of 2000, about 31 per cent higher year-on-year. There were large increases in mineral exports; in particular, copper products (roughly 16 per cent of total export value) experienced a price boom with export volume expanding by just over 11 per cent, but by almost 76 per cent in value. Import spending had also fallen by about 15 per cent in 1999, to reach $426 million. The year-on-year value of imports decreased by 37 per cent during the first four months of 2000. Among the main import categories were textiles, electrical appliances, and items of vegetable and mineral products.

The trade balance in Mongolia worsened in 1999, in spite of the depreciation of almost 19 per cent in its currency (the tugrik) against the United States dollar. The current-account balance improved slightly in 1999, as the deficit was just below 12 per cent of GDP, compared with 12.3 per cent a year earlier. Given these favourable outcomes, the level of gross international reserves, at almost $136 million, was sufficient to cover over 16 weeks of import expenditure at the end of 1999, compared with less than 10 weeks at the end of 1998. Nevertheless, managing the balance of payments at a sustainable level remains a challenge. The external current account is projected to be in deficit, equivalent to about 10 per cent of GDP in 2000; this shortfall is projected to decline to 7.5 per cent over the medium term. Foreign capital inflows, including ODA, will be crucial in bridging this large financing gap.

Exports from the Republic of Korea continued to be strong, as was the rate of import spending in 2000. Earnings from merchandise trade, at almost $145 billion in 1999, were over 9 per cent higher than the previous year's level. During the first nine months of the following year, merchandise exports recorded a year-on-year growth of over 26 per cent. Semiconductors, information and communications equipment, and heavy industrial and chemical products, were the main export categories. Demand for such products was boosted by the ongoing strong expansion in the developed economies, particularly exports to the United States which account for about one fifth of exports of the Republic of Korea.

Imports during the first nine months of 2000 expanded at 41.5 per cent. The main categories of imports were consumer goods, raw materials and equipment; these were growing at 12.4, 45.9 and 45.3 per cent respectively. Import value had gone up much faster than the growth of export earnings; it expanded by over 28 per cent, to almost $120 billion in 1999. A current-account surplus of about $11 billion was expected in 2000, despite the recent rise in import unit prices, and a deficit of about $1.97 billion and $1.36 billion respectively in the service and income accounts as a result of larger payments abroad of patents and royalties, and of profits and dividend in the first half of 2000. The exchange rate remained relatively stable in the Republic of Korea during the first half of the year. Indeed, the won had earlier been under considerable upward pressure as a result of the steady rise in net capital inflows. However, the won/dollar rate began to increase noticeably in the wake of the weaknesses displayed by several regional currencies in late 2000 together with the looming restructuring and financing problems of the *chaebols*.

Capital inflows and outflows

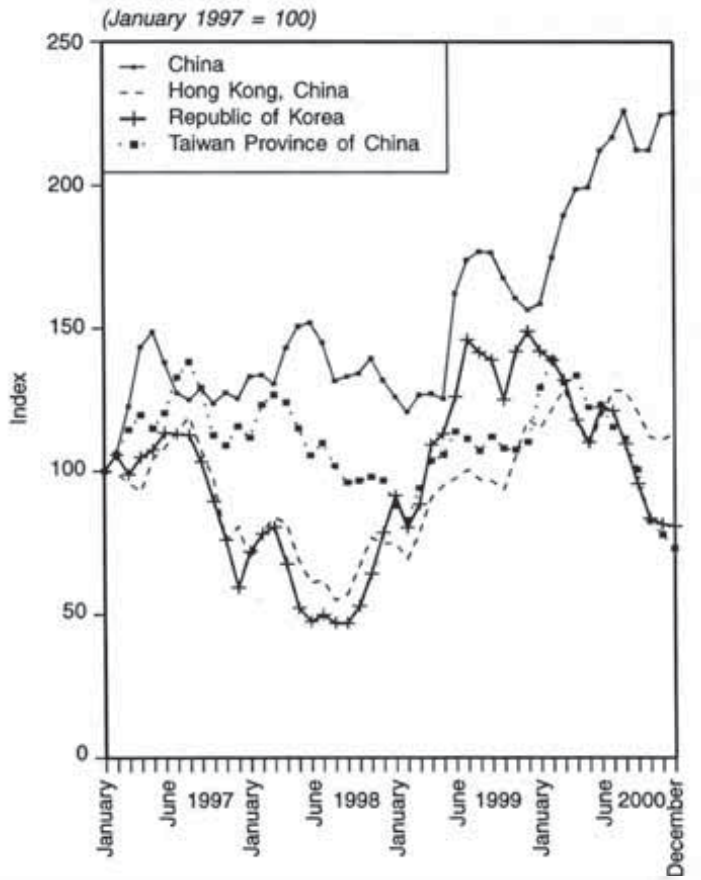
In the first half of 2000, China and the Republic of Korea witnessed strong inflows of both FDI and portfolio investment. China had become, and has remained, by far the largest host country for FDI among the developing countries. There had been some slowdown in foreign capital inflows, a trend reflecting the concern of foreign investors over the soundness of financial institutions, the persistence of excess capacity in some manufacturing industries and increasing competition from neighbouring countries. There was a decline in FDI flows to $40.4 billion in 1999 from almost $44 billion a year earlier. In particular, FDI under contract fell by 19 per cent and actual FDI by 10 per cent. Foreign banks, which registered about $4 billion in net payments in 1998, kept scaling down their lending to China in 1999 as well. Nevertheless, the external payments situation remains highly comfortable; the country holds one of the largest amounts of foreign exchange reserves in the world, approximately $155 billion. This is equivalent to about nine times the amount of short-term external debt, comprising just

about 12 per cent of the total external debt of $148.6 billion (as of June 1999). China's external debt service ratio, at less than 10 per cent of export earnings on goods and services, is much lower than those borne by most other developing countries.

The prospects of higher FDI flows to China appear to be bright in the near future. The country's imminent entry to WTO has greatly strengthened the likelihood of an upturn in capital inflows. In fact, portfolio equity flows to China were very strong in the first half of 2000, boosted by the listing abroad of two large Chinese state enterprises, PetroChina, a large oil and gas company, and China Unicom, a telecommunications company, which raised a total of $8 billion through such listing. In accordance with the enterprise reform programme, more companies are preparing to list their shares abroad, from such sectors as oil, petrochemicals, steel and telecommunications. However, domestic exchanges of B-shares, designed for foreign investors, were not newly listed in 2000, despite the relatively strong performance of China in the equity market (figure II.7). The flows of portfolio equity investment to China are expected to reach $11 billion in 2000.

Hong Kong, China remained the second largest recipient of FDI in Asia with the flow reaching a record level of $15 billion in 1998 and a much higher level of $23 billion in 1999. In 1998, a sizeable inflow came from overseas tax-haven economies. Some of these inward transfers might

Figure II.7. Index of stock markets of selected East and North-East Asian economies, 1997-2000



Source: *The Economist,* various issues.

be attributable to returning investment by foreign and domestic investors as a result of the recovery of confidence in the future of Hong Kong, China after reunification. In 1999, however, investment inflows mainly took the form of reinvested earnings. These accounted for over half of the total value of inward FDI and reflected, by and large, the distinct turnaround in local economic activities which, in turn, contributed to the doubling of earnings of foreign affiliates during that year. Meanwhile, the flows of outward FDI to developing economies in Asia and the Pacific recovered somewhat from the steep decline in 1998 associated with the financial and economic crisis. They were, however, still lower than the pre-crisis levels, averaging more than $25 billion during the period 1996-1997. The outflows were estimated to be about $20 billion in 1999. Hong Kong, China thus remained the largest outward investor among developing economies.

Mongolia's net foreign reserves rose from about $136 million at the end of 1999 to $140 million in April 2000, accounted for by advance payments for cashmere and disbursement loans from international financial organizations. An estimated amount of some $900 million has been borrowed from abroad since 1990, a large proportion of which was of a concessionary nature with a zero interest rate. As noted earlier, ODA is playing a crucial role in bridging the financing gap reflected in the large current-account deficit in Mongolia.

FDI flows to the Republic of Korea in 1999 reached a record level of over $10 billion, almost twice as much as in the previous year and more than four times the pre-crisis level in 1996. This upsurge reflected in part recent liberalization measures which permitted FDI-driven mergers and acquisitions. Moreover, the current process of public-sector reforms has encompassed large-scale privatization which has opened up additional opportunities for foreign investors. The Republic of Korea is being integrated more tightly into the regional and world production and alliance networks of transnational corporations in the process.

The strong portfolio equity investment in the Republic of Korea in the first half of 2000 was mainly due to the global boom in technology stocks and investors' confidence in the country's efforts to restructure its corporate and financial sectors. A (net) total of $8.4 billion of common stocks was purchased by foreign investors on the stock exchange in the first half of 2000. Portfolio capital inflows are expected to rise in the medium term, but the resources so gained will be offset to a considerable extent by the continued outflows. These result from high levels of payments on interest and principal as domestic borrowers have to service their large foreign-debt obligations. The aggregate capital outflows amounted to over $7 billion during the first nine months of 2000.

Fiscal and financial developments

In 1999, fiscal revenue in China increased by almost 16 per cent to over 1.14 trillion yuan renminbi and expenditure, by 22 per cent to 1.32 trillion. In 2000, overall budgetary receipts were projected to be 7.8 per cent higher (to 1.23 trillion yuan) and aggregate spending, about 15 per cent higher (to 1.51 trillion yuan). In an effort to bolster employment during the ongoing process of economic restructuring and to maintain the growth momentum, the fiscal policy stance continued to be expansionary in 2000. As was also the case in the earlier years, the fiscal stimulus has been focused on capital expenditure. Long-term treasury bonds of more than 100 billion yuan renminbi ($12 billion) were arranged in 2000 to fund mainly infrastructure development, including building reservoirs and power plants.

Such an expansionary stance appeared sustainable in the short term. Both the budget deficit and accumulated public debt, which were just over 2 and 12 per cent of GDP respectively in 1999, are comparatively low by international standards. Meanwhile government revenue has been on an upward trend in recent years, reaching just over 14 per cent of GDP in 1999; this represented a significant improvement in resource mobilization by the government as the fiscal revenue/GDP ratio fell to just under 11 per cent in 1996. The widening and deepening of the tax base to ensure greater elasticity and buoyancy of government receipts, while maintaining support for a high growth rate, will continue to be an important fiscal policy objective over the next few years.

The sustainability of the government's fiscal stimulus programme, however, is conditional on durable progress in corporate and financial sector restructuring, including the soundness of the banking system as a whole. This issue is discussed further below. In the meantime, the People's Bank of China

is expected to maintain a relatively easy monetary stance in 2000 and 2001 in support of government efforts to boost private consumption through the provision, by state banks, of more credit to consumers. Nominal interest rates are expected to remain low, although these rates have been cut several times since 1996. However, banks are expected to have greater freedom to set rates, even though the process of interest rate liberalization is likely to be gradual.

After the two consecutive years of budget deficit, Hong Kong, China is projected to have a surplus equivalent to 1 per cent of GDP in 2000; indeed, the stronger performance of the local economy enlarged the surplus by more than the HK$ 6.2 billion ($794.9 million), or 0.5 per cent of GDP, projected earlier in the year on the assumed GDP growth rate of only 5 per cent in 2000. However, output went up by over 14 per cent year-on-year in the first quarter of 2000, and GDP growth of almost 10 per cent was expected for the year as a whole. As the Hong Kong Monetary Authority has introduced a United States dollar clearing system, it is expected that the fixed currency link with the United States dollar will be further strengthened in 2001. The Hong Kong Exchange and Clearing Company (a merger of the stock and futures exchanges in Hong Kong, China) is also preparing to introduce a United States dollar clearing system for securities trading. The new systems are expected to strengthen the position of Hong Kong, China as an international financial centre. Meanwhile, the spread between the Hong Kong dollar forward rates and the spot rate tended to narrow further.

Mongolia's fiscal performance improved slightly in 1999, as the revenue-mobilizing measures introduced over 1998-1999 took hold. Tax receipts rose to 19 per cent of GDP in 1999, compared with 17.5 per cent a year earlier.

Tax collections increased further in the second quarter of 2000, providing almost three quarters of the budget revenue. These increases were manifest in personal income taxes (19 per cent), excise taxes (19 per cent), import taxes (11.6 per cent), and to the greatest degree, corporate taxes (69 per cent). On the expenditure side, total spending was contained within 36 per cent of GDP in 1999, compared with 39 per cent in the previous year. As a result, the overall fiscal deficit improved from almost 12 per cent of GDP in 1998 to some 10 per cent during the following year. Fiscal balance is expected to be stabilized and strengthened over the medium term because of various administrative and other reforms to enhance good governance and public-sector efficiency, with the support of multilateral donors. One of the main fiscal priorities is to bring down the overall budget deficit so as to promote financial stability and reduce the currently high degree of dependence on external resources for financing purposes. The sustainable target appeared to be about 4 per cent of GDP, compared with the current level of about 10 per cent.

Meanwhile, a relatively tight monetary policy helped keep inflation in check. Growth of the broad money supply (M2) will average 15 per cent annually over 2000-2001 compared with over 30 per cent in 1999. Such a target would provide sufficient liquidity for the local economy while maintaining single-digit inflation. In this connection, government borrowings and domestic credit extended to the public sector from the Bank of Mongolia must be reduced substantially so as not to "crowd out" or constrict the flow of credit to the private sector, and to keep interest rates from rising as well. Interest rates on deposits could be expected to fall in line with the downward trend in inflation, but they must be kept positive in real terms to provide incentives for domestic savings. As the restructuring of the banking sector progressed and better banking practices are expected, greater intermediation efficiency and better financial health of the major banks will emerge. These improvements may result in the lowering of lending rates to a level more conducive to longer-term investment.

In the Republic of Korea, a relaxed stance in macroeconomic policies was pursued when the economy entered into a severe recession during the recent financial and economic crisis. Government expenditure rose by 15 per cent in 1998, in part because of the adoption of various measures to assist the unemployed and contain the soaring unemployment problems at that time. Increased expenditure, coupled with the negative effects of the recession on revenue, resulted in a budget deficit of more than 4 per cent of GDP in 1998, compared with a shortfall of some 1.5 per cent a year earlier. In the 1999 budget, a 12 per cent rise in nominal spending was called for to aid the recovery process in its early stages, including such targeted priority areas as assistance to the unemployed, to financial-sector restructuring and to SMEs. On the revenue side, tax revenue was projected to go up by only 5

per cent as a result of the expected fall in corporate and personal income taxes. Consequently, the consolidated deficit from the central government budget was estimated to widen further to 5 per cent of GDP in 1999. In 2000, however, the budget deficit was expected to be down to just under 3 per cent of GDP owing to strong economic growth on the one hand and a scaling down of spending on social safety nets as the unemployment problem eased on the other. The number of unemployed fell by about 40 per cent from a year earlier. In addition, lower interest rates contributed to reducing the cost of bonds issued for funding the financial-sector restructuring.

Notwithstanding an expanding economy and the continued surplus in the external current account, there were signs of economic instability in the Republic of Korea. The financial markets, for example, showed large fluctuations at one stage owing to a combination of factors, including a rapid rise in international oil prices, the drop in semiconductor prices, and the breakdown of the planned deal for Daewoo Motor Company. Market apprehensions, however, have subsided somewhat following the relative stabilization in international oil prices and the recent announcement by the government of further plans for corporate and financial restructuring. The top four *chaebols* managed to meet the stipulated debt-equity ratio of under 200 per cent under the system of traditional (non-consolidated) accounting methods. However, these reported ratios would be considerably higher if consolidated accounting methods were applied. As such, the major conglomerates and, by the extension, the corporate sector as a whole, are still vulnerable to financial shocks. As regards financial restructuring, efforts were made by the government to sell one of the major banks and to induce several others to merge in order to improve efficiency. Between 1997 and 2000, the number of commercial banks was reduced from 26 to 17; this number is likely to fall further in the near future through mergers or closure. An estimated amount of NPLs of some 27.4 trillion won (or 8.3 per cent of total bank lending) was also disposed of as of June 2000. Meanwhile, the call rate has been kept low to provide some support to the growth process and to maintain some measure of stability in the financial market. There is, however, some concern that such a policy stance would give rise to a trade-off in the form of an undesirable bunching of funds at the short-term end of the market, thus generating undue inflationary expectations.

Policy issues and responses

China's fiscal deficit and the level of public debt are relatively low. The 2000 fiscal budget deficit is projected at around 3 per cent of GDP, and the ratio of public debt to GDP is expected to remain modest only when the direct liabilities of the state are included. The actual levels of spending are, however, not clearly discernible in the annual budget data. In fact, the contingent liabilities of the state are believed to be huge; an inclusion of the unpaid debts in the banking system or in asset management companies would greatly inflate the amount of public liabilities. The level of public debt would be even higher if many state-owned enterprises became insolvent during the ongoing reform and restructuring process.

Public-sector debt would need to be contained and the revenue base both widened and deepened in order to undertake the necessary infrastructure development and to sustain social spending. In particular, an expansion of the networks of telecommunications, electricity transmission, roads and water facilities would contribute much to raising the quality of life and the protection of the environment. It would also help address the growing inequalities across regions within China, with the western parts of the country remaining comparatively underdeveloped. The tax reform of 1993 can be said to be partly successful in altering the balance between local and central revenue collections and spending (in favour of the central government). Another overhaul of the fiscal system for fiscal balance is expected to carried out in the near future.

Meanwhile, the Asian crisis exposed the weaknesses in the financial and corporate sectors that need ongoing attention. Considerable progress has been made in recent years in improving private-sector access to financial resources, in re-capitalizing and strengthening banks, in developing a sound capital market that promotes efficient resource allocation and intermediation, and in providing a legal and regulatory framework that would be conducive to transparent and prudential financial practices. Nevertheless, there remains a formidable unfinished agenda. Many of the problems in the financial sector are related to ailing State-owned enterprises that account for a large portion of NPLs from banks. At the same time, the enterprise reform process needs to be anchored on alternative ways

to cope with the worsening unemployment situation, including through the redeployment and re-training of redundant workers and, equally important, adequate provision of the social security services that were built around the cradle-to-death employment and welfare practices of the state-owned enterprises. An unemployment insurance scheme, set up in the mid-1980s, was strengthened in 1998 when the central government raised the contributions to the unemployment fund from 1 to 3 per cent of the enterprise total payroll, requiring employees to contribute 1 per cent of their earnings. Some 15.8 million people were covered under this scheme as of 1999. The unemployment insurance system is expected not only to help speed up the reform of state-owned enterprises, but also to provide a sound basis for contributory pension fund arrangements, medical insurance and enterprise industrial insurance.

The main impetus of economic growth and job creation in Hong Kong, China was the manufacturing sector. Since the early 1970s, however, the share of manufacturing started to decline. It fell from about 31 per cent of GDP in 1970 to just over 6 per cent in 1998. Nevertheless, the sector remains important because of its forward and backward linkages with other activities and services, such as banking, insurance, legal, advertising, transportation, trade and communications. The eventual entry of China as a member of WTO is expected to lift significantly the volume of international trade and investment transactions. Both the manufacturing and service sectors of Hong Kong, China could benefit considerably from such an expansion owing to its strategic location and relationships, and its traditional comparative advantage in the provision of related services. However, the further opening up of China to imports and foreign investment will also increase the levels and intensity of competition in the domestic markets of the mainland. This would pose a significant challenge to the firms from Hong Kong, China already operating in China as investors, as well as companies which are more dependent on export sales in China.

Another issue of concern for Hong Kong, China is the budget position. There has been a considerable expansion in public spending on social welfare over the years so that the share of outlays on social welfare went up from just under 9 per cent in the mid-1990s to over 14 per cent in 1999. Demand for social welfare services is expected to increase further, particularly because of the ageing population and the large movement of people from the mainland who have residence rights in Hong Kong, China. The ratio of overall public expenditure to GDP has tended to be on an upward trend, from an average of under 17 per cent to about 22 per cent in the mid- to late 1990s.

With a significant portion of Mongolia's exports being in primary commodities, such as copper (26 per cent of exports) and cashmere (10 per cent of exports), macroeconomic stabilization was made more difficult in the 1990s. Although copper had contributed over 11 per cent of government revenue in 1999, its relative share dropped sharply to under 2 per cent in 1998 with its falling price. The sluggish export revenues exacerbated the difficult situation in the financial sector. Considerable drawdowns of bank deposits and rising NPLs severely affected corporate liquidity and profitability, causing enterprises to suffer cash shortages. The situation was worsened by persistent managerial and governance problems in some large banks.

The need to put the financial sector and the fiscal balance back on a sustainable track to ensure a high and durable growth in the future is pressing. Indeed, this is well appreciated by the policy makers and, as noted earlier, the ongoing measures aimed at a reduction in inflation rates, progressive privatization, and other structural reforms have helped the country to improve its macroeconomic performance. Nevertheless, the incidence of poverty is reported to have grown from 15 to 36 per cent of the population between 1991 and 1996. It stabilized at that level, although there is some evidence that the severity of poverty might have risen owing to the gradual breakdown of family and social support structures. The creation of viable opportunities for employment and income generation constitutes one of the crucial policy concerns in the near and medium terms.

Banking reform and corporate sector restructuring remain critical areas for continued attention in the Republic of Korea. The resolution and liquidation of non-viable firms, and the self-rehabilitation of troubled but viable firms would need to go beyond simple improvements in the balance sheet. Radical adjustments in investment and employment are required and the trade-off will be a possible increase in structural unemployment and social tensions.

Meanwhile, the creditor banks' incentive for an early resolution of NPLs should be strengthened. The injection of public funds should be made in a manner that minimizes moral hazard problems and the taxpayers' burden. This is particularly important because it was announced recently that an additional 40 trillion won (about $32 billion) in public funds would be mobilized by the government in support of financial-sector restructuring efforts, including bank recapitalization purposes.

In addition, the burden of creditor banks with regard to the resolution of NPLs could be lessened and the financial sector restructuring process expedited if there was greater reliance on public agencies, such as Korea Asset Management Corporation (KAMCO) and private specialized financial agencies. Furthermore, there could be a greater reliance on a market-driven approach in the establishment of a financial holding company to facilitate bank mergers, duly backed up by consistent prudential criteria. In the matter of privatizing banks, it will be necessary to review all the available options (including early sell-offs) and to ensure a well-designed policy framework which includes, among other things, judicious regulation of the ownership structure and operation of privatized banks. More transparent fund management and strengthened monitoring by a third party would help strengthen the transparent and prudential operations of investment and trust companies.

DEVELOPED COUNTRIES OF THE REGION

Australia, Japan and New Zealand

Diverse patterns of economic growth were registered by the three developed countries in the region in 2000. The Australian economy continued to expand strongly, a performance supported by robust domestic demand and buoyant exports. Unemployment declined further to 6.3 per cent in October 2000 (compared to 7.1 per cent a year earlier). Led by business investment and relatively strong export growth, Japan's economic recovery in the first half of 2000 was firmer than expected; thereafter, there were mixed signs with both overall growth and exports tending to lose momentum. Meanwhile, unemployment rose marginally over the 12 months to October 2000. In New Zealand, the economy slowed in the middle of 2000. Spurred on by exchange rate depreciation, however, exports continued to advance strongly and the growth momentum was regained later in the year.

Growth performance

Australia continued to enjoy an unusually long period of strong economic growth with GDP expanding (as of end-June 2000) by an annual average of 4.4 per cent over the past eight fiscal years. The robust growth over the last few years was essentially supported by firm domestic consumption although exports have also risen through a weak exchange rate and buoyant world trade. Domestic demand remained strong in 2000, an outcome underpinned by expenditure brought forward prior to the introduction of the goods and services tax (GST) from 1 July 2000; in particular, investment in housing was boosted by the new tax while there was also strong growth in public and private spending associated with the Sydney Olympic Games. Growth was expected to be marginally lower at 4.3 per cent for 2000 (table II.20).

The Australian economy has depended considerably on primary commodities for export, but the rising share of value added from other sectors has facilitated more broadly based growth. Services, including tourism, already constitute 70 per cent of GDP; they have also made a significant contribution to foreign exchange earnings. Before export performance moderated in 1998, buoyant consumption expenditure and the spread effects of strong and sustained export growth had supported the continuing strength of the Australian economy. Consumption expenditure was underpinned by the wealth effects of stock market gains, although robust export expansion is, and will increasingly be, an important engine of growth. Indeed, the anticipated slowdown of business investment after the Olympic Games and somewhat weaker consumer confidence, associated with higher oil prices and the ensuing inflation expectations, highlight further the role of exports. The strong Australian performance is also attributable to sound macroeconomic policies and an ongoing programme of microeconomic reform to ensure an investor-friendly and competitive environment, discussed in a later section.

Table II.20. Developed countries of the ESCAP region: major macroeconomic indicators, 1997-2000

(Percentage)

		1997	*1998*	*1999*	*2000*[a]
Australia	GDP growth	4.0	5.3	4.7	4.3
	Inflation[b]	0.3	0.8	1.5	4.6
	Consumption/GDP	84.2	79.6	81.0	83.0
	Investment/GDP	25.3	26.2	27.2	26.9
	Budget balance/GDP[c,d]	−0.2	0.2	0.7	0.8
	Short-term interest rates	5.4	5.0	5.0	6.2
	Money supply growth (M2)	7.3	8.4	11.7	7.6[e]
	Current account balance/GDP	−3.1	−4.9	−5.7	−4.9
Japan	GDP growth	1.6	−2.5	0.2	1.6
	Inflation[b]	1.7	0.7	−0.3	−0.6
	Consumption/GDP	70.3	70.3	71.4	71.8
	Investment/GDP	28.4	26.4	25.9	25.4
	Budget balance/GDP[d]	−3.3	−4.7	−7.4	−8.2
	Short-term interest rates	0.6	0.7	0.2	0.2
	Money supply growth (M2)	3.1	4.2	3.4	1.0[f]
	Current account balance/GDP	2.2	3.2	2.5	2.7
New Zealand	GDP growth	3.0	−0.7	3.9	4.0
	Inflation[b]	1.2	1.3	1.1	2.8
	Consumption/GDP	81.8	83.0	82.6	80.7
	Investment/GDP	19.4	20.0	20.8	21.4
	Budget balance/GDP[d]	2.3	2.2	1.3	0.8
	Short-term interest rates	7.7	7.3	4.8	6.5
	Money supply growth (M2)	1.2	14.6	7.8	4.1[g]
	Current account balance/GDP	−6.6	−4.9	−8.1	−7.5

Sources: ESCAP, based on United Nations, "Project LINK World Outlook", various issues; IMF, *International Financial Statistics,* vol. LIII, No. 9 (September 2000), *International Financial Statistics,* vol. LIII, No. 12 (December 2000) and *World Economic Outlook* (Washington DC, September 2000); *OECD Economic Outlook,* No. 68 (November 2000); and The Economist Intelligence Unit, *Country Forecast: Australia; Country Forecast: Japan; Country Forecast: New Zealand,* November and December 2000.

a Estimate.
b Referring to percentage changes in the consumer price index.
c Data exclude net advances (primarily privatization receipts and net policy-related lending).
d Referring to general government fiscal balance.
e January-September.
f January-August.
g January-June.

The Japanese economy started to display unambiguous signs of recovery in the second quarter of 2000, after recording negative growth (2.5 per cent) in 1998 and barely positive growth at 0.2 per cent in 1999. The series of economic stimulus packages finally produced dividends in the form of 0.8 per cent growth by the second quarter of 2000 on a year-on-year basis, with the second quarter itself registering an impressive 4.2 per cent increase in output on an annualized basis. Industrial investment, the driving force of the economic recovery, was stimulated by a sharp increase in

actual and expected profits, and by growing domestic demand for ICT products. Industrial production, for example, went up by 6.6 per cent year-on-year by October 2000. Nevertheless, the share of business investment in GDP and the growth rate of investment remained below historical levels. Firms were scrapping old machinery at a rapid rate but the overhang of old technology equipment will constrain investment demand for some time to come, along with expectations of lower output growth than in the past and with greater emphasis on profitability.

As a whole, the recovery of domestic demand in Japan is still fragile. Earnings growth depressed retail sales, whose volume fell year-on-year by almost 1 per cent up to September 2000. Consequently, GDP is estimated to expand by 1.6 per cent in 2000. Recently, the Economic Planning Agency switched the statistical system to ensure a broader look at the economy and there was a recalculation of GDP data as a result. Among other changes, for example, computer software development outsourced by companies is now classified as business investment and the depreciation costs of infrastructure, such as dams, are added to current government spending. Under the new calculation, Japan's economic growth was –1.1 per cent, instead of –2.5 per cent, in 1998; it became positive at 0.8 per cent (instead of 0.2 per cent) during the following year.[4] The recalculated outcomes obviously provide a rosier assessment of the Japanese economy but do not greatly alter its fundamental weaknesses and lack of growth over the last few years.

There are signs that private sector investment is gradually spreading from ICT to non-ICT sectors and therefore the current economic recovery may be increasingly driven by domestic demand. Positive growth in such demand in the third quarter of 2000, despite the significant decline of public investment during that quarter, appeared to be led by the consumption of ICT products such as mobile phones and computers. The share of ICT goods and services in total consumption was only about 5 per cent, but has been growing annually at 6 per cent since 1995, a rate much faster than that of retail sales. On the other hand, items such as clothes and services have been experiencing negative growth in the past five years and this has been mirrored by the relatively poor performance of department stores. Indeed, the ICT sector is likely to play an even more important role in the recovery process, and this was given its due recognition in the stimulus package of November 2000 with the promotion of ICT development as its central theme. Furthermore, extra appropriations in the budget for the fiscal year 2001 are aimed at bridging the digital divide, including the establishment of a comprehensive IT infrastructure in the country.[5]

Along with the open support for foreign investment, several sectors in Japan have witnessed increasing participation by foreign firms as a consequence of deregulation policies and the rising pressures for corporate restructuring following the economic slowdown of 1998 and 1999. Large inflows of foreign capital, some of it directed at the takeover of high profile companies, surged further in 1999, especially in the telecommunications sector, car manufacturing and financial services. Such penetration is expected to lead to the more rapid introduction of new and innovative business practices. It is also expected to exert stronger pressures for the ongoing restructuring of Japanese firms to ensure their survival through regained competitiveness. The traditional practice of lifetime employment is being gradually replaced, at least temporarily, by the hiring of contract workers, an arrangement which provides greater flexibility in adjusting labour costs to changes in business conditions. While this is rational behaviour on the part of the corporations concerned, it inevitably leads to lower labour earnings and a heightened sense of insecurity among employees, thus lowering household spending and confidence in the process.

The New Zealand economy bounced back from the short-lived recession in 1998 when output contracted by 0.7 per cent largely because of the East and South-East Asian crisis, a severe drought, weaker domestic demand and low international prices for farm commodities. GDP then expanded by 3.9 per cent in 1999. The strong growth in the

[4] Economic Planning Agency website: <http://www.epa.go.jp/2000/g/qe003/shihanki.gif>.

[5] *The Economist*, 4 November 2000.

second half of the year gave rise to concerns of a possible build-up of inflationary pressures in the economy and led to a modest tightening of the monetary stance in November. The economic turn-around from early 1999 was initially supported by domestic demand through an upsurge in investment spending and housing investment; the latter being significantly aided by the lowest mortgage interest rates in two decades. After two successive droughts, the agricultural sector (New Zealand's principal foreign earner) rebounded on the back of strong external demand from the country's major trading partners, including those in Asia.

Since the end of 1999, GDP growth in 2000 may be affected to some degree by higher interest rates along with weak residential investment, a decrease in government spending, and lower business and consumer spending. Overall output contracted by 0.6 per cent in the second quarter of 2000, although strong growth at the beginning of 2000 and robust external demand as a result of a falling exchange rate are expected to culminate in a relatively stronger expansion of 4.0 per cent in GDP for 2000 as a whole.

Inflation

Despite strong economic growth over the past several years, Australia has enjoyed very modest inflation with increases in consumer prices averaging less than 1.0 per cent until 1999, when inflation rose slightly to 1.5 per cent, all well within the Reserve Bank's inflation target range of between 2 and 3 per cent. Higher import prices were not passed on to consumers as a result of strong competition in the domestic market following deregulation. However, the rise in oil prices, the one-off effects of the implementation of GST in July 2000, plus the depreciation of the Australian dollar, led to a surge in import prices of more than 10 per cent up to late October 2000. Reflecting these pressures, the consumer price index rose at an annualized rate of 6.1 per cent in the third quarter. The Reserve Bank pushed up interest rates to 6.25 per cent in August 2000, the fifth increase since November 1999. Some further rate rises are projected if the GST generates any secondary price pressures in the economy. Inflation is expected to rise to about 4.6 per cent in 2000. Generally, however, the inflation outlook is benign in Australia, especially when measured by core inflation, as productivity gains have kept unit labour costs partly in check.

Inflation remained low or negative in Japan, hovering around 1.0 per cent in 2000, after falling by 0.3 per cent a year earlier, despite the zero interest policy throughout the year. The so-called deflationary spiral remains a matter of concern as both households and the business sector tend to delay their purchases in the expectation of a further fall in prices, leading to a vicious self-sustaining downward movement in prices. Even the oil price increases had little impact on Japanese inflation as their effects on both oil product prices and the overall price level have been largely absorbed by a decrease in the profit margins of oil companies in the still weak, but increasingly competitive, domestic market following deregulation of this sector.

On the other hand, wage increases have been occurring fairly consistently since the end of 1999, especially in the manufacturing sector; such earnings went up year-on-year by 1.5 per cent by September 2000, implying real wage growth of over 2 per cent. While this phenomenon reflects to a considerable extent higher levels of manufacturing productivity, it may also reveal the tendency of companies to retain existing employees, perhaps making them work longer hours, rather than hiring new workers. Little improvement in the unemployment rate is expected, however, as the practice of temporary employment contracts becomes more widespread in the Japanese economy. Against this backdrop, few cost-push factors are likely to emerge in the near future and inflation is expected to remain negative at 0.6 per cent for 2000 as a whole.

Inflation had remained low in New Zealand for most of the 1990s; it remained so at 1.1 per cent through 1999 and the beginning of 2000, despite a tightening labour market. Full-time employment rose more than 3 per cent in the first quarter of 2000 and the unemployment rate dropped from a peak of 7.8 per cent at the end of 1998 to around 6 per cent in 2000, the lowest level since 1996. Wage growth remained moderate at less than 2 per cent a year over the past two years. However, inflation was pushed up to 2.4 per cent in the middle of 2000, coming close to the top of the Reserve Bank's 0-3 per cent target band, on account of the surge in

petrol prices, the levying of an increased tobacco tax and the continued weakness of the New Zealand dollar. Furthermore, the third-quarter inflation rate reached 3 per cent, the highest annual increase in the past five years, although the rate would have stayed at 1.4 per cent (year-on-year) had petrol and tobacco prices remained unchanged. Consumer prices are expected to be about 2.8 per cent higher for 2000.

Trade and exchange rates

In Australia, the chronic current account deficit has been a major concern over the past decade. The deficit had not gone below 3 per cent of GDP for nearly 20 years, but recently the deficit deteriorated from 4.9 per cent of GDP in 1998 to 5.7 per cent in 1999, thus raising questions about its sustainability in the face of volatile conditions in the international financial market. Australia's strong economic performance has tended to suck in imports. Meanwhile, in 1999, commodity prices were weak and there was generally lower export demand from Asia. In consequence, the trade balance deteriorated from a positive $1.8 billion in 1997 to a deficit of $9.8 billion in 1999, as export earnings declined from $64.9 billion in 1997 to $56.0 billion in 1999, while import spending went up from $63.0 billion to $69.1 billion during the same period (table II.21).

Australia's external prospects became significantly brighter in 2000. September witnessed the first trade surplus since November 1997, of $A2 billion, relative to an August deficit of $A1.3 billion. The recorded surplus was largely due to the one-off effect of $A1.4 billion in receipts booked for the Olympic Games broadcasting rights, coupled with large spending by overseas tourists, many of whom came for the Olympic Games. Nevertheless, the weak Australian dollar has considerably discouraged imports and boosted exports, some two fifths being destined for the United States, Japan and economies of ASEAN. The growth and trading outlook in these economies is generally positive over the long term although some slowdown could occur in 2001. Overall, the improvement in Australia's trade balance should continue, albeit with some hiccups, in the near term.

The improved trade account is likely to be insufficient to offset a higher outflow of net income from foreign investment in Australia and thus, the current account deficit is expected to improve only marginally from 5.7 per cent of GDP in 1999 to 4.9 per cent in 2000. The chronic current account deficit over the past decade is largely attributable to a substantial outflow of net income and interest payments associated with a high level of net foreign investment and loans; the outflow is magnified in local currency terms because of the weaker Australian dollar. In this context, a number of factors

Table II.21. Developed countries of the ESCAP region: merchandise exports and imports and their rates of growth, 1997-2000

	Exports (f.o.b.)					*Imports (c.i.f.)*				
	Value (millions of US dollars)	*Annual rates of growth (percentage)*				*Value (millions of US dollars)*	*Annual rates of growth (percentage)*			
	1999	*1997*	*1998*	*1999*	*2000 (Jan-Jun)*	*1999*	*1997*	*1998*	*1999*	*2000 (Jan-Jun)*
Australia	56 087	4.3	−11.1	0.3	19.0	69 160	0.7	−1.9	7.0	11.9
Japan	417 623	2.5	−7.8	7.6	21.1	310 012	−3.0	−17.2	10.5	26.4
New Zealand	12 452	−1.1	−15.0	3.2	9.8	14 301	−1.4	−13.9	14.5	6.5

Source: United Nations, *Monthly Bulletin of Statistics*, vol. LIV, No. 9, September 2000, and *Monthly Bulletin of Statistics*, vol. LIV, No. 12, December 2000.

would lead to a widening of the net income deficit over the next year or so: global interest rates being at or near a five-year high; the level of inward foreign investment reaching record levels; and the higher Australian dollar costs of foreign-currency interest payments.

Owing to an increased deficit in the service accounts in Japan, the overall current account surplus narrowed to $106.9 billion (or 2.5 per cent of GDP) in 1999 after recording a surplus of $120.7 billion (or 3.2 per cent) in the previous year; the surplus is expected to expand slightly to 2.7 per cent of GDP in 2000 along with the continuing strong demand for exports. Japanese export growth has been driven by the strength of the United States economy together with the recovery of the economies of the region. In fact, Japan's trade surplus with its major trading partners increased strongly during the same period, for example, by 10 per cent with the United States, and by over 26 per cent with the Asian economies (including an increase of over 35 per cent with the Republic of Korea). By sector, ICT products are increasingly playing a leading role in exports as well as in meeting domestic demand. Earnings from electrical machinery exports were notably strong, with semiconductors and telecommunications equipment growing at 20 per cent on a yearly basis for the first seven months of 2000. Meanwhile, higher oil prices pushed up the import bill so that the overall trade surplus contracted by 7.1 per cent on an annualized basis for the first seven months of 2000. Despite a slight fall in volume terms (0.5 per cent on a yearly basis), the yen value of mineral fuel imports expanded by over 58 per cent on an annualized basis, owing to an increase of some 77 per cent in the value of crude oil imports for the same period. Moreover, imports are likely to be on an increasing trend in tandem with the domestic economic recovery and the inflow of goods produced by affiliated companies overseas, thus compressing further the trade surplus in the coming months.

As in the case of Australia, New Zealand's chronic current account deficit remains one of the major policy concerns for government. The country normally registers a small trade surplus and, as in the past, there were trade surpluses in the first two quarters of 2000; these were attributable to higher export earnings on dairy and forestry products, an outcome driven in turn by stronger international commodity prices in addition to the weakness of the New Zealand currency. On the other hand, the import bill in local currency in 2000 was also boosted by the depreciated New Zealand dollar; by early October, for example, the dollar had depreciated by 27 per cent from the beginning of the year. However, current account deficits go back several years. The shortfall improved to $2.6 billion (or about –4.9 per cent of GDP) in 1998, compared with $4.3 billion (–6.6 per cent) a year earlier; it then deteriorated again to –8.1 per cent of GDP in 1999 and will likely be about –7.5 per cent in 2000. The main outflows are repatriated incomes from foreign investment and business services, the former category accounting for about two thirds of the outflow over the period 1998-1999.

Capital inflows and outflows

Australia's current account problem is primarily a consequence of the large deficit on the income account, especially the large outflows of non-official investment income or, in other words, interest paid on foreign loans and dividend incomes accruing on foreign equity investment. The chronic current account deficit, and the consequent reliance on foreign capital, is a matter of concern as it implies a lack of sufficient savings to meet domestic investment requirements. There had been high levels of federal government deficits and of official borrowings in the early 1990s but privatization and cost-cutting measures since the mid-1990s greatly improved the public financial position which, in turn, led to a fall in official sector net borrowings. On the other hand, non-official borrowings have been rising, thus keeping the overall debt profile at about the same level. While the net amount of foreign debt in national currency terms fell in 1999 to below 40 per cent of GDP, the debt itself has tended to surge from the second half (to just over $A268 billion or 42.4 per cent of GDP as of the second quarter of 2000). At this level, it embodies a substantial burden on the economy in terms of debt service and interest payments. A higher savings rate is the obvious answer but progress in this direction may be difficult in the short term.

Until recently, Japan has not been an attractive destination for FDI; the inward flows were much less than those for New Zealand in the early 1990s.

However, there has been a series of recession-induced restructuring exercises by the corporate sector and policy deregulation in the automotive, financial services and telecommunications sectors since 1997. FDI inflows soared from $0.2 billion in 1996 to $3.2 billion in 1997 and to $12.3 billion in 1999, an amount equivalent to 0.3 per cent of GDP. Currently, such investment flows are channelled largely to financial and telecommunications companies and to manufacturing firms, especially those in the automobile sector. Meanwhile, FDI outflows from Japan have declined considerably compared to the early 1990s (at the height of the bubble economy) when the outward flow reached $50 billion. By 1996, such outflows had dropped by over one half (to $23.4 billion) and have remained roughly at about the same level since. In 1999, however, FDI outflows declined to $22.3 billion, compared to an inflow of $12.3 billion, leading to the lowest ever level of net outflows. Most large Japanese corporations are carrying out a radical restructuring of their domestic and external operations, and foreign investment is being consolidated and reappraised in the process, particularly in the automobile industry which has suffered from worldwide overcapacity as well as very stiff competition for market shares. Furthermore, the yen exchange rate, a central element in previous outflows, has lost some of its relevance as a determinant of outward FDI of late.

In New Zealand, the current account deficit has steadily deteriorated since 1993 as a result of a sharp widening of the deficit on invisibles and smaller trade surpluses; invisibles relate to higher levels of incomes and profits repatriated by external investors.[6] In particular, the shortfall in investment incomes went up from about $NZ6 billion ($4.0 billion) to $NZ7.8 billion in the three years between March 1997 and March 2000. It is worth noting, however, that the recent current account deficits have been accompanied by government budget surpluses, reflecting concerted efforts and commitment to reduce public-sector debt. This provides a sharp contrast to 1984, when the massive current account deficit peaked at 8.9 per cent of GDP along with an equally large budget deficit. Indeed, the public sector share of gross external debt had been reduced to 15 per cent by 1999, from over 50 per cent in 1990. On the other hand, New Zealand's external debt has been expanding in recent years, standing at 105 per cent of GDP in 2000 compared to 88 per cent in 1996. This trend is due largely to higher private sector obligations, an outcome induced by the earlier liberalization of capital account transactions and other policy reforms to generate a domestic business environment more conducive to investment (both domestic and external) and competition.

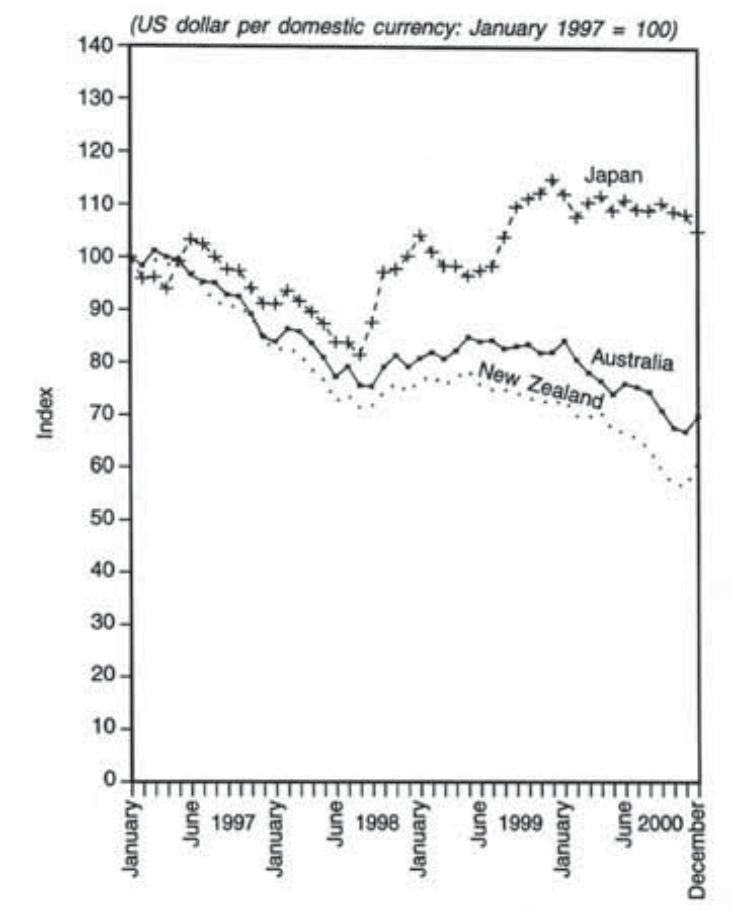
Money and finance

There had been several years of an easier monetary policy stance in Australia, with the interest rate standing at 4.75 per cent at the end of December 1998, the lowest level since the previous cyclical low over the 1993-1994 period. The low interest rate regime had been sustained despite a substantial depreciation of the exchange rate (figure II.8); success in this regard was the outcome of efficiency-raising deregulation measures and improved competition. The Reserve Bank of Australia then raised the cash rate in November 1999 by 25 basis points (to 5 per cent) as a precaution against any build-up of inflationary pressures. There were five other increases (to 6.25 per cent) by early August 2000 although with minimal impact on price pressures; indeed consumer prices were 6.1 per cent higher on a year-on-year basis at the end of September, a level well above the official inflationary target range of 2-3 per cent.

In the Australian banking sector, there has been considerable pressure on government from banks to relax the market-dominance provisions in the Trade Practices Act that have prevented mergers involving the four largest banks (the Commonwealth Bank of Australia, the Australia and New Zealand Banking Group, the National Australia Bank and Westpac). However, there seems to be no immediate prospect of a policy revision because of inadequate competition in the small-business loan market, among other considerations. In this context, the ongoing international trend towards consolidation in the financial services industry poses a formidable challenge that will need to be addressed in the future. Australian banks are not major players in the international or regional markets for financial services. Meanwhile, as in the

[6] Economist Intelligence Unit, *Country Profile: New Zealand 2000*.

Figure II.8. Index of exchange rates of developed countries in the ESCAP region, 1997-2000



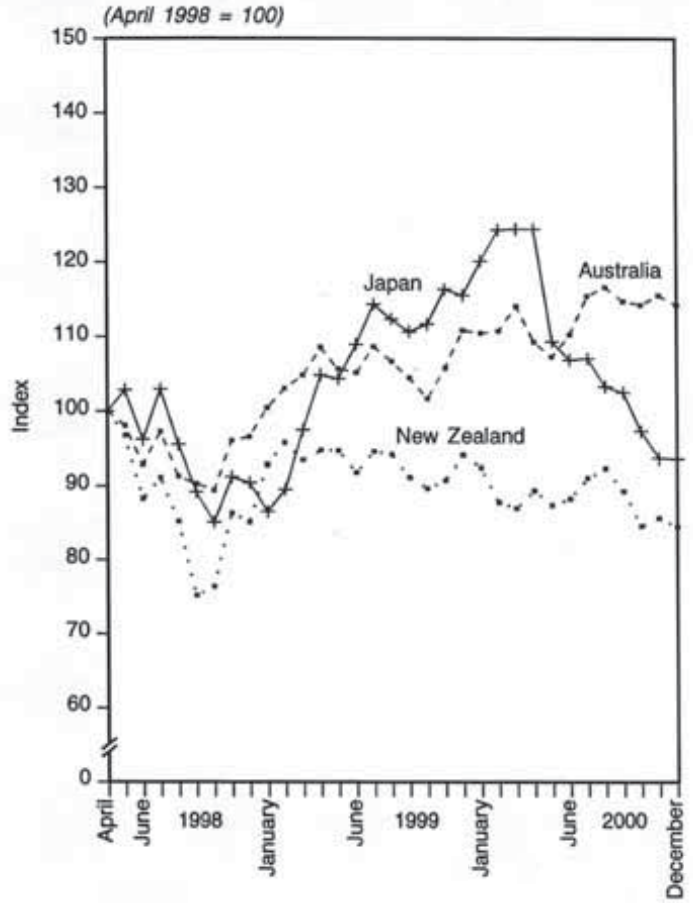
Sources: IMF, *International Financial Statistics,* various issues; and *Far Eastern Economic Review,* various issues.

case of many other countries, the Australian stock market weakened in 2000 in United States dollar terms, although it rose slightly in terms of the local currency (figure II.9).

The Bank of Japan had maintained its commitment to a zero interest policy stance until the threat of deflation disappeared; this was reversed in August 2000, when the uncollateralized call rate was raised by 25 basis points. The series of economic stimulus packages implemented over the last three years had boosted the amount of public debt, thus causing some concern in the financial markets and pushing up pressures on long-term interest rates. The Bank of Japan has begun to publish inflation and output forecasts, and the main risks associated with the forecasts, as a means of keeping the financial markets abreast of official central bank thinking on important monetary policy issues.

In the late 1990s, the negative impact of the bad debt problems in Japan was transmitted through, among other things, a tightening of loans

Figure II.9. Index of stock markets of developed countries in the ESCAP region, 1998-2000



Source: *Far Eastern Economic Review,* various issues.

and credit to companies, in particular SMEs, for which banks had traditionally been a major source of finance. The responsive policy measures have focused largely on strengthening the capital base of domestic banks and, facilitated by financial sector deregulation, the capital market. Foreign banks have also played a larger role in underpinning finance and credit growth. At the same time, the major banks have managed to increase their capital adequacy ratios to an average of 11.75 per cent as of March 2000; the two banks nationalized in late 1998 are to be reprivatized. However, the overall credit demand by private firms has remained stagnant.

As discussed in last year's *Survey,* there is the mega-merger of several domestic banks so as to consolidate the capital base and achieve better efficiency through economies of scale; in the process, however, the long-standing *keiretsu* ties among banks and companies involving complex structures of cross-shareholdings would have to be restructured radically. One of the keys for survival in the highly competitive global financial market concerns the return on equity. According to a United States investment bank study, the newly created Mizuho Financial Group (an alliance of Dai-ichi-Kango Bank, Industrial Bank of Japan and Fuji Bank) had a return on equity of just 4.2 per cent at the end of March

2000, compared to almost 22 per cent for the Citibank Group, 17.4 per cent for the Bank of America, and just under 21 per cent for the Union Bank of Switzerland.

The current transformation of *keiretsu* links has important implications for the Japanese economy. Indeed, the dramatic fall in the proportion of cross-shareholdings, from more than 50 per cent in early 1990s to less than 40 per cent in 1999, underlines the weakened ties among the same *keiretsu* group companies. The process tends to exert downward pressure on domestic stock prices; domestic banks, for example, sold around $210 billion in corporate shares in the year to March 2000. There will also be a shift in financing capital, from cross-shareholdings and *keiretsu* bank loans to debt and equity issues. This tendency may be constrained, in the short term, by the current weaknesses of capital markets in Japan. Meanwhile, systemic risks in the banking sector appear to have receded, although the restructuring process is far from complete. July 2000 witnessed Japan's second largest corporate bankruptcy case; the Sogo department store chain had a consolidated debt of some 1.87 trillion yen. This raised major concerns over the conditions and progress of corporate and financial sector reform, although a major difference from the past is the banks' greater capacity to absorb losses from the chronic non-performing loans. In this context, the major banks have already made provisions in their loan-loss reserves for the Sogo bankruptcy, and the residual financial impact of this case is likely to be limited.[7]

The Reserve Bank of New Zealand has been endowed with a high degree of independence for inflation targeting to within a narrow band of 0 to 2 per cent. Indeed, inflation had fallen to around 2 per cent in the early 1990s and has since remained around or below that level. The credibility so gained, in turn, has underpinned the shift towards a more flexible targeting approach with a longer time horizon. In particular, the target band was widened to 0-3 per cent in late 1996 and the policy horizon extended from a strict four quarters to between six and eight quarters in 1999. At the same time, the Official Cash Rate has been relied on as the Bank's primary policy instrument since March 1999, replacing the Monetary Condition Index. The official discount rate, raised in November 1999 as a pre-emptive move against incipient inflationary pressures resulting from the strong economic growth and capacity constraints in the economy, was again adjusted upwards to 6.5 per cent in October 2000. Inflation was expected to average 2.8 per cent for 2000 as a whole compared to 1.1 per cent in 1999.

On the whole, the financial system has coped well with the overall policy regime and with the recent recession in New Zealand. The growth of banking assets as a ratio of GDP is broadly in line with the growth of the non-agricultural sectors of the economy and the NPL problem is minimal. However, as in the rest of the world, the stock market weakened significantly in 2000. In addition, the banking system is highly concentrated and has a heavy foreign presence; the five largest banks, four of which are subsidiaries of Australian banks, accounted for 85 per cent of the assets at the end of 1999. The authorities are aware of the long-term systemic risks arising from failures or weaknesses of foreign banks owing to adverse developments largely unrelated to local economic and financial conditions. Currently under consideration is the issue of requiring all major banks to incorporate locally with specifically assigned equity capital.

Fiscal developments

Australia's fiscal policy in recent years has focused on budgetary consolidation and on establishing an institutional framework to support ongoing prudent fiscal management. The medium-term strategy is to achieve fiscal balance over the course of the economic cycle without crowding out private sector savings or aggravating directly the imbalance between national savings and investment. The process of fiscal consolidation since the mid-1990s, mainly through lower expenditures, notably for transfer payments, helped improve the underlying cash balance from a deficit (of 3-4 per cent of GDP in the early 1990s) to a surplus position (0.2 per cent by 1998). The sustained surplus is expected to reach 0.8 per cent of GDP in 2000. Meanwhile, the tax reform package introduced in July 2000 will further support revenue mobilization in the coming years and, based on an unchanged ratio of spending to GDP, the fiscal surplus could rise moderately in the future. Government debt went down to less than 10 per cent of GDP in 2000, from a peak of

[7] Kyodo News, Japan: Sogo failure has little impact on major bank rating, 21 July 2000, <http://home.kyodo.co.jp>.

25 per cent in 1995, thanks to the proceeds of privatization. Partly as a result, long-term interest rates have declined and are now comparable to those in the United States, an economy with a much deeper and more diverse financial sector.

In Japan, the still fragile economic recovery was initiated and driven by a succession of large fiscal stimulus packages which, in turn, contributed to a significant deterioration in the fiscal position as well as to great disquiet in the financial markets. Government debt amounted to 105 per cent of GDP in 1999 and 116 per cent in 2000, the highest among the developed countries. It is unlikely that the higher tax revenue, as a share of GDP, with economic recovery in 2000, will be enough to offset the increased expenditure from larger debt interest payments (some 26 per cent of the general account expenditure in fiscal year 2000) and spending on social services. On current assumptions, the operating budget deficit will increase to 8.2 per cent of GDP in 2000, from 7.4 per cent in 1999 and 4.7 per cent in 1998.

The stimulus package of $171 billion (18 trillion yen), announced in November 1999, included substantial spending on public works and credit guarantees for SMEs. There were also large allocations for retraining in response to increasing structural unemployment and the ongoing process of corporate rationalization, as well as to fund premiums for the elderly needing long-term nursing care. The tenth fiscal stimulus in a decade, worth 11 trillion yen, was introduced in the autumn of 2000. This "economic rebirth" package put greater emphasis on the promotion of ICT, environmental preservation, protection of the ageing, and the upgrading of urban infrastructure. These four priority areas absorbed about 60 per cent of the funds allocated for social infrastructure investment, compared with about 50 per cent in the November 1999 package.

The steady budget surpluses since the mid-1990s, achieved through tight policy, have declined slightly in New Zealand over the last four years, with the operational surplus in 2000 expected to be around 0.8 per cent of GDP, compared to 1.3 per cent a year earlier and 2.2 per cent in 1998. Nevertheless, net government debt has fallen significantly from 30 per cent of GDP in 1996 to around 20 per cent in 2000. Emphasis in the budget for 2000/01 is on social spending (such as education, health and welfare); ways are also being explored to move away from the current system of funding pension costs from general revenue. Indeed, attempts have been made since 1995 to put future pension funding on a more secure basis in the face of an ageing population and, in this context, a proposal was announced in late 2000 for a "pre-funding" scheme to ensure the adequate availability of state pensions in the future, especially for the post-second-world-war "baby boomer" generation who will retire from around 2006 onwards. Under this scheme, the annual contribution from the budget to a Superannuation Trust Fund would be made at 0.5 per cent of GDP in 2001/02, 1.0 per cent in 2002/03 and 1.5 per cent in 2003/04. However, the operational details have not yet been finalized except that the mooted fund would be kept apart from the fiscal budget and would become self-financing in due course.

Policy issues and responses

Sound macroeconomic policies have enabled the Australian economy to sustain, over the last several years, a surprisingly long period of above-trend economic expansion, a process which remained on track even during the East and South-East Asian financial crisis. The major challenge for the short to medium terms is to sustain this growth momentum and maintain macroeconomic stability as the world economy slows down. Another issue relates to the country's chronic current account deficit and the implied need to address the various constraints on domestic savings. A compulsory superannuation scheme introduced in the early 1990s apparently has had little effect on the savings rate thus far. Meanwhile, improvements in the overall incentives for savings are expected through the new, broad-based tax scheme implemented in July 2000 (including substantial cuts in personal income taxes as well as higher welfare payments to compensate for GST–related increases in the cost of living). In addition, the recent downturn in world stock markets may perversely stimulate personal savings by reducing the wealth effects of rising share portfolios. Another option to raise savings lies in further labour market reforms which could reduce the relatively high level of structural unemployment. This could also improve Australia's competitiveness and, by implication, boost exports and lower the current account deficits. Thus, a radical mix of policies are needed to tackle the twin issues of low domestic savings and the current account deficit in the next few years.

In Japan, the collapse of the asset bubble of the 1980s dealt a blow to the economy and consumer confidence. The cumulative economic losses were estimated at a staggering $10 trillion, or roughly the equivalent of two years of aggregate output of the Japanese economy; about two thirds of such losses were attributed to the fall in land prices. To meet the persistent stagnation in domestic demand, an inevitable consequence of this massive loss of national wealth, 10 stimulus packages (totalling well over 100 trillion yen) were introduced in the last 10 years, containing provisions for both spending on public works and tax cuts. The consequent fiscal deterioration has posed a serious concern for economic policy in the medium term. As noted earlier, government debt (expected to be 116 per cent of GDP in 2000) is the highest among the G7 countries; the figure is even higher (more than 200 per cent) with the incorporation of such off-budget items as the government's pension obligations and liabilities of the Fiscal Investment and Loan Programme, (FILP) a government credit programme.

The still fragile economic outlook, especially as far as personal consumption is concerned, and the rapid ageing of the population[8] together imply a grave picture of the fiscal balance over the medium term. FILP, which accounts for around 70 per cent of spending in the general account budget each year, was originally set up as a non-inflationary means for post-war economic reconstruction; it is funded mainly by post office savings. The channelling of FILP funds has not always been made strictly on the basis of a rigorous assessment of costs and benefits; major allocations are still geared towards construction activities which are relatively high cost, generating fairly low economic returns and often not shielded from abuse. As part of the reform efforts, FILP management is to be shifted from the Ministry of Finance to the Ministry of Posts and Telecommunications from fiscal year 2001, in part to reduce the direct influence of the Ministry of Finance in funding FILP.

In New Zealand, higher oil prices, concerns over the weakening economy and a steady and substantial fall in the exchange rate have focused attention on the country's external vulnerability. The large current account imbalance makes it very dependent on foreign investor sentiment. Policy makers thus have to be sensitive to the impact of their actions on overall business confidence. As a result, the focus of policy-making over the medium term should be on maximizing productive investment in order to reduce the current account deficit to a more sustainable level and to strengthen the exchange rate.

[8] See chapter III.

III SOCIO-ECONOMIC IMPLICATIONS OF DEMOGRAPHIC DYNAMICS

INTRODUCTION

"The production of wealth is but a means to the sustenance of man; to the satisfaction of his wants; and to the development of his activities, physical, mental and moral. But man himself is the chief means of the production of that wealth of which he is the ultimate aim", so wrote Alfred Marshall, one of the founders of modern economics.[1] This quotation aptly points to the existence of inseparable linkages between demographic dynamics and socio-economic conditions. The aspects of demographic dynamics that are particularly relevant from this perspective are the size and the rate of growth of population, its age composition and its spatial distribution. However, the analysis of socio-economic implications of demographic dynamics is inevitably fraught with many complexities.

One source of complexity is that the nature of the linkages is not unidirectional. For example, viewed simplistically, one can argue that, other things remaining the same, the higher the rate of growth of population, the lower the rate of growth of per capita income. This inverse relationship rooted in an arithmetic identity does not, however, carry much economic significance in all circumstances. Growth itself, determined by a host of factors, such as the rate of capital accumulation, technological progress and the quantity as well as the quality of the labour force, is likely to have an impact on the rate of population growth. Similarly, large-scale migration to urban areas, often associated with a high population growth rate, may create a series of problems in the form of degradation of the environment; pressure on economic and social infrastructure such as transport, housing and education; a rise in delinquency and crime; and exploitation of women and children. On the other hand, urbanization may have the effect of reducing fertility and population growth.

A second source of complexity relates to the fact that the socio-economic implications of demographic dynamics depend on the initial conditions and time frame of the analysis. To illustrate, high fertility is likely to change the age structure of the population so as to increase the dependency ratio of the young, leading, in turn, to a possible reduction in savings, a lowering of investment and a decline in the rate of growth of output. In a labour-constrained economy, however, high fertility may be desirable as the dependent young population could be expected to join the labour force a few years later.

A third source of complexity relates to attempts to assess the impacts of demographic dynamics. Practically all indicators of social and economic development are influenced by a multiplicity of factors. It is not easy to disentangle the effect of individual explanatory variables, many of which may have interactions among themselves. The analysis of the socio-economic implications of demographic dynamics of the vast ESCAP region is further complicated by the sheer diversity of the dynamics in different countries. Two of the world's most populous countries, China and India, are in this region, as are some with tiny populations, mostly in the Pacific. The average growth rate during the past decade ranged from over 4 per cent to negative numbers. There are also wide differences in the age structures and the patterns of mobility.

The above snapshot picture of the manifold complexities makes it abundantly clear that all aspects of the socio-economic implications of demographic dynamics and their varied nature in different countries cannot be dealt with adequately within the scope of the present exercise. This chapter focuses on the potentially adverse consequences of the prevailing demographic dynamics for

[1] Alfred Marshall, *Principles of Economics*, 8th ed. (London, Macmillan and Co. Ltd., 1956), p. 144.

selected aspects of economic and social development in order to draw policy makers' attention to related concerns. The rest of the chapter begins with information on the size, growth and age composition of populations in different countries of the region. This is followed by an analysis of the trends in urbanization and international migration. Selected dimensions of socio-economic implications, particularly poverty, environment, employment, education, health and savings, are then examined. The chapter concludes with a brief discussion of policy options.

DEMOGRAPHIC DYNAMICS

Size and growth of population

In 2000, 3.7 billion people lived in the ESCAP region, constituting more than three fifths (61.8 per cent) of the world population (table III.1). Because of this large base, the population of the region is expected to further increase by one billion by

Table III.1. Estimates of total population, 2000-2025, and the rate of population growth, 1980-2025 in selected economies of the ESCAP region

	Population in thousands		*Annual compound growth rate (percentage)*				
	2000	*2025*	*1980-1990*	*1990-2000*	*2000-2010*	*2010-2020*	*2020-2025*
Developing economies	3 594 296	4 561 432	1.8	1.4	1.1	0.9	0.7
South and South-West Asia	1 484 295	2 065 428	2.3	1.9	1.5	1.2	1.0
Afghanistan	22 720	44 934	−0.8	4.4	3.8	2.2	2.0
Bangladesh	129 155	178 751	2.2	1.7	1.6	1.2	1.0
Bhutan	2 124	3 904	2.6	2.3	2.6	2.4	2.2
India	1 013 662	1 330 449	2.1	1.8	1.3	1.0	0.9
Iran (Islamic Republic of)	65 634	94 463	3.7	1.9	1.3	1.5	1.2
Maldives	286	501	3.2	2.8	2.7	2.2	1.5
Nepal	22 904	38 010	2.6	2.5	2.2	1.8	1.4
Pakistan	142 392	263 000	3.4	2.8	2.5	2.0	1.5
Sri Lanka	18 827	23 547	1.4	1.0	1.0	0.9	0.7
Turkey	66 591	87 869	2.4	1.7	1.3	1.0	0.9
South-East Asia	524 327	681 341	2.0	1.6	1.3	1.1	0.9
Brunei Darussalam	339	459	2.9	2.5	1.6	1.3	1.0
Cambodia	12 227	16 526	2.9	2.6	1.7	1.6	1.2
Indonesia	212 107	272 442	1.9	1.5	1.2	1.0	0.8
Lao People's Democratic Republic	5 433	9 653	2.6	2.7	2.5	2.3	2.0
Malaysia	23 171	30 968	2.6	2.2	1.5	1.2	1.1
Myanmar	48 785	58 120	1.8	1.2	1.1	1.0	0.8
Philippines	75 967	108 251	2.3	2.3	1.8	1.2	1.1
Singapore	4 146	4 168	2.2	1.7	0.9	0.5	0.4
Thailand	62 320	72 717	1.8	1.0	0.8	0.7	0.5
Viet Nam	79 832	108 037	2.2	1.8	1.3	1.2	1.1
East and North-East Asia	1 359 009	1 574 291	1.5	1.0	0.7	0.6	0.4
China	1 277 558	1 480 412	1.5	1.0	0.7	0.6	0.4
Democratic People's Republic of Korea	24 039	29 388	1.5	1.6	1.0	0.7	0.7
Hong Kong, China	7 002	7 719	1.2	2.0	0.9	0.3	−0.1
Macao, China	473	530	4.0	2.4	0.6	0.4	0.3
Mongolia	2 662	3 709	2.9	1.9	1.5	1.3	1.1
Republic of Korea	47 275	52 533	1.2	0.9	0.6	0.4	0.2

(Continued on next page)

Table III.1 *(continued)*

	Population in thousands		Annual compound growth rate (percentage)				
	2000	2025	1980-1990	1990-2000	2000-2010	2010-2020	2020-2025
Pacific island economies	7 622	11 828	2.1	2.2	2.0	1.7	1.4
American Samoa	64	143	3.9	3.8	3.4	2.9	2.6
Cook Islands	19	24	0.3	0.6	0.7	0.8	0.9
Fiji	825	1 104	1.4	1.2	1.4	1.2	1.0
French Polynesia	233	324	2.6	1.8	1.5	1.2	1.1
Guam	148	228	2.3	2.3	1.4	1.1	1.1
Kiribati	91	119	1.7	1.4	1.5	1.5	1.4
Marshall Islands	62	127	2.8	3.4	3.0	2.8	2.4
Micronesia (Federated States of)	118	190	1.6	2.1	1.9	1.9	1.8
Nauru	12	18	2.5	1.9	1.8	1.7	1.7
New Caledonia	218	286	1.6	2.4	1.4	1.0	1.0
Niue	2	1	-4.0	-2.0	-1.5	-0.9	-0.5
Northern Mariana Islands	77	245	9.7	6.1	5.3	4.5	3.8
Palau	19	33	2.3	2.4	2.4	2.3	1.9
Papua New Guinea	4 807	7 460	2.2	2.3	2.1	1.7	1.3
Samoa	169	271	0.3	1.2	1.9	1.6	1.3
Solomon Islands	448	817	3.5	3.3	2.8	2.4	1.9
Tonga	100	105	0.4	0.3	0.2	0.3	0.2
Tuvalu	10	14	1.2	2.9	2.3	2.4	2.0
Vanuatu	200	319	2.4	2.5	2.4	2.0	1.7
North and Central Asia	219 043	228 544	1.0	0.2	0.2	0.2	0.1
Armenia	3 520	3 946	1.4	-0.1	0.5	0.5	0.3
Azerbaijan	7 734	9 403	1.5	0.8	0.8	0.8	0.6
Georgia	4 968	4 969	0.7	-0.9	0.1	0.3	0.1
Kazakhstan	16 223	17 698	1.2	-0.3	0.2	0.5	0.4
Kyrgyzstan	4 699	6 096	1.9	0.7	1.0	1.1	1.1
Russian Federation	146 934	137 933	0.7	-0.1	-0.2	-0.3	-0.4
Tajikistan	6 188	8 857	3.0	1.6	1.4	1.5	1.3
Turkmenistan	4 459	6 287	2.5	2.0	1.6	1.3	1.2
Uzbekistan	24 318	33 355	2.5	1.7	1.5	1.1	1.1
Developed economies	149 913	148 943	0.7	0.4	0.2	-0.1	-0.2
Australia	19 146	23 098	1.5	1.1	0.9	0.8	0.7
Japan	126 898	121 150	0.6	0.3	0.0	-0.3	-0.4
New Zealand	3 869	4 695	0.8	1.4	0.9	0.8	0.7
ESCAP	3 744 209	4 710 375	1.8	1.4	1.1	0.9	0.7
World	6 055 049	7 823 703	1.7	1.4	1.2	1.0	0.8
As a percentage of the world total	61.8	60.2	-	-	-	-	-

Sources: *World Population Prospects: The 1998 Revision, vol. I, Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9) and *2000 ESCAP Population Data Sheet.*

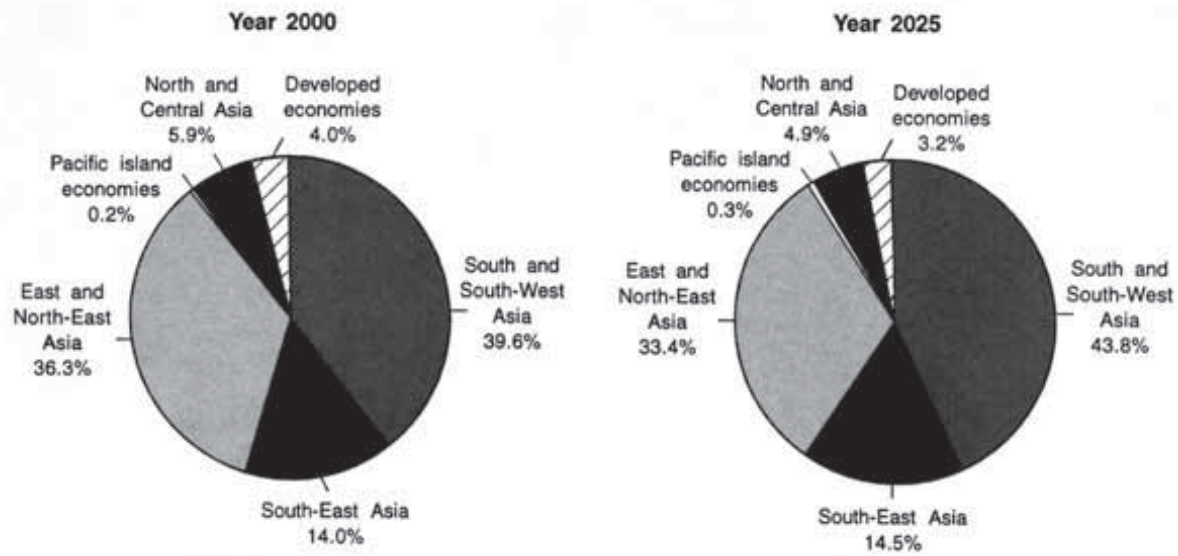
2025,[2] despite the fact that the annual population growth rate will slow down considerably from 1.4 per cent during the period 1990-2000 to 0.7 per cent during the period 2020-2025. While fertility rates have been declining rapidly, gains in life expectancy have been keeping population growth rates relatively high.

Of the total population of the ESCAP region, 39.6 per cent lived in South and South-West Asia in 2000, followed by 36.3 per cent in East and North-East Asia, 14 per cent in South-East Asia, 5.9 per cent in North and Central Asia, 4 per cent in developed economies and 0.2 per cent in the Pacific island economies (figure III.1). By 2025, South and South-West Asia will increase its share by about 4 percentage points at the expense of all the subregions except South-East Asia and the Pacific island economies. Total fertility rates remain high in several countries in South and South-West Asia and this, coupled with the rising proportion of women who are of child-bearing age, will contribute to the rapid increase in population of the subregion. Relatively high fertility rates in some of the South-East Asian countries will keep the share of this subregion from falling. It should be noted that Singapore and Thailand in this subregion have already achieved below-replacement fertility rates. The small share of the Pacific island economies at 0.2 per cent is expected to rise to 0.3 per cent. A fall in the shares of other subregions reflects low fertility rates. Several countries/areas in these had below-replacement fertility rates in 2000; the three developed economies (Australia, Japan and New Zealand) also had below-replacement fertility rates.

While population growth rates are on the decline, their levels exhibit large variations across countries/areas. Out of 57 countries/areas given in table III.1, 22 had growth rates of more than 2 per cent during the period 1990-2000, whereas 11 had below 1 per cent growth rates. Armenia, Georgia, Kazakhstan and the Russian Federation experienced negative growth rates. By 2020-2025, only four

[2] Based on the medium variant projections prepared by the United Nations. This applies to all subsequent projections given in the chapter.

Figure III.1. Population share of various subregions of ESCAP, 2000 and 2025



Sources: United Nations, *World Population Prospects: The 1998 Revision*, vol. I, *Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9) and *2000 ESCAP Population Data Sheet.*

countries/areas (three Pacific island economies and Bhutan) will have more than 2 per cent growth rates. A much larger group of countries/areas (23) will fall in the category of below 1 per cent growth rate, including the two most populous countries: China and India. Four economies, Hong Kong, China; Japan; Niue; and the Russian Federation, will have negative growth rates.

Age composition

Countries in the region are experiencing demographic transition from high to low birth and death rates. However, the stages of demographic transition differ significantly across countries. For some the demographic transition is in the early stages so that fertility and to a lesser extent mortality rates remain high. In such countries, population growth will remain high and the share of the younger population in the total population will continue to rise. Countries in which demographic transition began a few decades ago are witnessing a rapid reduction in population growth and a rise in the share of the working-age population. Where the demographic transition is nearly complete or at a very advanced stage, the share of the population aged 60 and over is rapidly increasing. As a result of this ongoing demographic transition, a wide disparity in the age composition of countries is inevitable.

The share of the younger population (under 15) in the total population was 30 per cent and over in 2000 in a large number of countries in the region (table III.2). The share of the working-age population (15-59) ranged from 51.2 per cent for Bhutan to

Table III.2. Percentage share of selected age groups in total population in selected economies of the ESCAP region, 2000 and 2025

	2000			*2025*		
	Under 15	*15-59*	*60+*	*Under 15*	*15-59*	*60+*
Developing economies	29.7	61.6	8.7	21.8	63.2	15.0
South and South-West Asia	34.5	58.5	7.1	24.4	64.1	11.6
Afghanistan	43.7	51.4	4.9	35.7	58.3	5.9
Bangladesh	35.1	59.8	5.1	24.1	66.8	9.1
Bhutan	42.6	51.2	6.2	35.4	57.2	7.4
India	33.3	59.1	7.6	23.0	64.3	12.6
Iran (Islamic Republic of)	36.2	57.5	6.3	24.8	65.1	10.2
Maldives	43.0	51.7	5.2	30.6	62.3	7.1
Nepal	41.0	53.5	5.6	29.2	63.1	7.6
Pakistan	41.8	53.2	4.9	29.5	62.0	8.5
Sri Lanka	26.1	64.2	9.6	20.7	61.7	17.6
Turkey	28.3	63.2	8.5	21.8	63.6	14.6
South-East Asia	31.5	61.3	7.3	23.0	64.0	13.0
Brunei Darussalam	32.4	62.4	5.2	22.2	59.8	18.0
Cambodia	40.9	54.3	4.9	29.4	62.1	8.5
Indonesia	30.6	61.9	7.5	22.9	64.2	12.9
Lao People's Democratic Republic	44.0	50.8	5.3	35.3	57.9	6.8
Malaysia	34.0	59.4	6.6	23.4	63.0	13.7
Myanmar	27.9	64.7	7.5	21.8	64.7	13.5
Philippines	36.7	57.6	5.7	24.2	64.9	10.9
Singapore	22.1	67.4	10.5	16.7	54.9	28.4
Thailand	25.2	66.1	8.7	18.9	63.1	18.1
Viet Nam	33.2	59.4	7.4	23.5	64.2	12.3

(Continued on next page)

Table III.2 *(continued)*

	2000			2025		
	Under 15	*15-59*	*60+*	*Under 15*	*15-59*	*60+*
East and North-East Asia	24.7	65.2	10.1	18.3	62.1	19.6
China	24.8	65.1	10.1	18.3	62.2	19.5
Democratic People's Republic of Korea	27.4	64.5	8.1	19.3	63.0	17.7
Hong Kong, China	17.3	68.5	14.2	13.6	56.3	30.1
Macao, China	22.7	68.0	9.3	15.5	55.8	28.7
Mongolia	34.6	59.6	5.8	23.6	65.3	11.0
Republic of Korea	21.5	67.9	10.6	17.0	60.7	22.3
Pacific island economies	37.5	56.9	5.5	27.9	63.4	8.7
Fiji	31.3	61.5	7.2	22.9	63.0	14.1
French Polynesia	33.3	60.3	6.4	23.5	62.8	13.6
Guam	32.9	59.3	7.8	23.0	60.6	16.4
New Caledonia	29.8	61.9	8.4	22.0	62.9	15.0
Papua New Guinea	38.7	56.3	5.1	28.8	63.9	7.4
Samoa	37.9	54.9	7.1	26.1	65.1	8.8
Solomon Islands	42.9	52.4	4.7	31.9	60.8	7.2
Vanuatu	41.6	53.7	4.7	30.5	61.0	8.5
North and Central Asia	22.9	61.5	15.5	18.3	61.2	20.5
Armenia	24.5	62.3	13.2	18.8	60.7	20.5
Azerbaijan	28.6	60.6	10.8	20.5	62.5	16.9
Georgia	22.1	59.5	18.4	18.6	58.7	22.7
Kazakhstan	27.6	61.0	11.4	22.1	61.1	16.9
Kyrgyzstan	35.0	56.1	8.9	24.0	63.7	12.3
Russian Federation	18.2	63.3	18.5	15.2	59.8	25.0
Tajikistan	40.3	53.0	6.7	26.1	64.3	9.5
Turkmenistan	37.7	55.8	6.5	24.4	64.9	10.8
Uzbekistan	37.4	55.6	6.9	24.6	64.6	10.8
Developed economies	15.7	62.2	22.0	14.4	54.2	31.4
Australia	20.6	63.2	16.2	18.1	57.2	24.7
Japan	14.8	62.1	23.1	13.5	53.6	32.9
New Zealand	22.7	61.7	15.6	19.5	57.2	23.3
ESCAP	29.1	61.6	9.3	21.5	62.9	15.5
World	29.7	60.3	10.0	23.5	61.4	15.1

Sources: *World Population Prospects: The 1998 Revision*, vol. I, *Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9).

68.5 per cent in Hong Kong, China. The high proportion of the working-age population helped many economies achieve high growth rates.[3] For example, the share of the working-age population was over 65 per cent in China; Hong Kong, China; Republic of Korea; Singapore; and Thailand. The share of the population aged 60 and over ranged from 4.7 per cent in Solomon Islands and Vanuatu to 23.1 per cent in Japan. The share is below 10 per cent in most cases and only 12 economies have 10 per cent or above. Most of them are in East and North-East Asia and North and Central Asia. Singapore from South-East Asia and the three developed economies also belong to this category.

[3] D.E. Bloom and J.G. Williamson, "Demographic transitions and economic miracles in emerging Asia", *The World Bank Economic Review*, vol. 12, No. 3, September 1998.

The share of the younger population in the total population will decline over time, the reduction being more rapid in countries passing through the early stages of demographic transition. By 2025, there will be around a 10 percentage point reduction in most of the economies in which the share of the younger population was over 30 per cent in 2000. Many of these will see increases in their working-age population. However, the proportion of the working-age population will fall in Brunei Darussalam; China; Democratic Republic of Korea; Georgia; Hong Kong, China; Macao, China; Republic of Korea; Russian Federation; Singapore; Thailand and the three developed economies. The share of the population aged 60 and over will rise in all economies and by 2025 about a dozen will have 20 per cent or more of the population aged 60 and over in their total populations. Japan will have the highest share at 32.9 per cent. In the ESCAP region as a whole, the share of the younger population will fall from 29.1 per cent in 2000 to 21.5 per cent in 2025, the share of the working-age population will increase from 61.6 to 62.9 per cent and the share of the population aged 60 and over will rise from 9.3 to 15.5 per cent.

The number of males and females in the total population of a country is normally close to equal. However, in the ESCAP region as a whole, the share of females was 49.1 per cent in 2000 against the world average of 49.6 per cent. In a number of countries in South and South-West Asia and East and North-East Asia, there are 105 males per 100 females. A strong preference for a son is partly responsible for this outcome in some of these countries. Since women usually tend to live longer, they have a higher share in the age group 60 and over than men in most countries.

Urbanization

Urbanization defined as a percentage of the total population living in urban areas is on the rise. It is the result of the natural increase in current urban populations, rural-to-urban migration and the reclassification of certain rural areas (including boundary adjustments) as urban. Economic growth and the resultant changes in production structures in the form of a rising share of non-agricultural output are closely related to urbanization. Labour migration occurs in response to changing demand for agricultural and non-agricultural products. Since income elasticity for non-agricultural products tends to be higher than that for agricultural products, income growth results in a changing composition of spending in favour of non-agricultural products, mainly produced in urban areas. As a result, employment opportunities continue to expand in urban areas. Growing employment opportunities and better social services in urban areas, as well as improved transportation facilities, tend to induce rural-to-urban migration. To some extent, urbanization occurs because people are attracted to decision-making powers often centralized in urban areas, particularly capital cities.

Four decades ago, the ESCAP region was largely rural; in 1960 roughly one in five people of the developing economies of the region lived in urban areas (table III.3). This situation started to change rapidly and in 1980, one in four, and in 2000, one in three, were living in urban areas. By 2025, half of the population of the developing economies in the region will be living in urban areas. The developed economies of the region are predominantly urban and their urbanization is expected to further increase, although at a much slower rate, given their already large urban population base. During the next quarter century (between 2000 and 2025), the total population of the ESCAP region will increase by 966 million and the urban population by 977 million. This means that roughly all of the population increase taking place in the region will be absorbed by the urban areas, with population in the rural areas remaining more or less at the current level. Thereafter, the rural population of the developing economies is expected to experience a steady decline, similar to what happened in developed economies some decades ago.

There are marked differences in the levels of urbanization across subregions and countries.[4] Among developing economies, the level of urbanization in 2000 was the highest (67.3 per cent) in

[4] Differences in the definition of urban areas adopted by the countries complicate a meaningful comparison of the level of urbanization. Additional problems are caused by the concentration of population occurring outside the periphery that is functionally linked to the urban areas but is not included as urban. Related to this is circular migration, where individuals move backwards and forwards between village and city, some commuting and others staying for many years.

Table III.3. Estimates of urban population, level of urbanization and rate of growth of the urban population in selected economies of the ESCAP region, 1960-2025

	Urban population in thousands		*Level of urbanization*				*Annual compound growth rate of urban population*	
	2000	*2025*	*1960*	*1980*	*2000*	*2025*	*1980-2000*	*2000-2025*
Developing economies	1 296 246	2 266 611	20.5	26.3	36.0	49.7	3.2	2.3
South and South-West Asia	482 271	957 437	17.9	24.3	32.1	46.4	3.5	2.8
Afghanistan	4 971	16 445	8.0	15.6	21.9	36.6	3.5	4.9
Bangladesh	31 665	72 414	5.1	14.4	24.5	40.5	4.7	3.4
Bhutan	152	608	2.5	3.9	7.1	15.6	5.6	5.7
India	288 300	565 900	18.0	23.1	28.4	42.5	3.0	2.7
Iran (Islamic Republic of)	41 700	68 800	34.1	49.6	61.6	72.8	3.9	2.0
Maldives	75	191	11.2	22.3	26.1	38.0	3.9	3.8
Nepal	2 844	8 901	3.1	6.5	11.9	23.4	5.6	4.7
Pakistan	57 970	139 156	22.1	28.1	37.0	52.9	4.5	3.6
Sri Lanka	4 430	9 090	17.9	21.6	23.6	38.6	1.7	2.9
Turkey	50 164	75 932	29.7	43.8	75.3	86.4	4.8	1.7
South-East Asia	192 621	363 433	17.6	24.4	37.2	53.3	4.0	2.6
Brunei Darussalam	237	373	43.4	59.9	72.2	81.4	3.6	1.8
Cambodia	1 778	4 742	10.3	12.4	15.9	28.7	4.0	4.0
Indonesia	86 833	166 523	14.6	22.2	40.9	60.9	4.9	2.6
Lao People's Democratic Republic	1 275	3 794	7.9	13.4	23.5	39.3	5.6	4.5
Malaysia	12 772	21 904	26.6	42.0	57.4	70.7	4.0	2.2
Myanmar	12 628	25 187	19.2	24.0	27.7	43.3	2.2	2.8
Philippines	44 530	77 834	30.3	37.5	58.6	71.9	4.6	2.3
Singapore	3 567	4 168	100.0	100.0	100.0	100.0	2.0	0.6
Thailand	13 252	26 031	12.5	17.0	21.6	35.8	2.6	2.7
Viet Nam	15 749	32 877	14.7	19.2	19.7	30.4	2.1	3.0
East and North-East Asia	471 886	776 170	17.1	22.0	34.7	49.3	3.6	2.0
China	409 965	697 368	16.0	19.6	32.1	47.1	3.8	2.1
Democratic People's Republic of Korea	14 481	20 571	40.2	56.9	60.2	70.0	1.8	1.4
Hong Kong, China	6 927	7 719	85.0	91.5	100.0	100.0	2.1	0.4
Macao, China	468	525	35.7	52.1	98.8	99.1	3.2	0.5
Mongolia	1 691	2 754	35.7	52.1	63.5	74.3	3.4	2.0
Republic of Korea	38 354	47 233	27.7	56.9	81.9	89.9	2.9	0.8
Pacific island economies	2 032	4 612	11.8	21.4	26.6	39.0	3.3	3.3
American Samoa	36	94	39.6	44.2	52.7	65.6	4.8	3.9
Cook Islands	12	16	49.2	54.8	59.4	67.7	0.9	1.2
Fiji	404	720	29.7	37.8	49.4	65.2	2.7	2.3
French Polynesia	124	191	41.6	57.1	52.7	58.8	1.8	1.7
Guam	66	121	21.1	39.5	39.2	52.9	2.3	2.5
Kiribati	33	64	16.0	31.7	39.2	53.6	2.8	2.7
Marshall Islands	46	102	67.5	58.3	71.9	80.6	4.3	3.2
Micronesia (Federated States of)	34	79	23.6	25.0	28.3	41.7	2.4	3.4

(Continued on next page)

Table III.3 *(continued)*

	Urban population in thousands		Level of urbanization				Annual compound growth rate of urban population	
	2000	2025	1960	1980	2000	2025	1980-2000	2000-2025
Nauru	12	18	100.0	100.0	100.0	100.0	2.7	1.6
New Caledonia	165	256	50.4	56.3	76.9	89.7	3.6	1.8
Niue	1	1	22.2	27.0	32.7	45.4	0.0	0.0
Northern Mariana Islands	41	150	53.9	53.1	52.7	61.2	7.9	5.3
Palau	14	26	52.5	64.8	72.4	79.7	2.8	2.5
Papua New Guinea	837	2 222	2.7	13.0	17.4	29.8	3.7	4.0
Samoa	39	90	18.9	21.2	21.5	33.1	0.8	3.4
Solomon Islands	87	286	8.6	10.5	19.7	35.0	6.7	4.9
Tonga	37	56	17.6	27.0	38.0	53.3	2.0	1.7
Tuvalu	6	14	14.1	30.0	52.2	68.7	5.6	3.4
Vanuatu	38	106	9.0	17.9	20.0	33.4	3.0	4.2
North and Central Asia	147 436	164 959	50.9	63.4	67.3	72.1	0.9	0.5
Armenia	2 462	3 085	51.2	65.7	70.0	78.2	1.0	0.9
Azerbaijan	4 429	6 454	48.1	52.8	57.3	68.6	1.6	1.5
Georgia	3 015	3 721	43.0	51.6	60.7	71.9	0.7	0.8
Kazakhstan	9 157	11 615	44.6	54.0	56.4	65.6	0.6	1.0
Kyrgyzstan	1 563	2 479	34.2	38.3	33.3	40.7	0.6	1.9
Russian Federation	114 141	116 169	53.7	69.8	77.7	84.2	0.8	0.1
Tajikistan	1 704	3 188	33.2	34.3	27.5	36.0	1.2	2.5
Turkmenistan	1 997	3 516	46.4	47.1	44.8	55.9	2.0	2.3
Uzbekistan	8 968	14 732	34.0	40.8	36.9	44.2	1.6	2.0
Developed economies	119 096	125 873	64.5	77.4	79.7	84.5	0.7	0.2
Australia	15 994	20 255	80.6	85.8	84.7	87.7	1.2	0.9
Japan	99 788	101 434	62.5	76.2	78.8	83.7	0.6	0.1
New Zealand	3 314	4 184	76.0	83.3	85.8	89.1	1.2	0.9
ESCAP	1 415 342	2 392 484	23.1	28.8	37.7	50.8	3.0	2.1
World	2 845 049	4 536 783	33.6	39.6	47.0	58.0	2.4	1.9

Source: United Nations, *World Urbanization Prospects: The 1999 Revision, Data Tables and Highlights* (ESA/P/WP.161).

North and Central Asia, followed by South-East Asia (37.2 per cent), East and North-East Asia (34.7 per cent), South and South-West Asia (32.1 per cent) and the Pacific island economies (26.6 per cent). Between 2000 and 2025, the level of urbanization will increase at more or less the same rate in all the subregions, except North and Central Asia where the increase will be less rapid owing to the existing large urban population.

Among developing economies with at least one million people in 2000, the majority of the population lived in urban areas only in Armenia; Azerbaijan; Brunei Darussalam; Georgia; Kazakhstan; Hong Kong, China; Islamic Republic of Iran; Malaysia; Philippines; Republic of Korea; Russian Federation; Singapore; and Turkey (table III.3). On the other hand, countries where the urban population was less than one quarter included Papua New Guinea, Sri

Lanka, Thailand, Viet Nam and all the Asian least developed countries with the exception of Maldives and Myanmar,. Countries where population growth rates remain relatively high and where people largely live in rural areas will see much faster growth in the urban population. For example, the urban population will grow at more than 4 per cent a year between 2000 and 2025 in most of the Asian least developed countries and in Pakistan and Papua New Guinea. The existence of a strong positive relationship between overall and urban population growth suggests that a reduction in overall population growth will have a significant effect in reducing urban population growth.

A salient characteristic of urban systems in developing countries has been the concentration of population and economic activity in one or a few large cities, partly a manifestation of the economies of scale needed to promote economic efficiency and growth. Many of these cities in the ESCAP region have grown to become mega-cities. In 1950, only one mega-city (New York) with more than 10 million people existed in the world. By 1975, the number rose to five, and two (Tokyo and Shanghai) were in the ESCAP region (table III.4). In 2000, 11 out of 19 mega-cities in the world were in this region. By 2015, 15 out of 23 mega-cities will be in this region. Tokyo was the largest city, with 26.4 million people in 2000, and despite no increase in its population, it will maintain this status at least until 2015. Dhaka and Mumbai will have more than 20 million people by 2015. Delhi, Jakarta, Karachi and Metro Manila will be other rapidly growing (at more than 2 per cent) cities; all other existing mega-cities will experience less than 1 per cent growth. Mega-cities attract people not only from rural areas but also from smaller cities. In other words, mega-cities are the product of both rural-urban migration and urban-urban migration.

Rural-to-urban migration has been playing an important role in rapid urbanization. As discussed earlier, all the increase in population in the region between 2000 and 2025 will be absorbed by urban areas. If it is assumed that the rate of natural growth of population is the same in both rural and urban

Table III.4. Population of cities with 10 million inhabitants or more in the ESCAP region, 1975, 2000 and 2015

(Millions)

1975		*2000*		*2015*	
City	*Population*	*City*	*Population*	*City*	*Population*
Tokyo	19.8	Tokyo	26.4	Tokyo	26.4
Shanghai	11.4	Mumbai	18.1	Mumbai	26.1
		Calcutta	12.9	Dhaka	21.1
		Shanghai	12.9	Karachi	19.2
		Dhaka	12.3	Jakarta	17.3
		Karachi	11.8	Calcutta	17.3
		Delhi	11.7	Delhi	16.8
		Jakarta	11.0	Metro Manila	14.8
		Osaka	11.0	Shanghai	14.6
		Metro Manila	10.9	Istanbul	12.5
		Beijing	10.8	Beijing	12.3
				Osaka	11.0
				Tianjin	10.7
				Hyderabad	10.5
				Bangkok	10.1

Source: United Nations, *World Urbanization Prospects: The 1999 Revision, Data Tables and Highlights* (ESA/P/WP.161).

areas,[5] then more than 50 per cent of the increase in urban population in the region will be accounted for by rural-to-urban migration and reclassification of rural areas as urban. This result is based on the fact that the majority of the population of the region in 2000 lived in rural areas, implying that the absolute natural increase in population in rural areas will be more than that in urban areas. The exceptions are those countries where the overwhelming majority of the population already lives in urban areas and their overall population growth rates are low.

Female migration from rural to urban areas is on the rise, particularly in South-East Asia and East and North-East Asia.[6] A large number of young and unmarried females are moving independently in addition to those moving as part of their families. Their concentration in urban areas is more pronounced in large cities. Many government policies have been conducive to female labour-force participation. These included investment in female education and the promotion of labour-intensive exports and foreign investment that generated employment opportunities in urban areas. In consequence, an increasing number of young women are moving to urban areas on their own in search of employment.

International migration

International migration affects the size and growth of population. It can take various forms, including permanent migration, short-term migration and refugee movements. Within the first two, a further distinction can be made between documented and undocumented migration. Much of the long-term migration from the ESCAP region is to developed countries such as Australia, Canada and the United States. However, its size is negligible when compared to labour migration on short-term contracts and undocumented migration. Disparities between the demand and supply of workers of different skills and the resultant disparities in wages among countries define the direction and pattern of international migration. Varying stages of demographic transition across countries also influence international migration; countries with a large and growing working-age population are potential sources of supply of migrants for countries experiencing labour shortages.

In today's globalized world, population movements are taking place in almost every country in the world. However, the involvement of some countries in this process is substantial and the discussion in this chapter mainly relates to them. Over the past five years (1995-2000), on average the net number of people who migrated annually out of the ESCAP region was 897,000 (table III.5). Most went to oil-producing countries in West Asia and developed countries outside the region. Except for the developed countries in the region, there was emigration from all the subregions. South and South-West Asia were at the top of the list in terms of absolute numbers, followed by South-East Asia, North and Central Asia, East and North-East Asia and the Pacific island economies. The population of the Pacific island economies is small and emigration from these is mainly to Australia, New Zealand and the United States.

The international migration of workers to oil-producing countries in West Asia became prominent in the mid-1970s after oil prices increased sharply and generated dramatic increases in demand for labour in that region. Initially, the demand for foreign workers was met from neighbouring Arab countries but soon India and Pakistan became major sources of supply. They were later joined by Bangladesh, Indonesia, Philippines, Republic of Korea, Sri Lanka and Thailand. By 1985, it was estimated that around two thirds of all workers in the six Gulf Cooperation Council member states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates) were from the ESCAP region.[7] Between 1975-1979 and 1985-1989, the proportion of migrants from Bangladesh, Indonesia, Philippines and Thailand to West Asia increased at the expense of India, Pakistan, Republic of Korea and Sri Lanka. Immigration continued, although at a slower pace,

[5] The assumption seems plausible. Fertility rates in urban areas are usually lower than those in rural areas, implying a relatively lower natural growth of the urban population. However, the migration of young adults in their early years of reproductive life from rural to urban areas can increase the natural growth of the urban population. Mortality rates are usually higher in rural than urban areas. All these opposing effects are likely to cancel each other.

[6] Philip Guest, "Mobility transitions within a global system: migration in the ESCAP region", *Asia-Pacific Population Journal*, vol. 14, No. 4, December 1999.

[7] Nasra M. Shah, "Migration between Asian countries" in United Nations, *Population Distribution and Migration* (United Nations publication, Sales No. E.98.XIII.12).

Table III.5. Net international migration in selected economies of the ESCAP region, 1995-2000

	Number of net annual migration (in thousands)	*Net migration rate (per 1,000)*		*Number of net annual migration (in thousands)*	*Net migration rate (per 1,000)*
South and South-West Asia	−376	−0.3	**Pacific island economies**	−6	−0.8
Afghanistan	−40	−1.9	Fiji	−4	−5.0
Bangladesh	−120	−1.0	French Polynesia	0	−1.1
Bhutan	0	0.0	Guam	0	0.0
India	−140	−0.1	New Caledonia	1	2.9
Iran (Islamic Republic of)	0	0.0	Papua New Guinea	0	0.0
Maldives	0	0.0	Samoa	−2	−9.2
Nepal	0	0.0	Solomon Islands	0	0.0
Pakistan	−100	−0.7	Vanuatu	0	−2.2
Sri Lanka	−40	−2.2			
Turkey	64	1.0	**North and Central Asia**	−244	−1.1
			Armenia	−31	−8.7
South-East Asia	−297	−0.6	Azerbaijan	−43	−5.6
Brunei Darussalam	1	2.6	Georgia	−80	−15.7
Cambodia	8	0.8	Kazakhstan	−218	−13.3
Indonesia	−180	−0.9	Kyrgyzstan	−58	−12.6
Lao People's Democratic Republic	−1	−0.3	Russian Federation	394	2.7
			Tajikistan	−61	−10.3
Malaysia	0	0.0	Turkmenistan	−15	−3.5
Myanmar	23	0.5	Uzbekistan	−133	−5.7
Philippines	−120	−1.7			
Singapore	15	4.4	**Developed economies**	90	0.6
Thailand	−40	−0.7	Australia	80	4.3
Viet Nam	−2	0.0	Japan	0	0.0
			New Zealand	10	2.7
East and North-East Asia	−65	0.0			
China	−160	−0.1	**ESCAP**	−897	−0.2
Democratic People's Republic of Korea	0	0.0			
Hong Kong, China	110	16.7			
Macao, China	5	10.6			
Mongolia	0	0.0			
Republic of Korea	−20	−0.4			

Source: *World Population Prospects: The 1998 Revision*, vol. I, *Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9).

after oil prices started to decline in the period 1985-1990, with more workers arriving for the service industries than for construction activities which had slowed considerably. The demand for domestic services increased and a large number of housemaids started to arrive. The war between Iraq and Kuwait in the early 1990s was a difficult time for immigrant workers and millions had to leave, but gradually many returned.

Commencing in the 1980s, and accelerating in the 1990s after the Gulf war, there was a shift in the destination of migrant workers. Japan and the rapidly developing economies of East and South-East Asia, such as Brunei Darussalam, Malaysia, Republic of Korea, Singapore, Taiwan Province of China and Thailand, became major destinations. Japan increased the level of technology to reduce the labour content of manufacturing, and also

invested heavily in production overseas.[8] But this did not suffice and after 1985, labour shortages in low-paid service occupations and construction began to be met largely by undocumented foreign workers. The newly industrialized economies also attracted a large number of foreign workers. They tried to raise the levels of technology to avoid labour shortages, but nevertheless had to permit foreign workers, particularly for industries such as construction that demand large numbers of unskilled workers.

Malaysia and Thailand are both origins and destinations of migrant worker flows.[9] Malaysia has become a large importer of unskilled workers, mainly from Bangladesh, Indonesia and the Philippines, while its own workers go to higher-wage countries, particularly Singapore, on a modest scale. This might be having some undesirable effects on the Malaysian economy. The country is deprived of some of its skilled workers who go abroad, making it difficult to raise the level of technology. Furthermore, it tends to raise the level of the remaining skilled workers' wages. At the same time, unskilled workers from overseas keep domestic wages low at the unskilled end of the labour market. This contributes to higher income inequality. The outflow of Thai workers has been diversified in terms of their destinations. At the same time, the country itself has become a major destination for migrant workers from neighbouring low-income countries, particularly Myanmar. A large number of undocumented migrants are mostly employed in agriculture and fisheries. The recent regional economic crisis forced the countries to toughen their stand on illegal migration. There have been some calls for and actual incidence of the forced repatriation of the undocumented migrants.

After the collapse of the former Soviet Union, a large number of people migrated to the Russian Federation from the other republics that had been part of the former Soviet Union. Many of them were Russians who had moved to what had become other republics. Some 2.7 million people are believed to have moved to the Russian Federation between 1993 and 1996.[10] Many others have moved in search of work; in 1996 there were reportedly 350,000 documented foreign workers in the Russian Federation, a large number of them in Moscow. Undocumented migrants were also in substantial numbers.

Undocumented migration is a major worry for many governments, particularly those that import labour. Because of its very nature, it is hard to ascertain the extent of irregular or undocumented migration. However, it is generally accepted that the numbers are very large and growing. One estimate put undocumented foreign workers at approximately one million, mostly Indonesian, working in Malaysia in 1997.[11] The estimates for Thailand were also approximately one million, with most of them being from Myanmar. In some labour-exporting countries, officially reported figures of overseas workers were around half of the actual numbers.[12] The most disturbing aspect of this irregular migration is the increased trafficking of people, particularly of women and children, often for commercial sex and other exploitative and abusive purposes.

There is a perception of increasing feminization of international migration in recent years, particularly within Asia. The documented flows and stocks of female migrants provide only partial support to this perception. For example, the share of females in the outflow from Indonesia was 78 per cent in 1988; it fell to 66 per cent in 1993 and then rose again to 78 per cent in 1997.[13] In Thailand, the share went up from 13 to 19 per cent and then fell to 16 per cent over the same period. However, there was a consistent increase in this share in the Philippines. Another study that analysed the stocks of migrants in Asia reports virtually no change in the share of women in total emigration between 1975 and 1990.[14] Because of large undocumented flows affecting both males and females in the region, it is difficult to arrive at any firm conclusion. However, the migration of females has become more visible because of their increasing participation as

---

8 Peter Stalker, *Workers without Frontiers, the Impact of Globalization on International Migration* (Geneva, ILO, 2000), pp. 21-33.

9 Piyasiri Wickramasekara, "Migrant worker issues in the ASEAN: some reflections", *Labour Education Journal* (Geneva, ILO, forthcoming).

10 Stalker, op. cit.

11 Ibid.

12 Shah, op. cit.

13 Wickramasekara, op. cit.

14 A.R. Kemal and G.M. Arif, "International migration of men and women workers: nature, extent, direction and working conditions", paper presented at the International Confederation of Free Trade Unions – Asia and Pacific Regional Organization (ICFTU-APRO) Regional Workshop on "Mainstreaming Migrant Workers", Bangkok, 4-7 October 2000.

autonomous economic migrants rather than as dependents of male migrants. Many recent labour migration flows, particularly from Indonesia, Philippines and Sri Lanka, have been female-dominated. The domestic service is the single most important category of employment among female migrant workers. The entertainment industry has been another important employer of migrant women in certain parts of the region. A large number of nurses from the Philippines are also working in West Asia.

A number of benefits accrue to both the sending and receiving countries. Overseas workers are a major source of foreign exchange earnings in many countries. In 1997, these remittances amounted to $10.33 billion in India, $6.79 billion in the Philippines, $1.74 billion in Pakistan, $1.74 billion in Thailand and $1.52 billion in Bangladesh.[15] These figures do not include remittances taking place through informal channels, which in some cases can be as high as from formal channels.[16] Migrants resort to informal channels because the banking system in the recipient country is inefficient or informal channels provide better exchange rates than the banking system. Remittances are also a major source of income for families of the migrants left behind and play a major role in poverty alleviation in some countries. These are used mostly for consumption purposes and for building or renovating houses. As a result the related industries benefit and the economy grows through the multiplier effect. Migration also reduces unemployment pressures in the sending countries. In 1996, unemployment in the Philippines was around 8 per cent; it would be around 12 per cent if all immigrants returned home.[17] The returning migrants can enhance the stock of human capital through the skill and experience acquired abroad and facilitate access to modern technology. On the negative side, emigration can also deprive sending countries of skilled people they actually need. Social costs are involved as a result of the separation of families.

The receiving countries are likely to benefit from diversified skills, lower labour costs, higher economic growth and enhanced tax receipts, but there may be some pressure on public expenditure to provide services. For countries with very low fertility, replacement migration is one way to keep their populations from falling. However, the likelihood of social tensions in the receiving countries, especially those with large volumes of migration, has to be taken into consideration.

Return migration is becoming quite significant in some countries. Migrants are returning to their countries after working several years abroad to reunite with their families and/or to take advantage of new opportunities in their own country. Some 750,000 people left the Republic of Korea between 1970 and 1990; the annual outflow peaked in 1976 at 46,533 and by 1994 it had come down to 14,604.[18] The flow of return migrants increased simultaneously with the decline in outflow. During the earlier years, the ratio of emigrants to returnees went up as high as 19 to 1, but in 1994 the ratio fell to 2 to 1. In some cases, the slackening of economic activities overseas forces the return of migrants. For example, in Pakistan, the return flow of workers was only 8 per cent of the total outflow in 1978, but as a result of weakening demand in West Asia, return migrants constituted more than half of the total outflow during the period 1993-1995.[19] The reintegration of the return migrants into the socio-economic structure of their countries of origin is a major challenge faced by countries such as Pakistan.

SOCIO-ECONOMIC IMPLICATIONS

Poverty

Absolute poverty is one of the most serious challenges facing many developing countries in the ESCAP region. Based on an international poverty line of $1 a day per capita at 1993 prices, around 800 million poor people lived in the Asian and Pacific region in 1998, accounting for around 67 per cent of the world's poor.[20] This was significantly

---

15 IMF, *Balance of Payments Statistics Yearbook 1999* (Washington DC, 1999). The reported remittances include workers' remittances plus employees' compensation as given in this publication.

16 Stalker, op. cit., pp. 75-92.

17 Ibid.

18 Ibid.

19 Kemal and Arif, op. cit.

20 An international poverty line is based on more or less the same minimal standard of living across countries. Price differentials in various countries have been incorporated through the use of purchasing power parity currency conversion rates that equalize the purchasing power of different currencies. For details, see World Bank, *World Development Report 2000/2001, Attacking Poverty* (New York, Oxford University Press, 2000).

lower than the 75 per cent in 1987, but this decline is entirely attributable to the reduction of poverty in East Asia and South-East Asia. The incidence of poverty in South Asia, at 40 per cent in 1998, was much higher than the 15 per cent recorded for East Asia and South-East Asia.

Countries have their own national poverty lines, and poverty estimates based on those are given in table III.6. Because of differences in poverty lines and methodology, strict comparisons between countries are not possible. These country poverty estimates, however, may be used to study trends in poverty within countries. The results show that with a few exceptions, the incidence of poverty has decreased in all the countries over the longer term. However, the decline in the incidence of poverty in a number of countries has slowed in recent years and, in a few cases, has even started to increase. With

Table III.6. Trends in poverty in selected countries of the ESCAP region

Country and period	*Head count index (percentage)*				*Number of poor (millions)*			
	First year	*Middle years*		*Final year*	*First year*	*Middle years*		*Final year*
Bangladesh (1974, 1982, 1992, 1996)	83	73	43	36	63.0	67.3	48.6	44.0
China (1981, 1985, 1990, 1999)	20	9	8	5	197.7	100.5	94.8	58.3
India (1978, 1983, 1988, 1994)	51	45	39	36	329.0	323.0	307.0	320.0
Indonesia (1976, 1980, 1996, 1999)	40	29	11	24	54.2	42.3	22.5	48.4
Malaysia (1976, 1989, 1995, 1998)	42	17	10	8	5.2	3.0	2.0	1.7
Mongolia (1989, 1992, 1993, 1994)	0	17	24	27	0.0	0.4	0.6	0.6
Nepal (1977, 1985, 1996)	40	–	42	42	5.3	–	6.8	9.2
Pakistan (1979, 1985, 1991, 1999)	29	25	23	33	23.4	23.6	26.6	43.9
Philippines (1971, 1985, 1991, 1998)	52	54	45	43	19.6	29.9	27.8	32.3
Republic of Korea (1970, 1980, 1988,1996)	37	24	8	7	11.5	9.3	3.5	3.2
Sri Lanka (1963, 1979, 1987, 1991)	37	19	27	22	3.9	2.7	4.4	3.8
Thailand (1988, 1992, 1996, 1998)	33	23	11	13	17.9	13.5	6.8	7.9

Sources: ESCAP, *Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries* (ST/ESCAP/2007); World Bank, *World Development Report 2000/2001* (New York, Oxford University Press, 2000); and national sources.

Note: Poverty estimates are based on country-specific poverty lines.

growing populations, this has resulted in either an increase or virtually no change in the absolute number of the poor in those countries. More recently, the regional economic crisis reversed some of the gains achieved in poverty reduction by the affected countries. The reversal was particularly striking in Indonesia.

Poverty is a complex phenomenon and its incidence is determined by many factors, including level of per capita income, the rate of economic growth, distribution of assets and income, quality of governance, and access to credit, education, health and other services related to human development. However, high population pressure cannot be dismissed as a notable cause of poverty in many developing countries. With a fixed amount of land and other natural resources, it becomes more difficult to provide a specified standard of living for a large and rapidly growing population. Even though birth rates have been declining in the region, the population growth momentum is such that the net absolute addition to population numbers in many developing countries each year is higher than in the previous year. Such demographic dynamics lead to what one may call the "population-poverty trap". This is evident in South Asia where, despite a reduction in the proportion of the poor from 45 per cent in 1987 to 40 per cent in 1998, rapid population expansion increased the absolute numbers of poor from 474 million to 522 million.[21] The avoidance of "population-poverty trap" requires proactive family planning policies. Examples of some innovative approaches to popularize family planning are given in box III.1.

Another linkage between high population growth and poverty is often manifested in large family size among the poor. Available empirical evidence from Bangladesh, India, Indonesia, Philippines and Thailand show that the poor households tend to have large families.[22] A large family size obviously strains the capacity of the poor families to provide adequate health care and educational opportunities for the children. The low level of human resources development of the young, in turn, tends to perpetuate poverty. However, it can be argued that the large family size is not only a cause but a result of poverty. The poor tend to have more children because typically they face higher child mortality, cheaper child-rearing costs, and a greater need for income from child labour.[23] In both rural and urban areas, the children of the poor start to help their parents to earn a livelihood at an early age and they are the only security the poor have for their old age. However, their earnings at a very young age are usually meagre, and yet work prevents them for attending school. The lack of education of poor children, in turn, helps to transfer poverty from one generation to the next. More children mean a larger labour force later on when children of the poor reach employable age and this may push down real wages per worker. Therefore, they provide a safety net only when there are sufficient gainful employment opportunities.

The large size of poor households frequently leads to higher dependency ratios as compared with non-poor households. The dependency ratio is defined as the proportion of non-earners in the household. Among many factors, the presence of a large number of children and elderly people in households results in a high dependency ratio. It is true that children of the poor start working at a young age but, as mentioned earlier, their earnings are usually extremely low. In Pakistan in 1984 the poorest 10 per cent of households had an average of 3.3 children under age 9 against the 2.0 national average. In Indonesia, households in the poorest decile had on average 1.7 children, as against 1.2 in households in the other deciles. In Nepal and the Philippines, poor households are characterized by a relatively larger family size with more young members. It is true that youth dependency ratios have been falling rapidly in the region, implying a trend toward smaller families. However, the better-off lead this trend.

The relationship between high population growth and high incidence of poverty holds when a

---

[21] Ibid.

[22] Arjan de Haan and Michael Lipton, "Poverty in emerging Asia: progress, setbacks and log-jams", *Asian Development Review*, vol. 16, No. 2, 1998.

[23] A recent empirical study on Pakistan establishes that children work on account of the compulsions of poverty. For details, see Sonia Bhalotra, *Is Child Work Necessary*, The Suntory and Toyota International Centre for Economics and Related Disciplines, London School of Economics and Political Science, DEDPS No. 26, August 2000.

Box III.1. Some innovative approaches to lower fertility rates

Many countries have been able to reduce their fertility rates to very low levels. In part, this success can be attributed to the implementation of innovative approaches to popularize family planning. A few examples of such approaches are elucidated below.

The Government of the Republic of Korea started the mothers' club programme in 1968.[a] The purpose of this village-level organization was to promote family planning practices and serve as a channel for information and for supplying contraceptives. About 25 mothers of childbearing age formed a typical mothers' club. The leader of this small discussion and action group received each month a copy of the *Happy Home* magazine, which contained information about family planning and other health-related topics. Besides family planning, the club undertook other activities for the benefit of individuals and the group. The activities of successful clubs were often broadcast on national radio. In 1975, a national television documentary programme was produced on one of the most successful mothers' clubs in the village of Oryu Li. Later, the club's story was used as the basis for one of the earliest entertainment-cum-education projects in Asia, a prime-time 28-episode television drama "Pearl of the Soil". In this way, a successful mothers' club in one village became a model for the whole country to follow.

The success of family planning programmes in Thailand is due to close cooperation between the government, NGOs and the private sector. In 1974, the Population and Community Development Association (PDA), a well-known NGO, decided to help the government in extending family planning programmes in rural areas.[b] PDA, in cooperation with local government officials, selected and trained volunteers from villages, including schoolteachers who were well liked, respected and closely associated with the community. The volunteers were supplied with an initial stock of contraceptives and information material to distribute within their villages. The people had access to information and contraceptives in their own village and this dramatically improved the promotion of family planning services; in five years the programme reached 15,000 villages, or approximately one third of the villages at that time. The same approach was also applied to urban areas where volunteers were recruited from industrial plants, slums and even taxi companies. Moreover, PDA offers free male vasectomies on special occasions, such as Father's Day, and also serves free hot dogs to every vasectomy recipient.

PDA has also been very active in enhancing the awareness of rapidly spreading HIV/AIDS in the country. It educated its network of volunteers in the causes and prevention of AIDS, emphasizing compassion and understanding. The campaigns for family planning and prevention of HIV/AIDS have been conducted using novel approaches. An example of this is the establishment of the Cabbages and Condoms Restaurants in various parts of the country, which not only offer excellent food but also promote the health and safety aspects of condom use in an amusing manner. In these restaurants, bowls of condoms are located at the exits for customers to take if they wish. Income from the restaurants is used to fund the social development activities of PDA.

An interesting feature of the family planning programme in Indonesia is the involvement of the private sector.[c] During the 1980s, survey data showed that, unlike other countries, Indonesia experienced higher contraceptive prevalence rates in rural areas than in urban areas, partly because villages were closely-bound communities whereas in urban areas individuals often did not know where to find family planning facilities. The government decided to increase the use of private-sector facilities in urban areas and reduce dependence upon the government, which would serve mainly poor clients. Doctors and midwives in private practice were trained and given continuing education and materials about family planning. Afterwards they received a Blue Circle sign to display outside their offices and a publicity campaign through the mass media promoted Blue Circle clinics as a way to find convenient, high-quality, private-sector services at an affordable price. The project started in 1988 and contributed to a major increase in contraceptive use. The proportion of family planning services provided by the private sector increased to 28 per cent in 1994 from 12 per cent in 1988.

---

[a] Phyllis T. Piotrow and Jose G. Rimon, II, "Asia's population and family planning programmes: leaders in strategic communication", *Asia-Pacific Population Journal*, vol. 14, No. 4, December 1999.

[b] The Population and the Community Development Association (PDA), available at http://www.sli.unimelb.edu.au/pda/welcome.htm (9 February 2001).

[c] Piotrow and Rimon, loc. cit.

(Continued overleaf)

(Continued from preceding page)

The successive governments of Bangladesh have strengthened and intensified family planning programme efforts. At the beginning, the main focus of family planning services was on domiciliary delivery and community participation. Later, the provision by both private and public sectors of a range of family planning, reproductive health, and maternal and child-health services at one place was promoted through the use of a green umbrella logo, with its slogan "take services, stay well".[d] To popularize the logo, a large number of green umbrellas was distributed to family planning workers. A parade through the streets of Dhaka was also held at the time the logo was launched. The green umbrella logo was quickly recognized as the symbol for available integrated health care and family planning services at the private sector and government clinics.

The green umbrella logo and its message were further reinforced through an entertainment-cum-education television serial, entitled *"Shabuj Shathi"*, meaning green friend. The programme featured a charming fieldworker with her green umbrella who went to see different families in villages to provide the needed family planning supplies and health advice for mothers with young children. The serial became very popular and approximately 80 per cent of the urban population and 60 per cent of the rural population watched its episodes. This greatly popularized the use of contraceptives and positively influenced health knowledge and reproductive health behaviour. Moreover, the television serial disseminated substantial knowledge about HIV/AIDS, childhood diseases and nutrition. In sum, the successful communication strategy in Bangladesh included a colourful, popular symbol, promoted through television spots, public appearances and the donation of a large number of green umbrellas to family planning workers, combined with a very popular, nationally distributed, television series.

With the start of the First Five-year Development Plan in 1989, the Government of the Islamic Republic of Iran placed renewed emphasis on population problems, stressing the strong need for a family planning programme.[e] As a result, the importance of a small family size for increasing the quality of children has been receiving wide publicity. Government officials, religious leaders and special religious television programmes have promoted family planning and its positive effects on the quality of life. The spectacular success of the country in family planning owes much to the support of religious leaders. Friday prayer sermons have been used, at times, by the national and local health and family-planning authorities to share their views with the public.

[d] Ibid.

[e] UNFPA, *Country Population Assessment, Islamic Republic of Iran*, August 2000.

broader view of poverty is used. A relevant quantitative indicator is the human development index (HDI) which incorporates measures of life expectancy, educational attainment and real GDP per capita.[24] The HDI from the UNDP *Human Development Report 2000* and population growth rates for a selected number of developing countries in the region have been reported in table III.7. A higher population growth is in general associated with a lower HDI. The negative relationship between HDI and population growth is clearly reflected in the negative value of 0.55 of the rank correlation coefficient between the two variables.[25] It is recognized that the correlation does not necessarily prove causality, but the arguments in the previous paragraphs suggest that a high population growth rate most likely had an effect on poverty. Any poverty-alleviation strategy should explicitly take into account population growth as one of the elements of such a strategy.

[24] Being a composite index, HDI is a simple average of life expectancy, education and GDP indices. The education index itself is a composite index and is constructed as a weighted average of the adult literacy index (two-third weight) and the combined gross primary, secondary and tertiary enrolment ratio index (one-third weight).

[25] For the computation of the rank correlation coefficient, a country with the highest value of the human development index is ranked 1 and the country with next highest value is ranked 2 and so on. The ranking of the countries on the basis of population growth proceeds with rank 1 for a country with the highest population growth and rank increases for countries with lower population growth rates.

Table III.7. Population growth rate, human development index and its component indices in selected economies of the ESCAP region

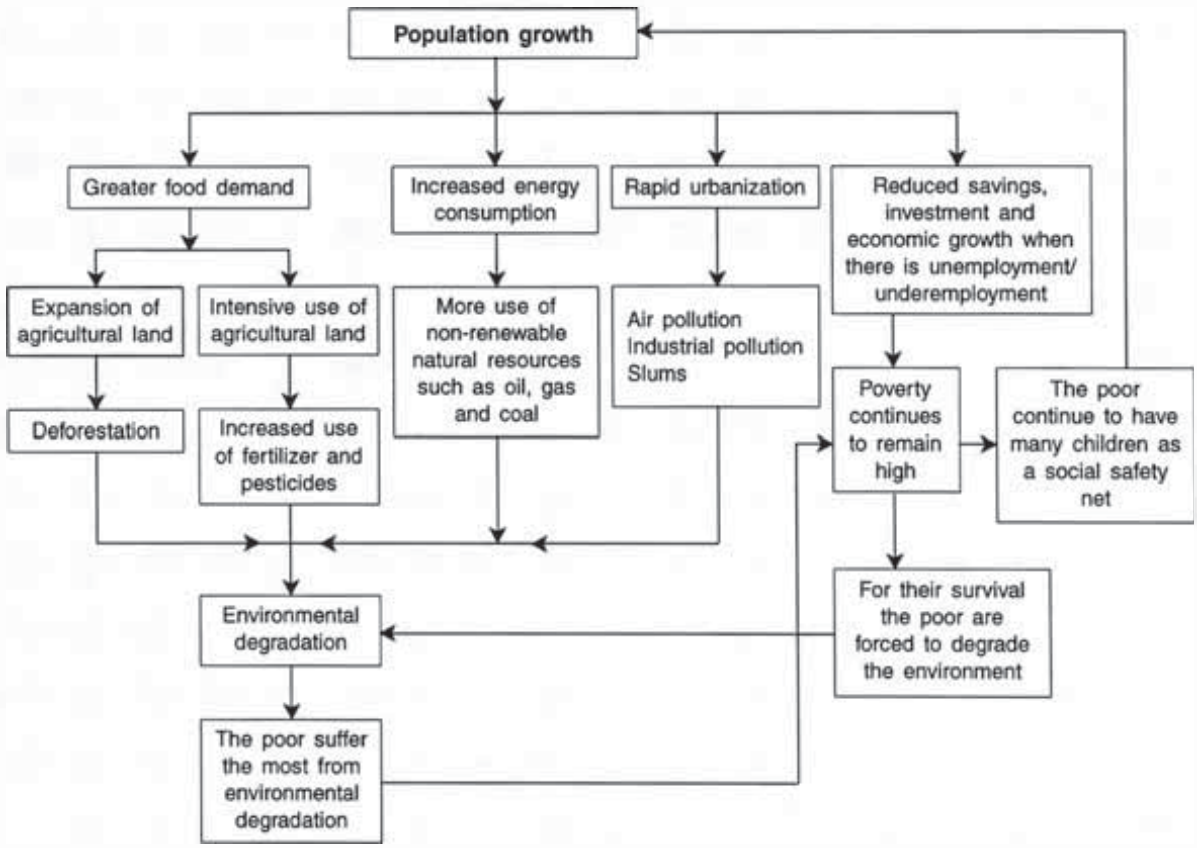
	Annual population growth rate, 1990-2000	*Human development index 1998*	*Components of human development index*		
			Life expectancy index	*Education index*	*GDP index*
High human development					
Singapore	1.7	0.88	0.87	0.86	0.92
Hong Kong, China	2.0	0.87	0.89	0.83	0.89
Republic of Korea	0.9	0.85	0.79	0.95	0.82
Medium human development					
Malaysia	2.2	0.77	0.79	0.79	0.73
Fiji	1.2	0.77	0.80	0.88	0.63
Georgia	−0.9	0.76	0.80	0.90	0.59
Kazakhstan	−0.3	0.75	0.72	0.92	0.63
Thailand	1.0	0.75	0.73	0.84	0.67
Philippines	2.3	0.74	0.73	0.91	0.60
Sri Lanka	1.0	0.73	0.81	0.83	0.57
Azerbaijan	0.8	0.72	0.75	0.90	0.51
Armenia	−0.1	0.72	0.76	0.90	0.51
Iran (Islamic Republic of)	1.9	0.71	0.74	0.73	0.66
Kyrgyzstan	0.7	0.71	0.72	0.88	0.52
China	1.0	0.71	0.75	0.79	0.57
Turkmenistan	2.0	0.70	0.68	0.89	0.54
Uzbekistan	1.7	0.69	0.71	0.84	0.50
Viet Nam	1.8	0.67	0.71	0.83	0.47
Indonesia	1.5	0.67	0.68	0.79	0.55
Tajikistan	1.6	0.66	0.71	0.89	0.39
Mongolia	1.9	0.63	0.69	0.74	0.46
Myanmar	1.2	0.59	0.59	0.75	0.41
India	1.8	0.56	0.63	0.55	0.51
Papua New Guinea	2.3	0.54	0.55	0.54	0.53
Pakistan	2.8	0.52	0.66	0.44	0.47
Cambodia	2.6	0.51	0.48	0.64	0.42
Low human development					
Lao People's Democratic Republic	2.7	0.48	0.48	0.50	0.48
Bhutan	2.3	0.48	0.60	0.39	0.46
Nepal	2.5	0.47	0.55	0.46	0.41
Bangladesh	1.7	0.46	0.56	0.39	0.44

Sources: *World Population Prospects: The 1998 Revision*, vol. I, *Comprehensive Tables* (United Nations publication, Sales No. E.99.XIII.9); and UNDP, *Human Development Report 2000* (New York, Oxford University Press, 2000).

Environment

There are linkages between environment and population. Rapid growth of population may affect the environment adversely, as more people consume more natural resources and produce more waste. The high density of population in many countries of the region is likely to pose serious challenges for environmental management in the coming years. Environmental degradation in turn can cause demographic changes by influencing health, mortality and even fertility. In addition to its linkages with population, poverty has an interrelationship with the environment; the poor are considered both victims and agents of environmental damage. As a result, a population-environment-poverty nexus becomes operative (see figure III.2).

Figure III.2. A simplified framework of linkages between population, environment and poverty



Population-related factors can affect the environment in a number of ways.[26] Some selective mechanisms are discussed here. Population growth increases demand for goods and services, particularly food and fuel. A growing demand for food can be met through increased agricultural production on land previously unused and through intensification of agriculture on land already in use. A World Bank study[27] reports that 90 per cent of the doubling in food production over the past quarter century came from higher yields and only 10 per cent from cultivating more land. The increase in total area used for agriculture in the region has contributed significantly to the loss of natural vegetation and has created severe environmental problems on steeply sloping land and fragile land. Further deforestation is taking place as a result of cutting fuelwood for domestic consumption by rural dwellers. The intensive use of land for agricultural purposes has risen significantly with the expansion of irrigation, improved varieties of seeds yielding crops with shorter maturity periods, greater mechanization and increased use of chemical fertilizers and pesticides. The irrigation dams have had environmental consequences in terms of loss of wild life habitat and agricultural land owing to flooding. Excessive exploitation of groundwater creates problems of land subsidence, salt-water

[26] The analysis here is based on a rather static framework. It is possible that major improvements in technology and productivity in the future may lessen some of the environmental damage resulting from population growth.

[27] World Bank, *World Development Report 1992* (New York, Oxford University Press, 1992), p. 19.

intrusion and groundwater pollution. The excessive use of fertilizers and pesticides is also a source of health and environmental problems.

Growing population leads to increased demand for fossil fuels, such as oil, gas and coal. These are non-renewable natural resources and their sustainable use is undermined by rapid population growth. In addition, environmental degradation occurs during their extraction, refining and downstream use.[28] Air pollution as a result of the use of various fuels is a good example.

The distribution of people between rural and urban areas also has important implications for the type of stress placed on the environment. As discussed earlier, urbanization is on the increase in the world and this process has been more rapid in Asia. Generally, urban residents have to face many environmental problems such as air pollution, noise pollution, industrial waste, contaminated drinking water, overflowing sewage and piles of garbage.

Linkages between population and poverty have been discussed previously. Often, there is a strong and vicious interaction between environmental degradation and poverty. The consequences of environmental deterioration fall the heaviest on the poor, partly because they depend directly on the natural environment for their livelihood. In fact, in developing countries where most of the poor live, the share of agriculture, forestry, fisheries and mining (all involving the use of natural resources) in GDP is quite large. For example, more than 25 per cent of GDP in India, Pakistan and Viet Nam still originated from these sectors in 1997, despite the fact that the share of agriculture in GDP has been falling. More importantly, the declining share of the primary sector in GDP is not accompanied by a corresponding decline in its share of the workforce. For example, the share of agriculture in total employment in 1997 was over 40 per cent in Bangladesh, China, India, Indonesia, Pakistan, Philippines, Thailand and Viet Nam. This only means that the pressure of poor people not absorbed by the fast-growing sectors remains on land, forests and fisheries. This is reflected in the form of encroachment on forest and other common lands to extend the cultivated area, leading to the over-exploitation of forests and fisheries.[29]

Since the poor are dependent on nature for their livelihood, they are highly vulnerable to natural calamities, environmental degradation and ecological disasters. According to one estimate, about half of the world's poor live in rural areas that are environmentally fragile.[30] They often have to endure flooding and landslides. In urban areas, the poor are forced to live in densely packed settlements and slums where they suffer greatly from urban environmental problems such as inadequate access to safe water and sanitation. They also end up living on the urban periphery where manufacturing, processing and distilling plants are built, and where environmental protection is frequently the weakest. Man-made ecological disasters, such as the poisonous gas leak in Bhopal in India in December 1984, affect the poor the most. Some 3,500 people, mostly poor, were killed and 200,000 injured in the Bhopal tragedy.[31] The vulnerability of the poor to such risks is heightened because of their poverty. This has a cumulative negative influence on the productivity of the poor. Similarly, soil degradation reduces the income of poor farmers and their capacity to provide basic care for the members of their families.

Poverty is also a contributor to environmental degradation.[32] The poor often lack resources and, in their efforts to survive, end up degrading their environment. When good-quality land is not available, they move into marginal lands or publicly owned forests, where they cut down the trees to make land cultivable. Similarly, their cultivation of steeply sloped and erosion-prone hillsides and overgrazing of these areas can cause floods and inundation in downstream areas. Because of fragile and limited resources, poorly defined property rights, and limited access to credit, the poor are unable or unwilling to invest as much as they should in environmental protection.

---

28 Clem Tisdell, "The environment and sustainable development in the Asia-Pacific: views and policies", *Asian-Pacific Economic Literature*, vol. 11, No. 1, May 1997.

29 M.V. Nadkarni, "Poverty, environment, development: a many-patterned nexus", *Economic and Political Weekly*, 1 April 2000.

30 World Bank, *World Development Report 1990* (New York, Oxford University Press, 1990), p. 30.

31 Nadkarni, op. cit.

32 World Bank, *World Development Report 1992* (New York, Oxford University Press, 1992).

The above description of the nexus between population growth, poverty and environment should not be interpreted to mean that high population growth rates or poverty are the sole or even the primary causes of environmental degradation. In fact, waste generation and pollution from industry, and wasteful consumption patterns of the rich are more responsible for environmental problems. This is obvious at the global level. For example, developed countries, accounting for only 24 per cent of the world population, consume approximately 70 per cent of the world's energy, 75 per cent of the metals, 85 per cent of the wood, and 85 per cent of the chemicals[33] and thus contribute disproportionately to the deterioration in the world's environment. Nevertheless, an understanding of the possible interconnections as described between population growth, poverty and environment provides a useful frame of reference for policy formulation.

Labour force and employment

Demographic changes impact directly on the labour force supply, as it is determined by the size and age structure of the population as well as the age/sex-specific labour force participation rates. The labour force participation rate in turn is determined by economic, social and cultural factors.

The total labour force grew rapidly during the period 1980-1990 in most countries of the region. Out of 29 economies reported in table III.8, the labour force grew at 4 per cent a year or more in 18 countries. Six countries, Indonesia, Malaysia, Mongolia, Pakistan, Philippines and Turkmenistan, registered a growth rate of 5 per cent or more. Labour force growth rates during the 1980s were higher than the corresponding population growth rates in most of the countries. This reflects higher fertility rates in earlier decades as well as rising labour force participation rates, particularly of females. Labour force growth rates slowed markedly in all the countries during the period 1990-1998 as compared to the 1980s. Only 10 countries had a growth rate of over 3 per cent, with Turkmenistan having the highest rate, at 4.3 per cent. Labour force growth rates were higher than the corresponding population growth rates in most countries.

The short-term future outlook varies somewhat across countries. Labour force growth rates are expected to slow further in 19 countries during the period 1998-2010 as compared to those in 1990-1998. China, Georgia, Kazakhstan, Russian Federation and Singapore will have annual growth rates of less than 1 per cent, whereas the Republic of Korea and Thailand will have slightly higher than 1 per cent growth. Some of these countries, particularly China, Republic of Korea, Singapore and Thailand, may face labour shortages. A large number of countries, including those in South Asia will experience a labour force growth rate of 2 per cent or more. Many of these countries have a relatively high incidence of poverty at present.

In all the countries the rate of female labour force participation tends to be lower than that for men.[34] However, there was a rapid increase in the share of the female labour force in the total labour force during the 1970s and by 1980 it was over 40 per cent in a large number of countries in the region (table III.8). The rapid decline in fertility rates gave more time to women to participate in economic activities. Among the other contributing factors were women's rising education levels, the expansion of employment in services (occupations typically dominated by women) and changing norms relating to the economic role of women. The female labour force share further increased during the period 1980-1998 in a number of countries, particularly those with a lower base. For example, Indonesia, Islamic Republic of Iran, Pakistan and Sri Lanka registered increases of 5 percentage points or more.

In general, countries with high labour force growth have relatively high unemployment rates. Moreover, those with a large rural population and a high share of agriculture in employment tend to have higher underemployment rates. Persistently high unemployment and underemployment rates are an important cause of a high incidence of poverty.

---

[33] ESCAP, *State of the Environment in Asia and the Pacific 2000* (ST/ESCAP/2087).

[34] Strict comparisons across countries may not be possible owing to differences in the perception of various tasks accomplished by women. In one country a task such as raising livestock may classify her as part of the labour force, in some other country it may not. Moreover, where women's labour force participation rates are low, there are often cultural and religious reasons.

Table III.8. Labour force and unemployment in selected economies of the ESCAP region

	Labour force								
	Average annual growth rate (%)			Total (millions) 1998	Total in 2010/ total in 1998	Female % of total labour force		Unemployment rate (%)	
	1980-1990	1990-1998	1998-2010			1980	1998	1990	1998
Armenia	2.5	1.3	1.4	2	1.0	47.9	48.4	..	9.3
Azerbaijan	2.2	1.6	2.0	3	1.3	47.5	44.2	0.1[a]	1.1
Bangladesh	4.5	3.3	2.2	64	1.3	42.3	42.3	1.9	2.5[b]
Cambodia	4.6	3.1	2.2	6	1.3	55.4	51.9	..	4.1[c]
China	3.2	1.5	0.8	743	1.1	43.2	45.2	2.5[d]	3.1[d]
Georgia	0.5	–0.1	0.2	3	1.0	49.3	46.6	..	2.6[c]
Hong Kong, China	3.4	2.5	1.4	3	1.3	34.3	36.9	1.3	4.7
India	3.5	2.7	2.0	431	1.3	33.7	32.1	..	..
Indonesia	5.2	3.1	2.0	98	1.3	35.2	40.4	1.7	5.5
Iran (Islamic Republic of)	4.6	2.3	3.4	19	1.5	20.4	25.9	..	..
Kazakhstan	..	–0.3	0.8	7	1.1	47.6	46.8	0.1[a]	3.7
Kyrgyzstan	2.6	1.6	1.9	2	1.5	47.5	47.0	..	..
Malaysia	5.5	3.5	2.7	9	1.4	33.7	37.5	5.1	4.9
Mongolia	5.0	3.1	2.3	1	2.0	45.7	46.9	..	5.8
Myanmar	3.1	1.9	1.6	24	1.2	43.7	43.4	..	4.1[c]
Nepal	4.1	2.8	2.6	11	1.3	38.8	40.5	..	..
Pakistan	5.2	3.2	3.3	49	1.5	22.7	27.7	3.1	6.1
Papua New Guinea	4.0	2.6	2.1	2	1.5	41.7	42.0	..	..
Philippines	5.2	3.3	2.4	32	1.3	35.0	37.6	8.1	9.6
Republic of Korea	4.0	2.3	1.1	23	1.2	38.7	41.0	2.4	6.8
Russian Federation	0.2	0.1	0.1	78	1.0	49.4	48.9	0.1[a]	13.3
Singapore	4.1	2.0	0.7	2	1.0	34.6	39.0	1.7	3.2
Sri Lanka	3.9	2.4	1.7	8	1.3	26.9	36.2	14.4	10.6
Tajikistan	4.1	2.8	3.0	2	1.5	46.9	44.3	..	2.7[c]
Thailand	4.1	2.1	1.2	37	1.1	47.4	46.3	2.2	3.4
Turkey	4.9	3.3	1.8	30	1.2	35.5	37.0	7.5	6.2
Turkmenistan	5.5	4.3	2.4	2	1.5	47.0	45.7	..	..
Uzbekistan	4.6	3.3	2.3	10	1.3	48.0	46.6	..	0.4[c]
Viet Nam	4.3	2.3	1.7	39	1.2	48.1	49.1	..	..

Sources: ADB, *Key Indicators of Developing Asian and Pacific Countries 1999* (Oxford University Press, 1999); ILO, *World Labour Report 2000* (Geneva, International Labour Office, 2000); LABORSTA Database by the ILO Bureau of Statistics, available at <http://laborsta.ilo.org/cgi-bin/broker.exe> (28 July 2000); *World Bank, World Development Indicators 2000,* available at <http://www.worldbank.org/data/wdi2000/pdfs/tab2_3.pdf> (17 July 2000); World Bank, *World Development Report 1999/2000* (New York, Oxford University Press, 2000); and UNDP, *Human Development Report Uzbekistan 1998* (Tashkent, 1998).

[a] = 1991.
[b] = 1996.
[c] = 1997.
[d] = Unemployed in urban areas.

Agriculture is still the major source of employment in many developing countries. As noted earlier, the reduction in the agricultural labour force has been much less than the corresponding reduction in the share of agricultural value added in GDP. As a result of heavy pressure on the rural agricultural sector and the lack of other employment opportunities, there has been a rapid migration of the labour force from rural to urban areas. In urban areas, these new migrants usually end up in the informal sector because of limited job opportunities in the formal sector.[35] For example, the share of the informal sector in urban employment was over 44 per cent in India, Myanmar, Pakistan and Thailand during the period 1993-1996.[36]

Countries with high labour force growth rates will face formidable challenges in generating much-needed employment opportunities. A number of elements in the present development scene may have the effect of aggravating unemployment problems. Downsizing of governments tends to reduce the supply of jobs in the public sector and puts extra pressure on the private sector to generate the required employment opportunities. The emerging global trade pattern, in which capital and/or technology-intensive goods and services constitute the fastest rising segment of exports, tends to reduce employment per unit of exports. With high import tariffs in many developing countries in the past, tariff-jumping FDI to produce for the domestic market is no longer required. As import tariffs are reduced in compliance with obligations under WTO, foreign investors can supply the markets of developing countries through trade rather than FDI. However, the overall effect on employment will depend on how these factors impinge on the rate of economic growth itself.

With few exceptions, countries with a high labour force growth also have lower educational levels. The challenge for these countries is not only to ensure the generation of adequate employment opportunities for the growing labour force but also to devote a greater share of resources to enhance the educational attainment and productivity of their labour force.

Education

All the countries in the region have invested heavily in education in the past few decades. However, the impact of such investment depends to a large extent on demographic factors because a specific level of investment in education achieves relatively more when there are fewer children. With an increase in fertility, the population of school-going age also increases after a lag of some years. To educate these children, more schools, teachers and books are required. If existing enrolment rates need to be improved, the resource requirement increases further. Some countries are facing a situation where they have to provide not only resources to meet the increased educational demand arising out of demographic factors but also funds to improve the enrolment of the existing population. Apart from problems related to a quantitative expansion in enrolment, a rapidly increasing school-age population also makes it difficult to improve the quality of education.

The educational achievements of countries are in general negatively associated with their population growth rates. The education index, a component of HDI, shows a negative relationship with population growth (table III.7). This negative relationship, as reflected in the negative value of 0.68 of rank correlation coefficient, turns out to be much stronger than that between HDI and population growth (rank correlation coefficient between these two is –0.55).

With a rapid increase in population in the past, the number of children going to school also went up sharply in some countries. For example, in 2000, the share of primary school age, 6-11, in the total population was 16 per cent or over in Cambodia, Lao People's Democratic Republic, Maldives, Nepal, Pakistan and Solomon Islands (table III.9). Despite this rapid growth of population of children, all countries in the region had impressive achievements in enhancing school enrolment rates, although there are differences across economies (table III.10). Countries in East Asia and South-East Asia have long had an impressive record of primary education; by 1980 or even earlier, primary education was universal in most of the countries in these subregions. In South Asia, gross primary enrolment rates have also been rising. India, Nepal and Sri Lanka

[35] ESCAP, *Role of the Informal Service Sector in Urban Poverty Alleviation* (ST/ESCAP/1706).

[36] ILO, *World Labour Report 2000* (Geneva, International Labour Office, 2000).

Table III.9. School-age population as a percentage of the total population in selected economies of the ESCAP region

	2000 Age group			2010 Age group			2025 Age group		
	6-11	12-17	18-23	6-11	12-17	18-23	6-11	12-17	18-23
Armenia	10.5	12.1	10.4	7.4	7.9	10.8	7.7	8.1	7.5
Azerbaijan	12.5	12.3	10.5	8.3	9.8	11.6	8.5	8.3	7.6
Bangladesh	13.3	15.6	13.6	12.5	11.0	11.8	9.5	10.3	10.6
Cambodia	16.1	14.6	8.2	13.8	13.7	12.9	12.1	11.6	10.8
China	10.2	10.5	9.1	8.1	8.6	10.0	7.5	7.5	7.3
Fiji	12.4	13.4	12.9	11.0	10.6	10.8	9.1	9.1	9.4
Georgia	9.2	9.4	9.1	7.7	8.1	9.0	7.5	7.8	7.6
Hong Kong, China	7.1	8.4	9.1	5.7	6.5	7.5	5.6	5.6	5.6
India	13.4	12.6	11.0	11.4	11.7	11.4	9.2	8.9	9.5
Indonesia	12.1	12.1	11.8	10.6	10.7	10.6	9.2	8.9	8.9
Iran (Islamic Republic of)	15.5	16.1	13.2	10.5	11.1	13.9	10.2	9.7	8.9
Kazakhstan	11.1	11.9	10.6	9.3	9.3	10.8	8.9	9.0	8.4
Kyrgyzstan	14.1	13.2	11.0	11.8	11.9	12.1	9.5	9.4	9.9
Lao People's Democratic Republic	17.1	13.7	10.6	15.5	13.9	12.2	14.2	13.0	11.5
Malaysia	13.8	12.1	11.1	11.6	12.4	11.0	9.2	8.7	9.3
Maldives	16.6	15.4	11.8	15.1	13.2	12.5	12.8	12.9	11.9
Mongolia	14.3	14.7	12.4	10.5	10.9	13.1	9.6	9.4	8.8
Myanmar	10.8	12.5	12.5	9.9	9.4	10.0	8.8	8.8	8.6
Nepal	16.0	14.3	11.5	14.4	13.3	12.3	12.0	12.1	11.5
Pakistan	16.3	13.6	10.9	14.7	13.5	12.0	12.2	12.1	11.4
Papua New Guinea	15.0	13.3	11.5	14.2	12.9	11.6	11.8	12.1	11.6
Philippines	14.4	13.2	11.9	13.0	12.5	11.6	9.4	10.0	10.6
Republic of Korea	8.6	9.0	9.9	8.0	8.1	7.8	6.8	7.1	7.5
Russian Federation	7.4	9.9	9.2	6.2	6.1	9.0	6.1	6.9	6.8
Samoa	15.0	14.1	12.8	13.6	12.7	12.1	10.3	11.1	11.1
Singapore	9.3	7.7	7.3	7.5	8.8	8.1	6.6	6.2	6.6
Solomon Islands	16.5	14.0	11.9	15.4	13.7	11.8	12.9	12.4	11.5
Sri Lanka	10.3	11.9	11.8	9.3	9.1	9.5	8.4	8.6	8.4
Tajikistan	15.9	14.7	11.1	13.5	12.8	12.9	10.5	11.2	10.9
Thailand	10.1	11.1	11.5	8.6	8.6	9.9	7.6	7.8	7.8
Turkey	11.0	11.3	12.5	10.4	10.3	9.3	8.7	8.8	8.8
Turkmenistan	15.2	13.7	11.3	12.5	12.6	12.5	9.5	9.8	10.2
Uzbekistan	15.0	14.1	11.3	12.6	12.3	12.5	9.6	10.2	10.5
Viet Nam	14.0	13.3	12.1	10.2	11.6	11.9	9.5	9.0	8.5

Source: *World Population Prospects: The 1998 Revision,* vol. II, *The Sex and Age Distribution of the World Population* (United Nations publication, Sales No. E.99.XIII.8).

have been able to raise enrolment rates to 100 per cent or more[37] and Bangladesh and Pakistan are not far behind. Other subregions have also made impressive achievements regarding primary education enrolment. In sum, there is a convergence of primary enrolment rates among all the countries towards the target of 100 per cent.

Gross enrolment rates at the secondary and higher level education have also increased over time. However, these rates need to be improved

[37] Enrolment rates of more than 100 per cent suggest that there are substantial numbers of over-aged students and grade repeaters occupying school places.

Table III.10. Gross enrolment ratios by education levels in selected economies of the ESCAP region, 1980 and 1997

	Enrolment ratio (1980)			Enrolment ratio (1997)[a]			Combined primary, secondary and tertiary ratio (1997)	
	Primary	Secondary	Tertiary	Primary	Secondary	Tertiary	Male	Female
South and South-West Asia								
Bangladesh	61	18	3	..	..	..	40	30
Bhutan	15	..	..	18	6	..	..	..
India	83	30	5	100	49	7	61	46
Iran (Islamic Republic of)	87	42	..	98	77	18	73	67
Maldives	146	4	..	128	69	..	74	75
Nepal	86	22	3	113	42	5	69	49
Pakistan	40	14	..	74	..	..	56	28
Sri Lanka	103	55	3	95	75	5	65	67
Turkey	96	35	5	107	58	21	67	54
South-East Asia								
Brunei Darussalam	109	61	1	106	77	..	71	73
Cambodia	121	32	1	113	24	1	68	54
Indonesia	107	29	4	113	56	11	68	61
Lao People's Democratic Republic	113	21	0	112	28	3	62	48
Malaysia	93	48	4	101	64	..	64	66
Myanmar	91	22	5	120	30	5	55	54
Philippines	112	64	24	117	78	..	80	85
Singapore	108	60	8	94	74	39	74	71
Thailand	99	29	15	89	59	..	58	59
Viet Nam	109	42	2	114	57	..	64	59
East and North-East Asia								
China	113	46	2	123	70	6	71	67
Hong Kong, China	107	64	10	94	73	..	64	67
Mongolia	107	92	22	88	56	17	50	62
Republic of Korea	110	78	15	94	102	60	94	84
Pacific Island economies								
Fiji	119	55	2	128	64	..	81	79
Papua New Guinea	59	12	2	80	14	3	40	33
Samoa	..	..	..	100	62	..	64	66
Solomon Islands	76	16	..	97	17	..	48	44
Vanuatu	..	..	..	98	21	..	49	44
North and Central Asia								
Armenia	..	..	..	87	90	12	75	68
Azerbaijan	115	95	24	106	77	17	71	71
Georgia	93	109	30	88	77	42	70	71
Kazakhstan	84	93	34	98	87	..	73	79
Kyrgyzstan	116	110	16	104	79	12	68	71
Russian Federation	..	..	..	106	87	45	75	81
Tajikistan	..	..	24	95	78	20	73	65
Uzbekistan	81	105	28	78	94	..	78	74

Sources: UNESCO, *Statistical Yearbook 1999* (Paris and Maryland, United States, UNESCO Publishing and Bernan Press, 1999); UNESCO statistical database available at <http://unescostat.unesco.org/en/stats/stats0.htm> (31 July 2000); and UNDP, *Human Development Report 2000* (New York, Oxford University Press, 2000).

[a] 1997 or most recent year for which data are available. In most cases data are for 1997 or 1996.

further in many countries; the gross secondary enrolment rate was below 50 per cent in 1997 in most countries in South Asia, while it was 102 per cent in the Republic of Korea. Countries in North and Central Asia were also relatively better placed. The rate was below 80 per cent in China, Philippines and Singapore, while in Indonesia, Malaysia and Thailand it varied between 56 and 64 per cent.[38] In some of the least developed countries, the rates are only in the 20s.

Despite improvement over time, disparities remain between the enrolment rates of males and females. These disparities are quite visible in several South Asian countries (table III.10). For example, the combined enrolment rate at all levels in Pakistan was 56 per cent for males and only half of this for females.

Higher enrolment rates reflect improved coverage and do not reveal much about the quality of education. It is not easy to ascertain changes in quality. One way in which low quality can manifest itself is through high rates of drop-out and grade repetition. The problem of dropping out seems particularly acute for Bangladesh, Cambodia, India, Lao People's Democratic Republic, Nepal and Pakistan; evidence suggests that of the cohort of children who enter primary school in most of these countries, only about half complete sixth grade.[39] Class repetition rates are the highest in South Asia; about a quarter of all children repeat a grade and, as a consequence, some children spend two to four years longer in primary school than normal. Class sizes are another indicator of the quality of education. A relatively higher pupil-teacher ratio usually adversely affects the quality of education. These ratios have been coming down in many countries in East Asia and South-East Asia, but not in South Asia. In 1990s the primary school pupil-to-teacher ratio in South Asia was more than double that in South-East Asia.

Countries where fertility rates have already slowed considerably will face less pressure on the educational system. Consequently, they can devote greater resources to expand enrolment in the higher levels of education and improve the quality of education. Between 2000 and 2010, the share of primary school-age population (6-11) in the total population will fall in most of these countries. In fact, the absolute numbers of this group will decline in 2010 as compared to those in 2000 in a large number of countries. This is reflected in the negative growth rates given in table III.11. Beyond 2010, it appears that primary and secondary school-age population will become relatively more stable. For example, between 2010 and 2025, only a few countries in the region will have negative or positive growth rates exceeding 1 per cent (table III.11).

Changes can be expected in the priorities of countries regarding the level and type of education as they attain different stages of development. For countries with low incomes, the first priority should be to have universal primary education, followed by improvements in secondary and higher level education. At the upper secondary level, relatively more emphasis should be placed on vocational training since many of these countries are facing problems of unemployment and underemployment. In the past, some achieved only limited success in this respect. For example, by 1994 technical and vocational schools accounted for less than 10 per cent of all upper secondary enrolments in Bangladesh and Pakistan. Economies with a high proportion of technical and vocational enrolments included China (60 per cent); Hong Kong, China (58 per cent); Thailand (48 per cent); Republic of Korea (41 per cent); and Singapore (38 per cent).[40] The challenges for many of the faster growing countries in East Asia and South-East Asia are somewhat different now as they attempt to make the transition to the next stage of development. They have to focus on improving access to and quality of higher/tertiary education, including more emphasis on scientific and technical education.

---

[38] From a cross-country regression model based on 121 countries, the predicted values on the basis of income levels for some of these countries turn out to be much higher than their actual values. It means that even these countries need to improve their gross enrolment rates. For more details, see Anil Deolalikar and others, "Competitiveness and human resource development in Asia", *Asian Development Review*, vol. 15, No. 2, 1997.

[39] Keith Lewin, "Educational development in Asia: issues in planning, policy and finance", *Asian Development Review*, vol. 15, No. 2, 1997.

[40] Ibid.

Table III.11. School-age population average annual growth rate in selected economies of the ESCAP region, 2000-2025

	2000-2010 Age group			2010-2025 Age group		
	6-11	*12-17*	*18-23*	*6-11*	*12-17*	*18-23*
Armenia	–2.6	–3.1	0.9	0.7	0.6	–1.7
Azerbaijan	–2.8	–1.3	2.0	1.0	–0.4	–1.8
Bangladesh	1.0	–1.7	0.2	–0.7	0.7	0.4
Cambodia	0.2	1.1	8.7	0.6	0.4	0.3
China	–1.5	–1.2	1.8	0.0	–0.4	–1.4
Fiji	0.2	–0.9	–0.4	–0.2	0.1	0.2
Georgia	–1.6	–1.3	0.0	0.0	0.0	–0.8
Hong Kong, China	–1.2	–1.6	–1.0	0.0	–0.8	–1.6
India	–0.3	0.6	1.8	–0.5	–0.8	–0.3
Indonesia	–0.2	–0.1	0.1	0.0	–0.3	–0.2
Iran (Islamic Republic of)	–2.3	–2.2	2.0	1.3	0.5	–1.4
Kazakhstan	–1.5	–2.1	0.4	0.2	0.3	–1.1
Kyrgyzstan	–0.8	0.0	2.1	–0.4	–0.5	–0.3
Lao People's Democratic Republic	1.6	3.0	4.8	1.8	2.0	2.0
Malaysia	–0.2	1.9	1.5	–0.3	–1.1	0.1
Maldives	1.9	1.2	3.8	0.9	2.1	1.9
Mongolia	–1.5	–1.4	2.2	0.7	0.2	–1.3
Myanmar	0.2	–1.6	–1.1	0.1	0.5	–0.1
Nepal	1.2	1.5	3.3	0.4	1.1	1.3
Pakistan	1.5	2.7	4.1	0.6	1.2	1.7
Papua New Guinea	1.7	1.9	2.4	0.3	1.2	1.7
Philippines	0.8	1.3	1.6	–0.9	–0.3	0.6
Republic of Korea	–0.1	–0.4	–1.6	–0.7	–0.5	0.1
Russian Federation	–1.8	–3.9	–0.4	–0.4	0.5	–1.9
Samoa	0.9	0.9	1.4	–0.4	0.6	1.0
Singapore	–1.2	2.4	2.1	–0.4	–1.6	–0.8
Solomon Islands	2.4	3.0	3.1	1.1	1.7	2.4
Sri Lanka	0.0	–1.5	–1.1	0.1	0.4	0.0
Tajikistan	–0.2	0.0	3.4	–0.2	0.6	0.3
Thailand	–0.8	–1.6	–0.7	–0.2	–0.1	–0.9
Turkey	0.8	0.4	–1.5	–0.2	–0.1	0.6
Turkmenistan	–0.4	0.8	2.9	–0.6	–0.4	–0.1
Uzbekistan	–0.3	0.1	2.8	–0.7	–0.1	0.0
Viet Nam	–1.7	–0.1	1.2	0.7	–0.5	–1.0

Source: *World Population Prospects: The 1998 Revision*, vol. II, *The Sex and Age Distribution of the World Population* (United Nations publication, Sales No. E.99.XIII.8).

Health

Demographic dynamics affect the provision of health services at least in two ways. As the size of population grows, the demand for health services rises. Given that the existing supply of health and related services is not very satisfactory in some of the countries with high population growth rates, they face the dual challenge of improving health services for the existing population as well as meeting the demands of a growing population. Population growth rates are, in general, negatively associated with health standards. The life expectancy index tends to be lower in countries with high population growth rates (table III.7). The value of the rank correlation coefficient of –0.57 reveals a strong negative relationship between the two.

Changes in the age composition of a population as a result of changes in fertility and mortality rates have implications for the health services. Where fertility rates are still high, a large proportion of the population will consist of infants and young children with particular health needs. At the same time, there is a larger demand for reproductive health services for women. Where fertility fell considerably some time ago, the share of the older population is on the rise as a result of improvements in life expectancy. In such countries, the health services have to take into account the needs of this age group. This demographic transition with the share of the older population becoming relatively quite large is going to happen in all the countries sooner or later. Therefore, when planning for future health services, countries should take into account this demographic transition. Usually, the health-care cost per person for the elderly is much higher than for the non-elderly.

Health standards of countries have improved considerably over time, but wide disparities still exist. For example, a child born in India today can expect to live 63 years, 13 years longer than a child born in 1970 (table III.12). Life expectancy in the Republic of Korea improved from 63 to 72 years over the same period. At present, life expectancy varies from 79 years in Hong Kong, China to 53 years in Cambodia and the Lao People's Democratic Republic. The significant increase in life expectancy over time has particularly been achieved because of a sharp drop in infant mortality rates.[41] Infant mortality of 157 in Maldives in 1970 was one of the highest; it came down to 62 in 1998, while in Nepal it fell from 156 to 72 over the same period. Infant mortality virtually disappeared (the rate being 5 or less) in the Republic of Korea and Singapore.

A combination of factors explain the variations in achievement in terms of health. Three theories, namely the well-being or nutrition-based theory, the public health or technology-based theory and the cultural-behavioral theory can be invoked in this context.[42] The nutrition-based theory explains improved health outcomes principally in terms of the secular improvement in food consumption made possible by the general increase in material prosperity and agricultural productivity. The public health or technology-based theory highlights the importance of access to safe water, sanitation and, more recently, mass vaccination and other public health measures for improving the length and quality of life. The cultural-behavioral theory comes into play because there are factors in addition to material prosperity and availability of health technology that are important. Thus, according to the cultural-behavioral theory there are cultural influences that predispose people to respond differently to the availability of food and health technology. Based on the above theories, a set of variables was identified to explain inter-country differences in survival chances (measured alternatively by life expectancy and infant mortality rate). The regression results show that the survival chances of a population depend on (a) the quantity of food that is available especially at the lower end of the income distribution; (b) access to such non-food inputs as health-care facilities, sanitation and safe water; (c) the spread and depth of education particularly for women; and (d) female labour force participation.

Access to health-improving factors, such as safe drinking water and adequate sanitation, has improved in almost all countries (table III.13). By 1995, more than 80 per cent of the population of Bangladesh, China, India, Islamic Republic of Iran, Kyrgyzstan, Malaysia, Philippines, Republic of Korea, Singapore and Thailand had access to safe drinking water. Only in Cambodia and Papua New Guinea did less than 50 per cent of the population have access to safe drinking water. The latest available comparable data on population with access to some health services is for the period 1990-1995. Again, in a large number of countries, more than 80 per cent of the population had access to some health services. In fact, this access was universal in the Republic of Korea and Singapore. It is important to note that access to health services does not necessarily mean utilization, which is essential for improving the health status of the population. Poor people usually do not have income to pay for health services. In public hospitals where medical services are subsidized or free, there are usually long queues and in rural areas people have to travel long distances to benefit from health services. Thus, high opportunity costs deter effective utilization of health services. The poor quality of public medical facilities also discourages their effective utilization.

---

41 The infant mortality rate is the number of babies out of every 1,000 live births who die before their first birthday.

42 For more detail on these theories, see S.R. Osmani and A. Bhargava, "Health and nutrition in emerging Asia", *Asian Development Review*, vol. 16, No. 1, 1998.

Table III.12. Estimates of life expectancy, infant mortality rates and maternal mortality ratios in selected economies of the ESCAP region

	Life expectancy at birth (years)		*Infant mortality rate (per 1,000 live births)*		*Maternal mortality ratio (per 100,000 live births)*
	1970-1975	*1995-2000*	*1970*	*1998*	*1990-1998*
South and South-West Asia					
Bangladesh	45	58	148	79	440
Bhutan	43	61	156	84	380
India	50	63	130	69	410
Iran (Islamic Republic of)	56	69	133	29	37
Maldives	51	65	157	62	350
Nepal	43	57	156	72	540
Pakistan	51	64	118	95	..
Sri Lanka	65	73	65	17	60
Turkey	58	69	150	37	130
South-East Asia					
Brunei Darussalam	68	76	58	8	0
Cambodia	40	53	155	104	470
Indonesia	49	65	104	40	450
Lao People's Democratic Republic	40	53	145	96	650
Malaysia	63	72	46	9	39
Myanmar	50	60	122	80	230
Philippines	58	68	60	32	170
Singapore	70	77	22	4	6
Thailand	60	69	74	30	44
Viet Nam	50	67	112	31	160
East and North-East Asia					
China	63	70	85	38	65
Hong Kong, China	72	79	..	..	..
Mongolia	54	66	105	64	150
Republic of Korea	63	72	43	5	20
Pacific Island economies					
Fiji	65	73	50	19	38
Papua New Guinea	48	58	90	79	370
Samoa	59	71	106	22	..
Solomon Islands	62	72	71	22	550
Vanuatu	54	67	107	38	..
North and Central Asia					
Armenia	73	71	24	25	35
Azerbaijan	69	70	41	36	37
Georgia	69	73	36	19	70
Kazakhstan	64	68	50	36	70
Kyrgyzstan	63	68	111	56	65
Russian Federation	68	67	29	21	50
Tajikistan	63	67	78	55	65
Turkmenistan	61	65	82	53	110
Uzbekistan	64	68	66	45	21
Developed economies					
Australia	72	78	17	5	..
Japan	73	80	14	4	8
New Zealand	72	77	17	5	15

Source: UNDP, *Human Development Report 2000* (New York, Oxford University Press, 2000).

Table III.13. Trends in health-related services in selected countries of the ESCAP region

	Population with access to safe water (%)		*Population with access to adequate sanitation (%)*		*Population with access to health services (%)*	*Doctors (per 100,000 people)*
	1982	*1995*	*1982*	*1995*	*1990-1995*	*1992-1995*
Azerbaijan	..	..	..	36	..	390
Bangladesh	40	84	4	35	45	18
Cambodia	..	13	..	..	53	58
China	..	83	..	..	88	115
India	54	85	8	16	85	48
Indonesia	39	65	30	55	93	12
Iran (Islamic Republic of)	50	90	60	81	88	..
Kyrgyzstan	..	81	..	..	..	310
Lao People's Democratic Republic	..	51	..	32	67	..
Malaysia	71	89	75	94	..	43
Mongolia	100	54	50	..	95	268
Myanmar	20	60	20	43	60	28
Nepal	11	59	..	23	..	5
Pakistan	38	62	16	39	55	52
Papua New Guinea	..	31	..	25	96	18
Philippines	65	83	57	77	71	11
Republic of Korea	83	83	100	100	100	127
Singapore	100	100	85	100	100	147
Sri Lanka	37	70	66	75	93	23
Tajikistan	..	69	..	62	..	4
Thailand	66	89	47	96	90	24
Turkey	69	..	..	..	..	103
Turkmenistan	..	60	..	60	..	353
Uzbekistan	..	57	..	18	..	335
Viet Nam	..	..	..	..	90	..

Sources: UNDP, *Human Development Report 1998* (New York, Oxford University Press, 1998); and World Bank, *World Development Report 1999/2000* (New York, Oxford University Press, 2000).

Savings

Domestic savings are an important source of financing investment. Higher investment leads to higher economic growth. Rapidly growing economies in East Asia and South-East Asia no doubt attracted a lot of foreign investment, but their domestic savings also increased to very high levels. While domestic savings as a percentage of GDP increased to above 30 per cent in a number of these economies, in Singapore at times the rate was over 50 per cent.

Domestic savings are determined by a number of factors, including GDP per capita, distribution of income, rate of return, financial depth, demographic factors and policy variables such as fiscal policy and the pension system.[43] Population growth impacts directly on savings if there is unemployment/under-employment in the economy. In such a situation, population growth does not lead to higher output, but at the same time consumption increases and savings fall. A reduction in savings leads to lower investment which in turn reduces economic growth. When the economy is operating at full employment and facing labour shortages, population growth is expected to lead to higher output and it is possible that savings may increase.

[43] Norman Loayza, Klaus Schmid-Hebbel and Luis Servén, "What drives private saving across the world", *The Review of Economics and Statistics*, vol. LXXXII, No. 2, May 2000.

Savings are also influenced by changes in the age composition within a country. Children and old people cannot usually work and the working-age group is mostly responsible for producing goods and services. As the share of either children or population aged 60 and over in the total population increases, aggregate savings in the country may fall and the reverse is true when there is a rising share of the working-age population.[44] As the share of the working-age population increases, aggregate income rises and consequently savings also increase. At the same time, government tax revenue increases and with falling numbers of children and people 60 and over, government responsibilities for the provision of schools and health care may also be lower, enabling the government to raise its savings. Higher saving rates in some economies in East Asia and South-East Asia have partly been associated with the increase in the share of their working-age populations. The econometric study entitled "What drives private savings across the world" (see note 43) combines cross-section and time-series data from over 68 countries to ascertain the determinants of savings, including demographic factors. The two dependency ratios of young and old (with respect to the working-age population) have a statistically significant negative impact on the private savings rate (defined as gross private savings as a ratio of gross private disposable income).[45] This also occurs with national savings. The coefficient on the old dependency ratio is significantly larger than that on the young dependency ratio. This probably reflects the fact that the labour force effectively includes a non-negligible proportion of the population under 16 years of age (the cut-off point for the young dependency ratio) in many countries.

The implications of demographic transition for savings in the near future vary across countries. The share of children under 15 in the total population has been declining in most countries and will continue to do so in the near future. The share of population aged 60 and over will increase in all the countries between 2000 and 2025. The economies in which this increase will be most prominent (more than 10 percentage points) include Brunei Darussalam; Hong Kong, China; Republic of Korea; Singapore; and Thailand. The share of the working-age population is on the rise in a large number of countries, particularly in South Asia and the least developed countries. Some increase in the share of the working-age population will continue until at least 2025 in some of the countries in South-East Asia. This demographic transition with the rising share of the working-age population should help in raising savings in these countries. On the other hand, in a number of economies, including Brunei Darussalam; China; Hong Kong China; Republic of Korea; Russian Federation; Singapore; and Thailand, the share of the working-age population will decrease significantly between 2000 and 2025. This may have a negative impact on the savings of these economies, with adverse implications for economic growth in the future.

POPULATION POLICY OPTIONS

The foregoing analysis has delineated the potentially adverse impact of demographic dynamics in the region on selected aspects of social and economic development. The exact impact in any country will depend on both the evolving demographic dynamics and other factors which influence the ultimate outcome in terms of indicators used in this chapter: poverty, environment, employment, education, health and savings. Nevertheless, the analysis clearly points to a need for population-related policies to minimize the adverse impacts of demographic changes on economic and social development. Three groups of countries can be identified for policy purposes: those with high fertility rates, those with low fertility rates and those with increasingly larger shares of population aged 60 and over.

Countries suffering from population pressure and relatively high fertility rates need to increase their efforts to stabilize their populations. Both the development process and reproductive health programmes have to play major roles in reducing

---

[44] ADB, *Asian Development Outlook 1998* (Manila, Oxford University Press, 1998), pp. 176-179.

[45] Another demographic variable included in the model is the urbanization ratio, which also has a statistically significant negative effect on the private savings rate. One possible explanation for this result is that the rural residents tend to save a larger share of their income as a precautionary motive, since they lack the means to diversify away the high uncertainty of their mostly agricultural income.

fertility.[46] With increases in income, more widespread education and improved health services, people tend to have fewer children and their demand for contraceptives increases. The wide availability of and access to contraceptives help them in keeping families small. However, a high level of socio-economic development is not necessary for the success of a family planning programme. For example, in Bangladesh a well-designed family planning programme helped in reducing the fertility level. Where there are a large number of poor who cannot afford modern contraception, governments will have to be involved in reproductive health programmes for some time to come. The programmes need to ensure the wide availability of a large range of contraceptive techniques to the poor, coupled with well-designed communication and information programmes.

The Programme of Action of the 1994 International Conference on Population and Development adopted a broad and more holistic approach to population issues, encompassing reproductive health and gender equality, equity and empowerment of women.[47] Reproductive health services provide men and women with the knowledge they need to protect their health and the health of their families. These include methods for planning their families, and for preventing and treating sexually transmitted diseases, including HIV/AIDS. (For an analysis of the challenges posed by rapidly spreading HIV/AIDS, see box III.2). However, family planning remains central to reproductive health and it is viewed as a fundamental human right that couples and individuals should be provided with access to, and information about, family planning techniques so that they can make informed choices that are consistent with their overall reproductive health needs.

A lasting solution to the diverse problems caused by rapid population growth lies in investment in human resources. Female education should have priority since it is negatively related to fertility. The extent of schooling received by females can affect their fertility by raising the age at marriage, reducing the demand for children (because educated women face greater opportunity costs in having children) and facilitating knowledge of contraception methods. Evidence from a cross-section of countries shows that, on average, secondary education reduces the number of children a woman has from seven to three.[48] Better-educated mothers also raise healthier and more educated children. In addition, female education may be particularly important for lowering infant mortality. For example, within India female literacy is much lower in Uttar Pradesh than in Kerala and at the same time, child mortality rates in Uttar Pradesh are six times higher than those in Kerala, despite the fact that overall poverty head-count ratios are similar in these two states.[49] Investment in schools, teachers and materials is essential. But so too are policies to encourage enrolment, such as scholarship programmes. In Bangladesh a scholarship programme has succeeded in almost doubling female secondary enrolment, as well as promoting higher labour force participation, later marriage and lower fertility rates.

Considering the enormous benefits of education, basic education for the entire population should be provided free or at minimal cost. The emphasis on primary and secondary education should not lead to the neglect of tertiary education. However, tertiary education should mainly be fee-based, with the provision of scholarships and loans to the poor.

While high population growth is a problem in many countries, it is the low growth of population that worries others. Countries with low fertility rates will have to evaluate the implications for the

---

[46] ADB, "Demographic change and human resource development", in *Emerging Asia: Changes and Challenges* (Manila, 1997).

[47] ESCAP and United Nations Population Fund, *Asia-Pacific Population Policies and Programmes: Future Directions*, Asian Population Studies Series No. 153 (ST/ESCAP/1923).

[48] World Bank, *World Development Report 1992* (New York, Oxford University Press, 1992), p. 8. Moreover, a recent study on India using district-level data finds a negative and highly significant effect of female literacy on the fertility rate. See J. Dreze and M. Murthi, *Fertility, Education and Development: Further Evidence from India*, The Suntory and Toyota International Centre for Economics and Related Disciplines, London School of Economics and Political Science, DEDPS No. 20, January 2000.

[49] Lori Mcdougall, "Gender gap in literacy in Uttar Pradesh: questions for decentralised educational planning", *Economic and Political Weekly*, 6 May 2000, p. 1649.

Box III.2. The challenge of rapidly spreading HIV/AIDS

A new health epidemic in the form of human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS) will pose serious socio-economic challenges for countries in the coming years. Though the epidemic entered most parts of the ESCAP region later than in other regions in the world, its spread has been rapid. In 2000, about 6.7 million adults and children living with HIV/AIDS, or 19 per cent of the world total, were in the ESCAP region.[a] New HIV infections in 2000 in the region were about 1 million, representing an annual growth of nearly 15 per cent. Countries that had high rates of HIV/AIDS in 1999 included Cambodia (4 per cent), Thailand (2.2 per cent) and Myanmar (2 per cent). The prevalence rate in India was 0.7 per cent only, but it had the largest number of people suffering from HIV/AIDS (over 3.7 million) in any single country in the world. The incidence of HIV/AIDS infection was relatively higher among men; in 2000, 32 per cent of adults with HIV/AIDS were women in the region compared with the 47 per cent world average. This does not mean that women are less vulnerable in Asia and the Pacific. In fact, owing to their economic dependence and subordination in general, women have a limited ability to negotiate safe sex and this increases their risk of being infected with HIV/AIDS.

If the spread of this disease is not controlled effectively, it will have serious socio-economic implications, particularly because the disease is concentrated among individuals in their prime productive age. With the rapid spread of HIV/AIDS, the mortality rate will increase among both children (born of infected parents) and adults. Gains in life expectancy can be reversed, as demonstrated in many African countries where the incidence of AIDS is very high.

There are, at least, two important ways through which HIV/AIDS affects the economy.[b] The first is through the reduction of both the quality and quantity of the workforce available to generate output. HIV/AIDS also contributes to a rise in labour costs as productivity declines owing to higher morbidity and increased absenteeism. Additional training costs are needed for workers replacing those who have died. The second economic impact of HIV/AIDS is through the effect on the volume and use of savings by households, the business sector and the government. Total domestic savings are likely to fall, which in turn can reduce investment and GDP growth. Households losing one or more productive members through adult mortality will suffer a loss of family income. Savings of businesses can fall because of increased labour costs and reduced profits. Government revenues and savings can drop as the economic growth rate declines. It also increases the health expenditure of families and the business sector. Governments are similarly affected through rising expenditures on health care for HIV/AIDS patients and on the rising number of orphans. Other indirect costs may include the loss of foreign investment and tourism owing to higher labour costs and the HIV/AIDS scare.

Many countries have started to attach greater priority to checking the spread of HIV/AIDS. Thailand has been prominent in the fight against this menace and has achieved some success in limiting its spread. Official recognition of the AIDS problem is a first step towards dealing with it and political commitment at the highest level is the key to achieving results and sustaining programmes. In the absence of any vaccination or effective and affordable cure, preventing infection is crucial. Preventive programmes should include educating the general public about HIV prevention and closely liaising with the most vulnerable population groups, such as commercial sex workers, intravenous drug users and commercial blood donors. Boosting the educational and economic opportunities of vulnerable young girls not only reduces HIV transmission by providing alternatives to commercial sex, but also contributes to sustainable development and an improvement in the status of women.

Readily available testing and counselling facilities can help individuals from infecting others unknowingly. Some conservative estimates by the Joint United Nations Programme on HIV/AIDS (UNAIDS) show that nine tenths of HIV-positive individuals do not know that they are infected. At the same time, countries with high infection rates need to build health facilities to cope with this problem. Some of the less expensive alternatives may include developing outpatient care facilities and expanding home-based service delivery and family-based care. A comprehensive national HIV/AIDS plan involving a wide range of actors, government, civil society, the private sector and (where appropriate) donors, is needed. In addition, efforts are needed to identify and capitalize on synergies between AIDS programmes and other programmes.

---

[a] UNAIDS/WHO, "AIDS epidemic update: December 2000", available at <http://www.unaids.org/wac/2000/wad00/files/WAD_epidemic_report/css/WAD_epidemic_report_1.htm> (10 January 2001).

[b] UNFPA, "HIV/AIDS and STDs: causes, consequences and preventive programmes", Occasional Paper Series No. 8, UNFPA Country Technical Services Team for East and South-East Asia, Bangkok, January 2000.

Efforts at the global level to contain the epidemic have accelerated. World leaders at the United Nations Millennium Summit showed a strong commitment to the fight against HIV/AIDS and unanimously adopted the United Nations Millennium Declaration which resolves to begin to reverse the spread of HIV/AIDS by the year 2015. To further intensify international action to fight the epidemic and to mobilize the resources needed, the General Assembly at its fifty-fifth session decided to convene a special session on HIV/AIDS in New York from 25 to 27 June 2001. At the special session, governments are expected to agree on a declaration of commitment outlining priority areas requiring stronger action. These are likely to include prevention, improved access to care and treatment, care of children orphaned by AIDS, expanded public/private sector partnerships, accelerated multisectoral responses to the epidemic and a commitment to mobilize resources commensurate with the crisis.

labour force. As discussed previously, in some countries labour force growth is expected to slow considerably and such countries may face labour shortages in the near future. It is important for these countries to invest more in human resources development to raise productivity in order to remain competitive in international markets. The relocation of labour-intensive industries to labour-surplus countries is also an option which has been used by countries. Raising the retirement age appears very appealing given the fact that life expectancy is on the increase and older people remain productive beyond current specified retirement ages in most countries. Moreover, older people can be given greater flexibility in their working hours and they can also be shifted to less strenuous tasks. Raising the retirement age will increase the share of the working-age population relative to the retired population, reducing pressures on pension and social security systems. There is still potential to enhance female labour force participation in countries expected to face labour shortages. In 2000, the estimated female labour force participation rate was 62 per cent in Japan, 58 per cent in the Republic of Korea and 55 per cent in Singapore. These rates were significantly lower than the over 70 per cent in some European countries and in the United States and 67 per cent in Australia and New Zealand.[50]

Another solution is increasing the reliance on international migrant workers. Given the trend of globalization and growing interdependence among countries and their varied demographic situations, migration in the future is likely to remain substantial. For orderly migration policies and minimum social tensions in the receiving countries, there is need for greater cooperation between sending and receiving countries.[51] Bilateral and regional consultations can help in sorting out problems related to international migration, without this the field remains open for market-place abuses.[52] Labour-receiving countries should attempt to formulate a suitable migration policy based on longer-run considerations of the labour market and, at the same time, migrant-sending countries should attempt to reduce undue dependence on overseas employment, especially of unskilled workers. Enhancing the skill levels of potential emigrants can increase their demand and maximize the benefits from labour migration for countries of origin.

Given the complexity of the migration issues and problems, progress on solutions will be slow. One area requiring urgent attention is related to human trafficking. Countries should take a firm stand against trafficking, particularly of women and children, and should deal harshly with the organized syndicates and traffickers. As a preventive measure, public information campaigns on the risks and dangers of illegal migration and related abuses should be launched.

---

[50] ILO, *World Labour Report 2000* (Geneva, International Labour Office, 2000), pp. 267-271.

[51] See Wickramasekara, op. cit. for a discussion of this and related policies.

[52] It is interesting to note that institutional arrangements in the form of WTO exist for free movements of goods across countries. Similarly, IMF, the World Bank and the Bank for International Settlements provide some institutional arrangements for the free movement of capital. However, there is no institutional arrangement for dealing with the movement of labour.

Population ageing is an inevitable outcome of the demographic transition. The share of the population aged 60 and over has been rising in most countries and this is expected to accelerate in countries with low fertility rates. With the gradual erosion of extended family support systems, the working-age population will need to save more for their retirement. At the same time, governments will have to provide, or facilitate the establishment of, social security/pension systems. In most countries, government employees enjoy retirement benefits, but private sector employees and the self-employed do not. Malaysia and Singapore have mandatory central provident funds for employees of both the public and private sectors. The self-employed can also participate in these funds. There is a need to explore viable options vigorously to ensure that adequate social security coverage can be expanded to a much larger share of the population in all countries.

The need for health services and hospitalization is usually greater for the older people than for other age groups. At the same time, health services for the older people are relatively more expensive. Therefore, better health-care facilities for older people should be planned and access to these services facilitated.[53] A rising share of the older population relative to the working-age population reduces the potential support population for older people. However, with the increasing productivity of successive generations, some decline in the potential support ratio should not be cause for worry. A related issue of greater concern is that there will be a shortage of care-givers for the older population. In addition, greater investment will have to be directed towards housing, entertainment goods and other industries catering to the needs of older people.

Countries in which the share of the working-age population will start dropping at the expense of the population aged 60 and over may experience a reduction in savings. This can influence their investment and growth rates. If such countries wish to maintain or raise growth rates, they will have to look for investments with higher productivity or new ways to raise domestic savings.

Rapid urbanization is posing new challenges, including congestion, pollution and slums. Although the percentage of people living below the poverty line in urban areas is on the decline in most countries, absolute numbers of the urban poor are on the rise in some countries owing to fast growth in the urban population. Huge financial resources are needed to provide social services, sanitation and infrastructural facilities in urban areas. On the positive side, rural-urban migration releases pressure on the agricultural sector and indirectly promotes its productivity. It also enhances the linkages between rural and urban areas and contributes to the diffusion of information. Given the fact that further urbanization is inevitable, managing this process for the benefit of the poor and for sustainable development is the challenge that planners will face in the coming decades.[54]

In view of strong linkages between population growth, environmental degradation and poverty, it is important that all of them be dealt with simultaneously. The synergies resulting from the positive impact of financial and human resources being devoted to treating these problems can lead to a virtuous circle of improvement in the environment and alleviation of poverty. Developed countries should help developing countries in this effort since they will also benefit from an improved world environment.

All population-related policies and programmes require financial resources. These can be generated more easily in a growing economy. Therefore, it is essential that policies promoting broad-based economic growth should be vigorously pursued.[55]

---

[53] A recent study on Thailand reports very long queues at public hospitals and doctors being unable to devote sufficient time to each patient for detailed examination. The rapidly increasing share of the population aged 60 and over will add further pressure on medical facilities in public hospitals. The study recommends the allocation of more financial resources by the government to deal with this problem. For further details, see Peerasit Kamnuansilpa and others, "An assessment of the Thai Government's health services for the aged", *Asia-Pacific Population Journal*, vol. 15, No. 1, March 2000.

[54] For more on this, see ESCAP, *Reducing Disparities: Balanced Development of Urban and Rural Areas and Regions within the Countries of Asia and the Pacific* (ST/ESCAP/2110), theme study prepared for the fifty-seventh session of the Economic and Social Commission for Asia and the Pacific.

[55] For details on such policies, see ESCAP, *Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries* (ST/ESCAP/2007).

Part Two

FINANCING FOR DEVELOPMENT

IV INTRODUCTION

The topic of financing for development has engaged the attention of policy makers and development economists for several decades. However, the importance of this topic being considered at the regional and international levels has acquired new urgency. For most of the 1980s and early 1990s, the approach of the international community to development was dominated by what came to be known as the Washington Consensus,[1] the elements of which incorporated an emphasis on domestic resource mobilization through fiscal restraint and tax reform. The content of tax reform was to be influenced by the move towards creating a market-friendly policy regime. The reduction of income, corporate and trade-related taxes and a greater reliance on domestic value-added taxes were the major planks of this strategy. Another major element was the liberalization of the domestic financial sector involving, inter alia, the deregulation of interest rates, the elimination of directed credit and freedom of entry into the financial sector for both domestic and foreign private investors. To meet import-financing needs, developing countries were to rely on exports and access to foreign private capital as the primary instruments.

The above approach to development financing has come under serious questioning. Many developing countries were not adequately prepared in terms of institutional and human resources capacity to deal with the inevitable challenges associated with its implementation, especially against the backdrop of the globalization of financial markets which was occurring with phenomenal speed. This was starkly demonstrated by a series of financial crises during the 1990s in Asia and elsewhere. The idea of relying on exports to generate resources also did not evolve in the way anticipated, with the WTO outcomes not being as favourable to developing countries as had been expected. Concomitantly, aid flows declined and the list of developing countries classified by the United Nations as "least developed" became longer. In the light of these factors, the time is ripe for a new look at the issue of financing for development, using a more holistic approach and reaching agreement on a set of options appropriate for today's global economic setting. This is what has been decided by the General Assembly in its various resolutions on financing for development.[2]

It needs to be appreciated that the topic of financing for development is extremely vast and difficult to tackle unless the issues to be analysed are narrowed to a reasonable number. The preparatory discussions on the agenda of the High-level International Intergovernmental Event on Financing for Development under the auspices of the General Assembly led to a six-point agenda:[3] mobilizing domestic financial resources for development; mobilizing international resources for development: FDI and other private flows; trade; increasing international financial cooperation for development through, inter alia, ODA; debt; and addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development.

---

[1] The popular name for the neoliberal policy programme promoted by the Bretton Woods institutions: IMF, the World Bank and WTO.

[2] The General Assembly adopted resolution 52/179 of 18 December 1997 on global partnership for development: high-level international intergovernmental consideration of financing for development; resolution 53/173 of 15 December 1998 on high-level international intergovernmental consideration of financing for development; resolution 54/196 of 22 December 1999 on high-level international intergovernmental consideration of financing for development; and resolution 55/186 of 20 December 2000, "Towards a strengthened and stable international financial architecture".

[3] Preparatory Committee for the High-level International Intergovernmental Event on Financing for Development, revised draft decision on preparation for the substantive preparatory process and the high-level international event (A/AC.257/L.2/Rev.1, annex, preliminary agenda).

It appears that the premise underlying these discussions is that development is still basically measured by progress in economic growth. This remains largely valid despite the fact that over the last decade, the concept of development has been increasingly accepted as a broader concept incorporating social and environmental dimensions as integral parts. While these aspects are crucial and there needs to be a policy focus on the implied concerns, without economic progress the financial and other resources needed to deal with them would not be available. Thus the inevitable conclusion is that economic growth is a necessary but not sufficient condition for development.[4]

In fact, the development of a country is determined by a multitude of factors, including its natural resource base, its human resources, the state of its physical infrastructure, the technology available, the development strategy of the government, and its openness to the outside world. It is almost impossible to make an exhaustive list of the factors or of their interactions. However, this is not necessary for the current exercise. Basically it can be considered that development, or economic growth, is a direct function of the various investments made in a country. It is recognized that a comprehensive discussion needs to go beyond the pure quantum of investment. In particular, there are important management and governance issues involved in investment activities within each sector to avoid or minimize wastage and leakage. There are also questions relating to the intersectoral allocation of investment. It can be claimed that when investment decisions are made on the basis of market competition, the relative rates of return over time should determine its allocation and hence intersectoral allocation should not be a matter of policy concern. However, there are always market imperfections in many different forms: inadequate information flows; complications due to the structure of industry (monopoly, oligopoly, imperfect competition); and a variety of positive or negative externalities. These make the reliance on relative rates of return of investment as the main determinant of intersectoral allocation, and thereby economic growth and development, more than problematic. There are, in addition, questions relating to the role of the government vis-à-vis the private sector. This issue is becoming more important as some of the development functions traditionally performed by the government, such as the provision of infrastructure, are being increasingly provided or financed by the private sector. When investment is made by the public sector, as often done and needed for, inter alia, providing public goods and alleviating poverty, many issues arise with respect to how the requisite resources are raised and used. These include transparency of government budgets, impact of tax-subsidy policies, criteria applied for intersectoral allocation within the public sector and efficiency in the use of resources. Considering all these complications, this study does not include an analysis of the uses of investment. It is rather limited to an investigation of the level and composition of the financial resources invested in a country. The emphasis is thus on policy measures to generate the funds required for investments in the variety of sectors crucial to development, both economic and social.

Broadly speaking, investible resources can be divided into two broad sources: domestic and foreign. Domestic resources comprise household, corporate and government savings. Some of the factors that influence domestic resource mobilization include the level and growth of per capita incomes, savings preferences of individuals in the society, the degree of development of and confidence in financial intermediation, demographic structure, and fiscal/monetary policies. Transforming these resources into investment in productive activities depends on the quality of the macroeconomic fundamentals, including fiscal/monetary prudence, the structure of the financial market, including the regulatory and supervisory framework of the banking sector and the size and quality of the securities and bond markets, and the continuity of a consistent investment policy. Other factors, such as the law and order situation, the availability of an appropriately skilled workforce, the state of development of physical infrastructure, and property rights, also weigh on decisions to intermediate savings into investment. The promotion of exports allows countries to generate foreign exchange to pay for import needs, many of which are investment-related. Exports are often crucial to pay for the import of new technologies, capital goods and raw materials not produced at home to improve the productivity and efficiency of investment as well as to take advantage of economies of scale.

[4] As said by Horst Köhler, Managing Director of IMF, in his address to the Board of Governors of the Fund in Prague in September 2000, "Economic growth is not everything, but without growth we get nowhere".

Foreign investible resources comprise funds from the international banking system (commercial short- and medium-term loans), from international capital markets (foreign private portfolio investments), from corporations (FDI) and ODA from bilateral donor governments and from multilateral financial institutions such as the World Bank and ADB. The factors which influence the size and composition of private external inflows are broadly similar to those for domestic private savings, with the addition that economic factors in the rest of the world, particularly the country of origin of the funds, such as relative growth prospects, interest rates, and tax regimes, also become relevant. Foreign official inflows are more related to political and strategic interests, the relative level of development and the amount of funds allocated to aid budgets by donor countries. In addition, it should be noted that national efforts to mobilize resources are interrelated with the external economic and financial environment: adverse developments in prices of exports, sharp fluctuations in key exchange rates or instability in the international financial system can constrain such efforts severely.

In general, the degree of economic security in a country is crucial to its success in raising resources to finance its development. The political and economic environment variables affecting savings and investment decisions include government leadership, the risk of external conflict, corruption, the rule of law, racial and ethnic tension, political terrorism, civil war, the quality of the bureaucracy, the risk of repudiation of contracts, the risk of expropriation by government, political rights and civil liberties. An analysis of 53 developing countries over the period 1984-1995 shows that the countries with better economic security had significantly high levels of investment and economic growth. Reforms to improve economic security can raise private investment by a half to one percentage point of GDP in the short to medium term, and a half to one and a quarter per cent over the longer term.[5] It is also true that the increasing globalization of the world economy has brought with it serious implications for the economic security of countries. The increasing mobility of factors of production coupled with the lowering of the degrees of freedom for national macroeconomic policy independence has led to the necessity of developing and implementing universal codes of conduct for business and financial markets. Countries which partake in these exercises will certainly be viewed as preferred recipients of investment flows.[6]

The following chapters of this study focus on various aspects of the mobilization of resources for development (domestic, foreign private and foreign official) with an emphasis on the experience in the ESCAP region. These present a review of trends and experience, and outline areas where further progress could be made. The last chapter presents some key recommendations for action by governments at the national, regional and international levels. There is, however, only scant treatment of trade issues. These issues are important in their own right for reasons not exclusively connected with financing for development. In fact, trade-related issues were the theme topic of the fifty-sixth session of the Commission held in 2000.[7] As member states took the opportunity at that session to discuss and make recommendations on the issues involved,[8] it seems preferable to focus this study on other issues of importance to financing development in the region.

---

[5] Helene Poirson, "Economic security, private investment, and growth in developing countries" *IMF Working Paper No. WP/98/4* (January 1998), pp. 17-19.

[6] For a discussion of these issues, see *Survey 1999*, chap. VIII, "Conclusion: from passive followers to active participants", pp. 231-232.

[7] ESCAP, *Development through Globalization and Partnership in the Twenty-first Century: An Asia-Pacific Perspective for Integrating Developing Countries and Economies in Transition into the International Trading System on a Fair and Equitable Basis* (ST/ESCAP/2054).

[8] See the report of the Commission on its fifty-sixth session *(Official Records of the Economic and Social Council, 2000, Supplement No. 19)*, paras. 77-97.

V DOMESTIC RESOURCE MOBILIZATION

TRENDS IN SAVINGS AND INVESTMENT

The largest share of financing for development has to originate from domestic resources. This is an inescapable necessity. Official development assistance has been declining. The tremendous increase in international private capital flows has bypassed the overwhelming majority of developing countries and a significant part of such flows is highly volatile, responding to the vagaries of unpredictable market sentiment. Data on savings and investment in the ESCAP region since 1985 show that overall the ratio of savings to GDP has been on a slight upward trend from around 21 per cent in 1985 to 29 per cent in 1999. This is a very positive sign for the region. However, when the overall picture is disaggregated, it is clear that this relatively high level of the overall savings rate is mainly accounted for by the high-growth countries in East Asia and South-East Asia. Four ASEAN members (Indonesia, Malaysia, Singapore and Thailand) as well as China; Hong Kong, China; and the Republic of Korea have all had savings rates greater than 30 per cent since 1990 (except Indonesia in the last three years). Savings rates in South and South-West Asia and the new members of ASEAN have historically been and remain, with a few exceptions, below 20 per cent. Most of the Central Asian republics also have quite low savings rates, two (Armenia and Kyrgyzstan) even having negative rates.

The contribution of government savings to overall savings has been small, or even negative, in most countries in the region. Indeed, the figures prepared by countries are probably overestimates as account has not been taken of off-budget expenditures and non-transparent subsidies. Thus, it is the private sector (households and enterprises) which generates most of the savings and stores them in monetary form for intermediation to investment. However, as government savings is a net concept, it is the level of resources raised by the government relative to its level of recurrent expenditure which actually determines its capacity to undertake investment.

For the ESCAP region as a whole there is a relatively close correspondence between the savings rate and the investment rate. This implies that the region is generating almost enough resources itself for its development purposes. However, this is not true across subregions or countries. All South and South-West Asian countries, except the Islamic Republic of Iran, have had investment rates higher than their savings rates, implying a significant inflow of external resources. Much of this has come in the form of ODA, rather than FDI. This is also true overall for many of the Central Asian republics in recent years, where the domestic savings rate is about one half of the investment rate. (As exceptions, the Russian Federation has an increasing excess of savings over investment, whereas in Kazakhstan and Uzbekistan, the two have been almost in balance.) In South-East Asia and the Republic of Korea there has generally been a close balance between the savings and investment rates, except in the heydays of high growth in the early 1990s when FDI and other private flows surged in, and in the aftermath of the recent crisis when savings considerably exceeded investment. In most of these countries, except Indonesia, savings rates have been more or less maintained whereas investment rates have fallen considerably. Among these countries Singapore appears similar to China and Hong Kong, China where the savings rate has usually been larger than the investment rate and there has been a net outflow of funds.

THE DETERMINANTS OF PRIVATE SAVINGS

Analyses of the determinants of savings have been undertaken by economists over many decades with no conclusive result. The factors which motivate households or enterprises to save are many, complex and often interrelated. Most analyses

conclude that the most important factors are those related to economic growth (lagged savings, level of per capita income and growth rates of real per capita income), demographic structures and changes therein, as well as the degree of financial sector development. The results of one recent global study provided in table V.1 strongly support similar conclusions.

The capacity of a household to hold savings voluntarily in monetary terms depends mainly on the level and growth of personal income and its sustainability. Households also often keep their savings in non-monetary forms, such as gold bars, jewellery, land and buildings, livestock or other goods kept in store at the household level. The motivation to save in monetary terms depends crucially on the credibility and convenience of access to savings

Table V.1. The determinants of savings

Determinants	*National savings*	*Private savings*	
	Global dataset	*Global dataset*	*Developing countries dataset*
Lagged national (private) savings rate	0.381	0.587	0.476
	(6.650)	(9.254)	(17.820)
Real per capita gross national (private) disposable income[a]	0.102	0.049	0.071
	(2.685)	(2.458)	(7.473)
Real growth rate of per capita gross national (private) disposable income[b]	0.447	0.450	0.425
	(4.831)	(5.828)	(13.282)
Real interest rate[a,c]	−0.136	−0.253	0.002
	(−1.215)	(−5.011)	(0.084)
M2/GNP	−0.019	−0.020	0.024
	(−0.410)	(−0.562)	(1.001)
Terms of trade[a]	0.057	0.078	0.044
	(5.243)	(5.096)	(4.875)
Urbanization ratio	−0.500	−0.382	−0.240
	(−3.373)	(−3.538)	(−5.101)
Old dependency ratio	−0.772	−0.655	−1.370
	(−1.687)	(−3.069)	(−4.321)
Young dependency ratio	−0.156	−0.299	−0.279
	(−2.236)	(−4.017)	(−5.816)
Domestic credit flow/gross national disposable income	−0.359		
	(−4.136)		
Government saving/gross private disposable income		−0.285	−0.238
		(−5.097)	(−8.333)
Private credit flow/gross private disposable income		−0.318	−0.508
		(−3.989)	(−9.955)
Inflation rate[a,c]	0.180	0.143	0.177
	(2.044)	(2.034)	(4.181)
Number of observations (number of countries)	1 640 (98)	872 (69)	475 (49)

Source: N. Loayza, K. Schmidt-Hebbel and L. Serven, "What drives private saving across the world?", *The Review of Economics and Statistics*, vol. LXXXII, No. 2 (May 2000), pp. 165-181.

Notes: Statistical significance computed using the generalized-method-of-moments system estimator, *T*-statistics (in brackets) computed with heteroskedasticity-consistent standard errors.

[a] Expressed in log form. For the real interest rate and the inflation rate, log of [1 + x].
[b] Measured by the first difference of the log.
[c] Both the real interest rate and the inflation rate are bounded between −50 and 50 per cent.

institutions. Once the capacity to save exists, savings decisions are influenced by several other factors. High and sustained growth in per capita income tends to increase the savings rate (see, for example, the large coefficient for both the level and the growth rate of per capita income in table V.1). Once savings rates start to increase, they are usually self-sustaining (hence the significance of lagged savings). However, the propensity to save may rise even though the economic growth rate stays the same, depending, inter alia, on the tax structure and government fiscal policies. For example, fiscal stimuli, such as lowering taxes or increasing spending or subsidies, can increase the savings rate. An important consideration in this context is the level and composition of taxes; high personal income taxes tend to discourage household savings. Various cross-country and time-series studies on savings behaviour indicate that growth in real GDP and real deposit rates have positive, and growth in fiscal deficits and foreign and domestic debt have negative, impacts on savings. Expectations of high inflation or an unstable macroeconomic environment or both create uncertainty in the system, especially for future growth. Public policies that reduce economic uncertainties, including keeping the rate of inflation down, thus have a positive impact on savings.

The influence of demographics is significant. It is clear that a transition to a smaller household size (lower fertility rates) can help improve the savings rate. Several cross-country studies show that both the rate of growth of population and the share of population below 15 years of age have a negative relationship with the savings rate.[1] At the same time a growing proportion of the 60 and over appears to have a negative impact. The net effect on per capita savings depends on the initial conditions, such as the share of individual cohorts in the total population and the rate of participation in the labour force. Increasing urbanization is sometimes seen as negatively related to savings owing to the better availability of consumer and other goods in urban areas, but this is of less significance when rural and urban differences are reduced.

The sensitivity of national or private savings to real interest rates is ambiguous in most studies. However, there is some evidence that the significance of the interest rate on savings rises as the income level of a country increases. For the very poor developing countries, the coefficient is rather low and in most of these countries it is not even statistically significant. However, interest sensitivity for middle and upper-income groups is relatively much higher.[2] This is probably related to the degree of development and use of the financial sector, particularly banks and other savings institutions. It should be noted, however, that any positive relationship between the interest rate and savings can be outweighed by the negative effect of increased consumption expenditure permitted by easier consumer credit and expanded use of credit cards. In fact, as shown in table V.1, there appears to be a significantly negative relationship between flows of credit and savings, particularly in developing countries.

As mentioned earlier, the willingness of the public to save in monetary terms is influenced by the functioning of financial markets.[3] For example, as financial repression forces financial institutions to pay low and often negative real interest rates, it can result in a reduction of the amount of household savings held in these institutions, and therefore makes it more difficult to intermediate savings to investment. A high level of NPLs reduces the confidence of potential depositors in the ability of banks to honour their deposits, thus inducing a lower supply of funds to them. A large share of bad loans in the portfolio also induces banks to widen the spread between borrowing and lending interest rates, and so to make the returns on savings accounts less attractive. Accordingly, reform of the financial sector of an economy in terms of improving the functioning of financial institutions and reducing

---

[1] For example, evidence from South-East Asia indicates that a reduction in population growth increases the savings rate by reducing the young dependant cohort. See Stefano Manzocchi, *Foreign Capital in Developing Economies: Perspectives from the Theory of Economic Growth* (New York, St. Martin's Press, 1999), pp. 49-51 and 123-125.

[2] Masao Ogaki, Jonathan Ostry and Carmen Reinhart, "Saving behaviour in low- and middle-income developing countries: a comparison", *IMF Working Paper WP/95/3*, 1995, pp. 25-26.

[3] The financial sector development comprises liberalization, deepening and broadening. Liberalization implies removal of entry barriers, reduction of directed credit allocation, deregulation of interest rates and removal of controls on inflows and outflows of capital. Financial deepening involves the growth of financial instruments measured by the ratio of turnover in the financial sector to GDP. Financial broadening refers to an increase in the variety of financial institutions and instruments in a country.

NPLs can help significantly in increasing the savings rate. It appears that financial deregulation leads to higher savings mainly in the longer run. While some countries show immediate positive results from such deregulation, in others the negative short-term association which has been observed is attributed to increased consumer spending because of more liberal access to consumer credit.

Corporate savings can be important in the aggregate savings rate of an economy, but they are difficult to estimate. Many firms in Asia, particularly those that are family-owned, save in the form of retained earnings, which are then reinvested in the business. These savings are not recorded in any systematic way. In all countries the majority of firms have used only bank loans as a source of investment finance. This practice has not led to any systematic demand for corporate transparency because of client-related banking practices and so retained earnings are not properly reported. However, firms listed on stock markets or firms that issue bonds have to meet the related reporting requirements on their earnings profiles. These are the firms for which it is possible to report corporate savings. For example, in Taiwan Province of China, it is reported that they account for almost one quarter of the total savings. It is known that fiscal measures can be used to encourage corporate retention; a tax structure that creates incentives to retain profits may result in a higher level of corporate savings.

As the motivations for savings are complex, and not easy to address in a policy format, it seems preferable to concentrate the analysis of domestic resource mobilization on the instruments available to savers for storing their funds and the institutions which hold these funds and intermediate them to investors. If savers have access to a diversified array of instruments in well-regulated, supervised and sound financial institutions in their own country, they will most likely put their cash savings in these instruments. If they face a narrow range of instruments in poorly supervised and financially insecure financial firms, they would prefer to save in non-monetary terms or park their savings abroad. Therefore, the following sections review the instruments and institutions available to savers in the ESCAP region, analyse the problems being faced and the reforms under way, and suggest further actions to widen the range of attractive instruments and strengthen the institutions offering them.

INSTRUMENTS AND INSTITUTIONS

The principal instruments in the ESCAP region to attract private-sector (both households and enterprises) savings have been bank deposits of various sorts. There has been very limited diversification in most developing economies into the holding of stocks, bonds and related financial instruments, and some development of pension and insurance funds as well as postal savings or unit trust systems, provident funds and other institutional forms for holding deposits. In a large- and medium-sized economy there should be a more diverse financial system with not only banks (and equity markets) but also markets for longer-term instruments such as public and private bonds and mortgage markets, as well as institutional investment groups such as pension funds, life insurance and mutual funds and various non-bank financial institutions. There is also a need for some securitization modalities[4] particularly for infrastructure development and real estate markets. For smaller economies, the banking structure might be better complemented with access to capital markets of larger neighbours or regional capital markets, as domestic ones would be too small, too shallow and too thin to be viable. Nevertheless, the development of a professional and modern banking system remains crucial for all countries.

The sound functioning of a financial system requires both the internal discipline provided by market forces and the external governance provided by regulation and supervision. The regulations that impinge on transactions in financial markets relate to governance arrangements, transparency requirements, financial accounting and auditing rules, debt covenants, and bankruptcy procedures. A well-functioning financial sector is one that has a transparent and efficient overall legal framework and administration, complemented by efficient and independent regulatory and supervisory institutions to reduce excessive risk-taking and moral hazard as well as an effective insolvency regime that properly balances the rights and obligations of debtors and creditors. The system should foster good corporate

[4] Securitization is a means used by a financial institution to package a group of unrelated loans it has made (such as mortgages) into a security which can be sold to another financial institution and so clear its books of these outstanding debits.

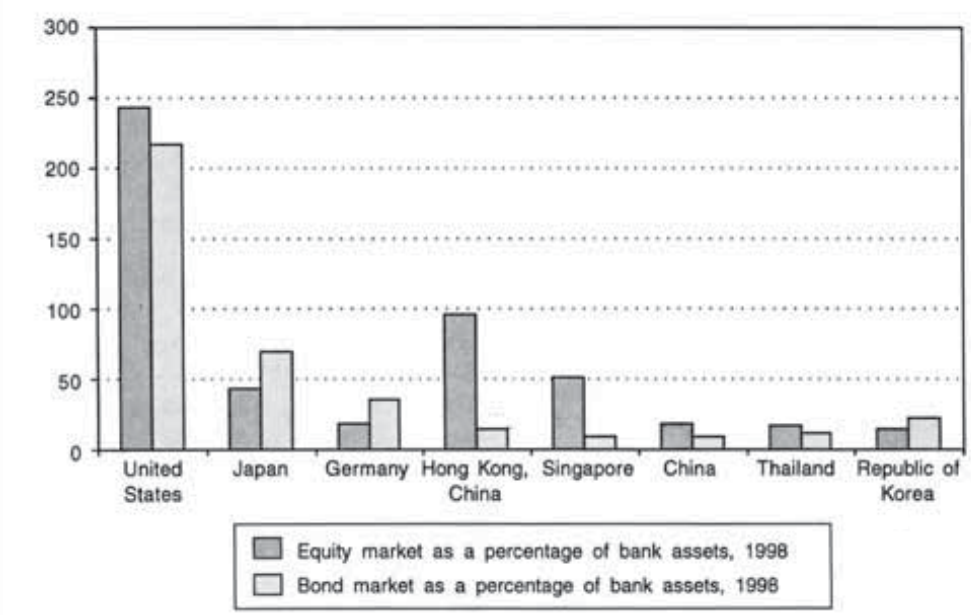
governance, transparency by both financial institutions and enterprises, and high standards of accounting and auditing practices in private and public entities; it should also foster a competitive environment to facilitate efficiency and innovation in financial services, including the encouragement of in-country operations of foreign financial institutions. It is not obvious that these conditions are being met in the majority of ESCAP member countries.

The banking sector

The banking sector continues to dominate as the major savings/investment conduit in all financial markets in the ESCAP region (see figure V.1). Except for Hong Kong, China; and Singapore, equity markets in the more advanced economies are no more than one quarter of the size of the banking sector and the bond markets in all these countries are no more than 10 to 15 per cent, except in the Republic of Korea. In other economies, capital markets are even smaller. Therefore, the health of the banking sector is central to the ability of countries to mobilize their domestic resources for development. However, it should be noted that heavy reliance on bank financing can lead to a significant mismatch between the maturity structure of assets and liabilities of corporate entities and that of banks. Since a significant number of corporations, both public and private, require funding for long-term investments (such as infrastructure and construction or capital goods projects), a dependence on bank loans, which are short-term by definition, makes the financial viability of these corporations highly susceptible to short-term swings in the economic environment.

The banking sector in the region has undergone considerable change over the last 10 years, and even more so after the recent financial crisis. The sector has been modernized in the use of IT, liberalized in the ownership and deregulated in terms of being less a direct instrument of government economic and investment policy. There have also been regulatory and supervisory reforms and approaches to solving the NPL problems. There has been considerable progress regionwide, but there are still a number of outstanding issues to be tackled. These are described below.

Figure V.1. Diversification of financial markets



Source: Standard & Poor's, *Emerging Stock Markets Factbook 2000* (June 2000).

The structure of the banking sector varies considerably among countries. In some, including Malaysia and Thailand, there is a relatively small number of major banks, mainly private ones; in other countries, such as India and Pakistan, with a relatively small number of banks, the major ones are in the public sector. In yet others, including Indonesia and the Philippines, there is a much larger number of relatively small banks, usually private ones. The reasons for these varying structures are often historical and are directly influenced by the bank licensing policies of the government. Recent post-crisis reforms have included more stringent rules on starting up and operating banks. Thus, in several countries there have been bank closures or mergers leading to a decline in the number of banks. This should increase confidence in the banking sector and leave it with a set of more financially viable banks.

The recent financial crisis in the region exposed considerable operational weaknesses in the banking sectors of countries in East and South-East Asia, including problems with cash-flow management; risk identification and management; maturity management; project evaluation and transparency. While these areas are being addressed, much remains to be done as large segments of the banking industry remain undercapitalized and loan growth is minimal. Without further progress, the domestic mobilization of resources and the capacity of banks and the corporate sector to raise funds for investment of various sorts will remain weak.

The financial sectors of most other Asian and Pacific countries are considerably more underdeveloped and weaker than those of the crisis countries. For instance, South Asian countries are, in general, less financially developed in terms of selected quantitative indicators in comparison to both the crisis economies and to world norms (table V.2). In qualitative terms, a recent study[5] on the financial markets of selected countries concludes that transparency and bank supervision in a large number of non-crisis countries are not in any better shape than in the crisis countries. Financial weaknesses in these non-crisis countries are due, in part, to distortions arising from the need to finance large government budget deficits (South Asia) or directed lending to state-owned enterprises (such as in China and Viet Nam). State banks in these countries are usually afforded preferential treatment, often in terms of tax concessions and access to public-sector deposits. This can thwart competition and reduce efficient bank intermediation. The poor quality of bank supervision has also led to NPLs being understated and banks being insufficiently capitalized. Reform and liberalization of the financial systems of these countries is under way, with considerable progress noted in India,[6] but enforcement of key legislation remains weak in many countries.

As testified by the high level of NPLs prevalent in the banking systems of almost all developing countries in the ESCAP region, most commercial banks have not followed market signals in their lending policies. Instead they have been primarily using relation-based lending practices and have been non-transparent about their financial performance. Thus, there is an urgent need to find ways of inducing banks to move towards data-based lending practices, such as credit scoring. One proposal worth considering is to increase the transparency of operations in both the banking and corporate sectors by putting pressure on the banks to improve their disclosure practices. They, in turn, would then have to demand enhanced disclosure (in terms of quantity, quality and timeliness of reports) from their clients, particularly enterprises, in order to meet their own reporting obligations. Pressure on the banks could be through domestic regulatory agencies and could, in addition, be backed up by good practices recommended by BIS or IMF. This would add weight to the regulatory authority's demands and compliance with it could form part of the BIS or IMF country reports which are available worldwide.

Most banks have used rudimentary credit assessment methodologies, when these have been applied at all. A significant improvement in their credit assessment capabilities is urgently required. The bank regulatory authorities need to verify use of these assessments for the granting of loans and impose appropriate penalties in the event of any breach. While this can be done with concerted in-house training in larger banks, it is difficult and

[5] ADB, *Rising to the challenge in Asia: a study of financial markets*, vols. 1-12 (Manila, 2000).

[6] See, for example, the description and analysis of these reforms in Urjit R. Patel, "Outlook for the Indian financial sector", *Economic and Political Weekly*, 4 November 2000.

Table V.2. Size of the financial sector in selected ESCAP economies (average 1998-1999)

	Deposit money banks/GDP (1)	*Stock market capitalization/GDP (2)*	*(1)+(2)*
Indonesia	0.36	0.35	0.71
Malaysia	0.99	1.65	2.64
Philippines	0.45	0.59	1.04
Thailand	1.11	0.39	1.50
Republic of Korea	0.76	0.56	1.32
Hong Kong, China	1.66	2.11	3.77
Singapore	1.08	1.12	2.20
Bangladesh	0.30	0.02	0.32
India	0.26	0.33	0.59
Nepal	0.28	0.06	0.34
Pakistan	0.25	0.10	0.35
Sri Lanka	0.24	0.11	0.35
World average	0.43	0.44	0.87
Average of non-Asian developing countries	0.30	0.19	0.49

Sources: World Bank, *World Development Indicators* (Washington DC), various issues; IMF, *International Financial Statistics* CD-ROM, November 2000; and World Bank web site <http://www.worldbank.org/data/databytopic/GDP.pdf> (28 November 2000).

expensive for smaller ones. It is necessary to devise some modalities for coping with this problem: BIS standards for data-based credit rating and assessment of risks could be a useful reference. Banks need to reduce their high percentage of NPLs before implementing improved credit assessment methods.

One of the problems facing banks is how to conduct credit assessments of SMEs, which usually have no track record and no proper financial recordkeeping. One initiative which has proved somewhat successful in Hong Kong, China is to establish an independent credit bureau, supported by an adequate legal and institutional framework, whose job it is to check the credit standing of SMEs and other firms not listed on any equity market. Such bureau could provide a useful service for banks until they can undertake such functions themselves or until firms of all sizes develop track records on loans. However, the large number and variety of SMEs make such a proposition very difficult to implement in an economy of any size.

The ownership structure of banks in some of the crisis countries has changed dramatically in the last few years. This has been due to liberalization, allowing the ownership of banks, finance and security firms by foreigners, and the consequent inflow of FDI to buy significant equity stakes in such firms.[7] There has been a similar but slower liberalization of ownership of banks in the other economies of the region. There are arguments for and against an increase in foreign participation in the banking sector. While foreign competition can increase pressure for consolidation and modernization and for the introduction of new products and services, there can also be a flight to quality as domestic clients

[7] In Thailand the amount of FDI inflow to the finance sector amounted to $2.1 billion. Six banks accounting for 20 per cent of the banking sector had majority foreign ownership: Bank of Asia, Thai Dhanu Bank, Radanasin Bank, Nakornthon Bank, Bangkok Metropolitan Bank, Siam City Bank, presentation by Pisit Leeahtam, Deputy Finance Minister of Thailand at the High-level Regional Consultative Meeting on Financing for Development, Jakarta, 2-5 August 2000.

might prefer to deal with banks having foreign participation, leaving domestically owned banks to service less attractive and more risky segments of the market. This could negatively influence the financial viability of the latter institutions.

In many countries the number of finance companies, which had soared in the East Asian and South-East Asian high-growth economies in the early 1990s, has declined substantially and only the more viable firms are left in the market. Nevertheless, the importance of banks in providing commercial lending in the medium to large economies of the region is slowly declining, and capital (stock and bond) markets are of increasing importance as a modality for mobilizing domestic funds. This is partly the result of a deliberate government response, and it is expected over time to increase the stability of the economy through the diversification of modalities to finance investment. In the longer run, banks should assume a less dominant role in the financial structure and learn how to cope with competition from a more diversified set of institutions.

While banks have been the traditional modality for savings and loans for both individuals and enterprises, they have not catered well to the needs of the poor, the remote, the landless, the asset-less, or the dispersed population, nor of SMEs and the informal sector.[8] In many countries both public and private banks have extended their geographic coverage within national borders over the past decade, thus making bank savings available to a wider proportion of the population. The increased use of information technology in the banking sector, particularly the use of ATMs (automatic teller machines), has assisted this development.[9] However, there is still a need to expand bank networks, including taking advantage of new technologies for electronic banking, in several countries where such services are mainly urban-based. The unmet demands for service from the disadvantaged groups could then be met through the banks as well as through other means (see the next section).

In most countries, irrespective of their level of development, there are public-sector specialized banks with a distinct focus on a specific sector, such as agriculture or housing. These banks often have an important role to play in mobilizing savings (and intermediating these into investment) in sectors which are of little or no interest to commercial banks, either private or public. The promotion of these specialized banks needs to be undertaken with care so that they operate as closely as possible on commercial terms and yet are able to service their particular clients. Sometimes they play an important anti-cyclical role in the economy, encouraging savings and making loans when other banks are reluctant to do so. This has been the experience, for example, in Thailand in the last couple of years with the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives.

Policy issues

The reform of the banking sector in almost all ESCAP member countries, developed and developing alike, has been an ongoing process over many years. Much has been written about the reforms needed. IMF and the World Bank as well as ADB have been promoting reform packages and governments have taken selected reforms on board. However, much remains to be done if the banking sectors of the developing countries are to be ready and able to face the challenges of continuing to be the main conduit for the mobilization and use of domestic resources for development in an open, competitive and globalized financial system. The reforms required have several components. These include:

(1) Increasing the ***clarity of objectives*** for the operation of the central bank and the lines of its reporting (accountability) to the government. Usually the central bank is responsible for the operation of the exchange rate regime and for the money supply and related monetary variables such as inflation. However, the degree of independence that the central bank enjoys in formulating and implementing policies in these two areas varies considerably. It is generally accepted that, given the inherent conflict of interest between the objectives of the central bank to keep inflation low and the exchange rate reasonably stable and those of the government in its fiscal operations, the more independent the central bank, the better

---

[8] For commercial banks, the costs of conducting business in their traditional format with these groups are high because of their lack of any form of recognized collateral and diseconomies associated with small volumes of individual transactions.

[9] See *Survey 1999*, chap. VII, "Financial flows", pp. 205-209.

it performs in relation to its objectives. However, there are limits to this independence as it is the government which is ultimately responsible for the development policy of the country.

(2) Clarifying the division of responsibility between various ***supervisory and regulatory agencies*** on the supervision and regulation of the banking sector and their relationship with supervision and regulation of other financial firms, some of which are owned at least in part by banks. Several countries have or are considering making the supervisory agencies independent of the central bank to avoid any conflict of interest between the modalities used to achieve macroeconomic policy objectives and those for the effective supervision of banks. However, there may be problems of duplicating information and reporting functions, with each agency wishing to collect its own data, as well as of coordination.

(3) Implementing the ***Core Principles for Effective Banking Supervision*** developed by the Basle Committee on Banking Supervision, including a capital adequacy ratio and standards for credit/risk assessment and auditing of banks. The Core Principles are now becoming part of IMF conditionality and training on them is increasingly available from BIS, IMF and the World Bank. Being able to state that banks are supervised according to these standards would certainly increase both domestic and foreign confidence in the soundness of a country's banking sector. However, the capital adequacy ratio was constructed for more mature banking sectors and many developing countries should consider it as a minimum, preferably imposing higher ratios in their own system.

(4) Demanding an increase in the ***levels, quality and timeliness of disclosure*** by banks and using BIS or IMF to back up standards of bank reporting and disclosure as discussed earlier.

(5) Dealing with ***NPL problems*** in an orderly and definitive manner and implementing a legal process for intervening in, rehabilitating or liquidating banks in financial straits. Recent exchanges of experience among the crisis countries on the treatment of NPLs reveal that the responsible authorities are aware of the need to improve their handling of this problem. However, the large volume of NPLs poses a problem for financing development in many countries in the region, not just the ones affected by the crisis.

(6) Promoting ***information-based professional credit and risk assessment procedures*** in banks, including through the application of BIS standards and enhanced disclosure by banks of their operating procedures.

(7) Promoting the ***use of information technology*** and new ways of conducting business to improve efficiency in the banking sector for the benefit of depositors, including the spread of ATMs and ATM pools, e-banking and new products of interest to savers supported by professional investment counselling services.

(8) Promoting ***human resources development*** in the central bank and in other banking institutions in a wide variety of areas, including all those mentioned above.

(9) Reducing the ***direct use of banks*** by the government as a source of funds or as a modality for directing credits, and putting public-sector and government-specialized banks progressively on the same footing as commercial banks.

(10) Ensuring ***competition*** within the banking sector, including further cautious liberalization of entry by foreign banks or financial firms.

The above list should not be seen as exhaustive. Given the continuing need to rely on the banking sector as a primary engine for intermediating domestic resources, it requires ongoing attention to enable it to serve a country well; no country can afford to let its banking system fail as this would severely disrupt the flow of funds and development. The reform process is thus not static and its contents have to be specific to the country context and to the evolution of banking standards worldwide.

Other institutional arrangements for household savings

There are several other instruments used to raise savings from the household sector. These may be involuntary or compulsory savings by households promoted through government-sponsored instruments

or voluntary savings through pension funds, insurance schemes, microfinance arrangements etc.

Mandatory provident funds, state-sponsored unit trust schemes or fully-funded pension schemes have been employed very effectively in Japan, Malaysia and Singapore, among others. They have the potential to raise the savings rate by 3 to 4 per cent of GDP, and also to provide an ideal source of institutional finance, mainly for the public sector. However, the impact of such schemes on aggregate savings depends on the extent to which they substitute for other voluntary savings. Evidence on the fully-funded Central Provident Fund in Singapore shows that it has stimulated aggregate saving. Box V.1 provides a brief summary of the experience of the Central Provident Fund of Singapore. Nevertheless, such schemes so far have been successfully organized in countries that have a significant proportion of the labour force in the formal sector.

Pension funds add to the modalities for savings. But more importantly they provide a valuable addition to the institutional investor pool for domestic capital markets, as well as a source of social security and a safety net for the retired. In most Asian and Pacific countries, there is no universal retirement system beyond the public sector that fosters the regular contribution of funds from both employers and employees. With the increasing age of the population in many countries, pension funds could potentially be quite large. However, starting new schemes is a long-term proposition as they take years to build up a sufficient financial base; many smaller pension funds in the region have inadequate capital and high operating costs. In addition, it does not seem currently feasible to organize pension funds on a sustainable basis for the informal or unregistered sector.

Insurance schemes offer another form of savings with the funds collected being invested in various financial instruments. Life insurance, unemployment insurance and other forms of insurance in the ESCAP region exist mainly in the government sector and in the formal sectors of the economy. The coverage varies from country to country; 11 per cent of the population of Thailand have life insurance compared with 80 per cent in Japan and 70 per cent in Hong Kong, China. In India, premium payments for all forms of insurance are a tiny proportion of financial savings. However, the liberalization of this sector is under way and a number of firms have applied to offer life and general insurance.[10] In the aftermath of the recent crisis and in line with WTO agreements on services, this sector is being opened up to foreign investment. For example, in Thailand in 2000, foreign companies had stakes in 13 out of 25 life insurance companies.[11] One of the constraints facing expansion in this area is that many insurance schemes lack credibility because of unscrupulous brokers who deal with the individuals buying and claiming under the schemes. It appears difficult to supervise all brokers even through a viable national association of dealers which undertakes self-regulation and stresses ethical behaviour.

Using the postal system as a vehicle for collecting household savings[12] has been a modality in a number of countries for quite some time. As post offices tend to have a wide geographic distribution, they are often accessible by rural households in areas where there are no banking outlets. They have been a natural vehicle for uses beyond postal services. In addition, governments have given incentives to households to save through post offices and, with governments being the holder of the deposits, they have used the funds to invest in more projects, including social infrastructure, than they could have without access to these funds. However, as private banks and other financial institutions have improved their outreach, postal savings systems have tended to die out. There have also been problems with the viability of some of the government investments made with postal savings deposits, affecting the financial sustainability of the system. Nevertheless, there is some renewed interest in postal savings systems, especially for remote rural areas, as a modality for encouraging households to save in forms available for intermediation to government investment.

---

10 Patel, op. cit.

11 "Insurance: Foreign connection provides stimulus", *Bangkok Post,* 10 November 2000.

12 See ESCAP, *Domestic Resource Mobilization through Postal Savings: Experiences of Selected Asian Countries* (ST/ESCAP/1279). Japan has had a long experience with postal savings, and the funds raised have been as much as 20 per cent of total household savings. Bangladesh, India, Indonesia, Malaysia, Pakistan and Sri Lanka also have postal savings schemes. In the Lao People's Democratic Republic, Myanmar and Thailand such schemes were not viable and were closed down.

Box V.1. The role of the Central Provident Fund in promoting domestic savings and socio-economic development in Singapore[a]

The Central Provident Fund (CPF) was set up in 1955 as the national pension scheme. Over the years, it has evolved into a comprehensive social security scheme to take care of a member's retirement, home ownership and health-care needs as well as to provide financial protection to its members and their families through its various insurance schemes. CPF covers all employees who are Singaporean citizens and permanent residents. All self-employed Singaporean citizens and permanent residents are required under statutory rules to contribute for health-care coverage only.

Singapore has one of the highest domestic savings rates in the world, around 50 per cent of GDP in recent years. CPF has played a major role in raising domestic savings to such a high level. Both employers and employees are required to contribute to CPF. Contributions from both were gradually raised from 5 per cent of employee wages in 1955 to 25 per cent in 1984, or 50 per cent in total by both employer and employee. This was indeed a very high rate of forced savings. In the wake of an economic recession in the country in the mid-1980s, the contributions of employers were reduced to 10 per cent in 1986 and then gradually raised to 20 per cent by 1994. In addition, from 1988 contributions by those employed were gradually reduced, reaching 20 per cent in 1994. As a result of the recent regional economic crisis, the employers' contribution was again reduced to 10 per cent in January 1999. With economic recovery, these contributions are to be increased gradually to 20 per cent, currently standing at 16 per cent. The employees continue to contribute 20 per cent.

CPF is not a conventional pension system. Through carefully timed measures, this increasingly large amount of forced savings has been used to finance the socio-economic development of the country. In 1968, CPF savings were allowed to be withdrawn by members to purchase government-built flats. The policy was a great success and today about 80 per cent of Singaporeans live in such flats. Moreover, the purchase of a flat turned out to be a very profitable investment as most flats command a market value several times their purchase price. Later, rules were liberalized to allow the purchase of private property also. This further boosted home ownership and about 90 per cent of citizens and permanent residents now live in their own homes.

CPF members can use their CPF savings not only for old age and housing, but also for health care. A part of the CPF contribution is put into a Medisave Account. While working, a member can withdraw money from this account for approved medical treatment and for medical insurance premiums. The amount of these withdrawals is linked to a member's contribution. After retirement, Medisave savings are available for health care.

The government is conscious of the fact that an ever-growing national pension fund, unless profitably deployed, becomes an economic deadweight. As such, the government allows individual members who are not content with the minimum guaranteed tax-free return paid by the government to invest part of their pension money in pursuit of higher return. In fact, the government has tried to encourage investment in securities and other financial instruments for this purpose as well as to develop greater depth in the financial markets. In 1978 members were allowed to withdraw some of their contributions to buy shares in the Singapore Bus Services, the national public transport company, which arose from the merger of several private and public bus services. In 1986, an Approved Investment Scheme specifying financial instruments and other assets permitted for purchase was initiated. The original list of approved assets included selected blue-chip stocks, unit trusts and gold, and it has been regularly updated.

Despite the increasing liberalization of the use of CPF savings for investment, the contribution of the CPF scheme in the development of the equity market has been quite limited. At the end of 1996, only 14 per cent of the outstanding membership of CPF had made cumulative net investments of S$15 billion, representing 21 per cent of the members' existing balance with the CPF Board. This means that almost 80 per cent of the compulsory savings were held as passive deposits. Equity investment from CPF savings accounted for only 3.4 per cent of the market capitalization on the Stock Exchange of Singapore and about 6 per cent of the total number of shares issued. This may reflect the risk-averse nature of CPF members as well as their

(Continued overleaf)

[a] This box draws on Edward Ng, "A study on the Central Provident Fund (CPF) in Singapore: its contribution to the development of the capital market", a report for the Asian Development Bank, March 1998 and Central Provident Fund Board, *Annual Report* 1998 and 1999, available at *<http://www.cpf.gov.sg/cpf_info/AnnRpt.asp>* (26 January 2001).

(Continued from preceding page)

unfamiliarity with investment; the complicated procedures for withdrawing CPF savings for securities investments are also viewed as a major reason for the lack of enthusiasm.

Most CPF contributions are invested by the CPF Board to purchase government bonds; more than 70 per cent of government bonds are held by it. With the government running a nearly perpetual fiscal surplus, there is no need for public debt. Therefore, government bonds are issued purely to absorb the increasingly large CPF members' balances and to meet the demand by commercial banks for their statutory reserves. The CPF Board, being a passive national custodian of pension funds, is under no pressure to produce a competitive return to its members. Therefore, there is no need for it to actively maximize the yield on its funds.

The government has used the CPF system effectively as a macroeconomic tool by changing the employer's contributions to regain cost competitiveness for businesses and the economy. As discussed earlier, the employer's contributions were reduced in 1986, which helped in the quick economic recovery at that time. Similarly, the reduction in employer's contributions in early 1999 helped to soften the impact of the recent economic crisis by reducing business costs and maintaining employment. CPF savings tapped through the issue of government bonds have certainly helped Singapore build up its foreign reserves, as the government usually invests its surpluses and other public funds overseas. CPF is an interesting model which is worth considering by other developing countries as a means of raising domestic savings. However, it may require a rethinking of the types of contributions that the funds held by a central compulsory savings scheme can make to development, without putting the contributions (or pension rights) of its members at risk.

Microfinance schemes provide savings and credit mechanisms for those beyond the reach of the formal banking system, often the poor who lack collateral. Many have been successful in inculcating the habit of savings and so provide a way to intermediate resources at a micro level. It is likely, though, that the effect on the overall savings rates in an economy is rather small. According to the World Bank,[13] there are at least 120 microfinance institutions in East Asia and South-East Asia, and about 100 in South Asia. In East Asia and South-East Asia, about 44 per cent of the funding for microfinance comes from donors; this figure is larger, about 54 per cent, in South Asia. About 32 per cent of the funding in East Asia and South-East Asia is from deposits (savings) and only 4 per cent from governments. In South Asia, deposits contribute about 30 per cent. It is interesting that for the microfinance schemes run by banks or credit unions, around 70 per cent or more of the funding comes from savings deposits, whereas for NGO-run schemes, over 50 per cent comes from donor contributions. However, in South Asia, NGO schemes obtain about 22 per cent of funding from deposits, the highest percentage in any region.

The proliferation of microfinance institutions has led to the need to reassess their role as a tool for resource mobilization and as a poverty alleviation mechanism. The question is whether users (savers and borrowers) can "graduate", that is, if people go on saving or borrowing small amounts, has their situation really changed?[14] Evidence on this is very mixed as it is difficult to conduct counterfactual studies. It would appear desirable to graduate some of the users with good savings and loans track records to regular savings accounts and larger loans.

Some microfinance institutions themselves have graduated into the regular financial system. Some, including the Grameen Bank of Bangladesh, are registered banks and so follow rules on capital adequacy etc. This means that users have reduced risks in saving with and borrowing from the institution. Another option under consideration in countries with a history of microfinance is to use an apex-type organization as an intermediary between local NGO microfinance schemes and formal financial institutions. Such an organization can, as one of its functions, borrow funds from the formal institutions and lend them on to the microfinance institutions, presumably at a better rate of interest than the individual NGOs

[13] World Bank, *An Inventory of Microfinance Institutions in South Asia*, available at <http://www.esd.worldbank.org/sbp/MICRO/SA/soasia.HTM> and *An Inventory of Microfinance Institutions in East Asia and the Pacific*, available at <http://www.esd.worldbank.org/htnl/esd/agr/sbp/MICRO/EAP/micro2.HTM>.

[14] Moreover, providing financial intermediation to the poor may not be enough; some form of "social intermediation" in the form of encouragement to utilize opportunities for building assets would be necessary for their graduation towards formal finance.

could. Palli Karma-Sahayak Foundation plays this role in Bangladesh and recently has provided as much as 17 per cent of the funds for NGO microfinance.[15] Such an arrangement should increase the willingness of individuals to save with NGO institutions. However, when microfinance schemes are sustained by injections of funds from governments or donors, both of which may be unpredictable sources of funds, their future is quite uncertain. There is, thus, a need to increase the number of savers and the percentage of loans covered by saving deposits. All schemes should work towards being more self-supporting as a way of encouraging more micro-level domestic resource mobilization.

Policy issues

The main issues for government policy in the area of mobilizing domestic resources for development through non-bank institutions include:

(1) Whether to create or strengthen ***mandatory savings schemes***. The benefits of mobilizing funds for government investments through these modalities need to be weighed against the efficiency of the investment decisions and a judgement as to whether the savings generated are additional or a diversion from the other modes.

(2) How to encourage ***pension and insurance schemes***. The decision on whether to legislate such schemes nationwide or to leave this area to private initiatives under better developed regulation and supervision is a country-specific one. However, with an increase in the older-age population in many countries of the region, pension and life insurance schemes are definitely likely to be on the agenda. The regulatory legislation for these schemes and their effective enforcement are crucial to their being viewed as an attractive form of savings for households.

(3) How to make ***microfinance schemes*** an attractive and secure modality for small-scale savings and how to provide ways and means for users to graduate to formal-sector financial institutions. The following options need to be considered: registering microfinance institutions under banking legislation; using an apex organization to provide intermediary services between the microfinance institutions and the banking sector; and increasing the security of funding of microfinance schemes, inter alia, through increased reliance on deposits as a source of loan finance.

Capital markets

Stock markets

Stock markets have assumed, as yet a small, but increasing, role as a means of mobilizing domestic resources and providing a wider range of financial services. This has been facilitated by deregulation and liberalization measures, as well as by specific policies to foster their development. Until recently, domestic capital markets have had a rather restricted clientele, mainly urban and relatively well-off groups, and sometimes foreign investors. The robustness of these markets is thus positively associated with a widening of their participants, including through the emergence of mutual funds and provident funds which collect individual savings into funds for investment by professional managers.[16]

Tables V.3 and V.4 provide a perspective on the growth of equity markets in the region, table V.3 providing some statistics of the size of stock markets and table V.4 showing the level of trading activity on these markets. Except for Malaysia, all developing countries that are not financial centres have markets less than 100 per cent of GDP. The ASEAN members Indonesia, Philippines and Thailand, as well as China and India, have shown considerable growth over the last decade in both the number of companies listed and the capitalization relative to GDP; for the other countries the stock market remains small, less than 20 per cent of GDP. Table V.4 reveals a very similar trend with many countries having the value traded and turnover ratios less than 20 per cent of GDP. Consequently, their stock markets are too thin and too shallow to be a viable place for investing or raising funds. They are rather vulnerable to corners, speculative runs and other forms of manipulation. There

[15] Rushidan Islam Rahman, *"Poverty Alleviation and Empowerment through Microfinance: Two Decades of Experience in Bangladesh"*, Research monograph No. 20, Bangladesh Institute of Development Studies, Dhaka, June 2000.

[16] In India, for example, the assets under the management of mutual funds currently account for about one seventh of bank deposits but resources mobilized by them are increasingly very rapidly. See Patel, op. cit.

Table V.3. Number of listed companies and stock market capitalization

	Number of companies				Stock market capitalization (millions of us dollars)				Stock market capitalization (percentage of GDP)			
	1990	1995	1997	1999	1990	1995	1997	1999	1990	1995	1997	1999
Australia	1 089	1 178	1 219	1 162	107 611	245 218	311 988	874 283	36	70	177	224
Bangladesh	134	183	202	211	321	1 323	4 551	865	1	5	4	2
China	14	323	764	950	2 028	42 055	206 366	330 703	1	6	23	33
Hong Kong, China	284	518	658	658	83 397	303 705	449 381	343 394	112	211	241	217
India	2 435	7 985	5 843	5 863	38 567	127 199	128 466	184 605	12	39	34	40
Indonesia	125	238	282	277	8 081	66 585	29 105	64 087	7	34	14	45
Iran (Islamic Republic of)	97	169	263	242	34 282	6 561	17 008	14 874	28	..	7	15
Japan	2 071	2 263	2 387	2 416	2 917 679	3 667 292	3 088 850	2 495 757	98	72	53	57
Kazakhstan	..	..	..	18	..	..	..	..	..	..	..	..
Malaysia	282	529	708	757	48 611	222 729	93 608	145 445	114	261	95	195
Mongolia	..	..	434	430	..	..	..	40	..	..	6	4
Nepal	..	83	98	104	..	244	208	267	..	6	4	5
New Zealand	171	205	190	135	8 835	31 950	38 288	89 373	21	56	140	167
Pakistan	487	764	781	765	2 850	9 286	10 966	6 965	7	15	18	12
Philippines	153	205	221	226	5 927	58 859	31 361	48 105	13	79	38	64
Republic of Korea	669	721[a]	760	725	110 594	181 955	41 881	308 534	44	40	9	76
Russian Federation	13	170	208	207	244	15 863	128 207	72 205	0	5	29	19
Singapore	150	212	303	321	34 308	148 004	150 215	94 469	94	177	110	111
Sri Lanka	175	226	239	239	917	1 998	2 096	1 584	11	16	14	10
Thailand	214	416	431	392	23 896	141 507	23 538	58 365	28	85	15	47
Turkey	110	205	257	285	19 065	20 772	61 090	112 716	13	13	32	60

Sources: World Bank, *World Development Indicators* (Washington DC), various issues; and World Bank web site <http://www.worldbank.org/data/databytopic/GDP.pdf> (28 November 2000).

[a] 1996.

are doubts about the future of these markets unless ways can be found to increase their robustness. Another issue that needs intensive examination is whether countries without stock markets should be encouraged to develop small ones or other more viable ways of diversifying their financial sectors.

In general, almost all of the major stock markets in the region, including those that were most severely affected by the Asian currency crisis, suffered dramatic drops in size and turnover during the crisis but recovered by the end of 1999 to levels that exceeded their respective levels in 1990, then experiencing another drop in 2000. Most of these markets had opened trading to participation by foreign investors during the 1990s (the issues connected with the foreign inflows of short-term capital are dealt with in chapter VI). A few markets that were not so affected by the crisis, including China, have continued to grow. The turnover ratios in developing country markets tend to be quite variable and generally reflect both efforts to widen the investor base and investor sentiment (including sentiment by foreign investors) about the strength of the economy.[17] A higher turnover reflects more confidence, but this is almost impossible to achieve in small, thin or narrow markets.

Despite signs of economic recovery and continued positive private savings behaviour, most corporations in the region are experiencing difficulties in raising funds. This is caused by three factors: (a) banks and other financial institutions have become more reluctant to approve new loans or to roll over existing credit lines; (b) alternative means of financing (for example, structured financing and syndicated loans) have become almost unavailable; and (c) the weak performance of individually listed companies on

[17] It is interesting to note that the stock market in Japan declined as a percentage of GDP during the 1990s, and in terms of capitalization and turnover activity, it has declined considerably since the crisis.

Table V.4. Stock market trading volume

	Value traded (% of GDP)				Turnover ratio[a]			
	1990	1995	1997	1998	1990	1995	1997	1998
Australia	14	28	79	113	32	42	52	52
Bangladesh	0	1	1	2	2	13	24	24
China	0	7	41	30	159	116	231	130
Hong Kong, China	46	74	286	124	43	37	44	44
India	7	4	14	15	66	11	42	56
Indonesia	4	7	19	10	76	25	64	61
Iran (Islamic Republic of)	0		1	1	30	16	22	22
Japan	54	24	30	25	44	33	37	37
Malaysia	25	90	149	40	25	36	73	29
Mongolia	..	..	2	2	..	..	..	..
Nepal	..	..	..	..	..	7	2	2
New Zealand	5	15	38	96	17	28	28	28
Pakistan	1	5	19	14	9	30	104	114
Philippines	3	20	24	15	14	26	35	31
Republic of Korea	30	41	37[b]	43	62	99	172	185
Russian Federation	..	..	4	3	..	2	19	6[c]
Singapore	55	72	66	60	..	43	29	29
Sri Lanka	1	2	2	2	6	9	16	15
Thailand	27	34	15	19	93	42	39	71
Turkey	4	31	31	35	43	45	114	155

Sources: World Bank, *World Development Indicators* (Washington DC), various issues.

[a] Turnover ratio is the value of shares traded as a percentage of capitalization.
[b] 1996.
[c] 1999.

stock markets makes it difficult for them to raise funds through this market. The difficulties in the financing process appear to be a manifestation of an information asymmetry problem for these corporations. As a result of the recent financial crisis, there is a general decline in the credit standing of borrowers. Given a general lack of credible information from the stock-issuing companies to investors and lenders, investors tend to focus on the larger better-known corporations with a perceived higher level of credit performance. Corporations that are unable or unwilling to demonstrate their creditworthiness, as exhibited through company financial reports, suffer from a deterioration in access to funding sources. The most seriously affected firms are those listed on stock markets with small capitalization (which suffer from a lack of investor interest) and SMEs (which suffer from the reluctance of banks to provide financing and which have limited or no access to other forms of finance).

An illustration of this phenomenon is found in Hong Kong, China, where blue chip companies have enjoyed significantly better performance than the broad market index. The Hang Seng Stock Index comprises 33 blue chip stocks whereas the All Ordinaries Index is an aggregation of all listed companies (approximately 700 as of 1999). In terms of market capitalization, the 33 Hang Seng Stock Index constituent companies represent approximately 70 per cent of the total market size. For the period January 1997 through June 2000, the Hang Seng Stock Index increased by 52 per cent whereas the All Ordinaries Index rose by merely 22 per cent. Among the constituent stocks of the Hang Seng Stock Index, China Mobile (previously China Telecom) and Hutchison Whampoa are among the largest and highest rated companies. From 1997 through June 2000, the value of the stocks of the two companies increased by 500 and 200 per cent, respectively.[18] The discrepancy in stock price

[18] It should be noted that the majority of the operations of China Mobile is carried out in China rather than in Hong Kong, China. Similarly, Hutchison Whampoa has a substantial amount of investment in telecommunications and port facilities that are not in Hong Kong, China.

performance illustrates the fact that only a handful of good name companies are regarded by investors as worthy of investment; the rest of the corporations are still very constrained in their ability to raise funds on the stock market. Some governments, such as that of Thailand, have encouraged their stock market regulators to improve rules on disclosure and accounting/auditing. However, much remains to be done and it would be beneficial to Asian stock markets to promote best practices in shareholder communication and in related corporate governance.

The financial infrastructure for stock markets refers to the environment in which financial transactions are carried out; it includes the legal and regulatory framework, the financial institutions involved and the trading mechanisms. An important component of the financial infrastructure is the trading, clearing and settlement system. An efficient and effective trading environment can enhance investor (saver) participation and reduce systemic risk, such as the inability to complete a trade. These benefits are translated into a higher liquidity and a reduced cost of capital for listed companies. Improvements in the infrastructure of local stock markets can stimulate local investors (savers) to hold domestic stocks, thereby enhancing the robustness of the market. Box V.2 provides a few important ideas for improving the financial infrastructure of equity markets. In India, for example, much progress has been made recently in three areas, trading modalities, depositories and settlements. Most trading is now automated and investors should be soon reaping benefits in terms of cheaper transaction costs and better service.

Rights issues

Rights issues refer to the selling of new shares on a pro rata basis to the existing shareholders. Rights issues are usually initiated following the positive performance of a stock. However, the general impact of a rights issue announcement is that the stock price will decline significantly because there is an impression in the market that rights issues are initiated only when the stock price is overvalued. Prior to the financial crisis, rights issues contributed a major source of new equity financing for listed companies in the ESCAP region.[19] Since 1997, rights issues have almost disappeared. In several cases the information effect of a rights issue was so negative that the stock suffered a dramatic decline following the announcement of an issue. Such an effect significantly increases the risk borne by the underwriter. As a result, companies tend to refrain from rights issues, and even if a firm tries to initiate a rights issue, it is difficult to arrange a suitable underwriter. When the Asian financial markets began to recover in 1999, firms that had good stock price performance adopted alternative means of raising capital. For example, some firms chose to place new shares with a group of institutional investors. This approach appears to be more favourably accepted by the market. As institutional investors are usually better equipped than individual investors to assess the risk and return profile of the issuing firm, subscription by this group of informed investors is seen as providing certification that the issuing firm is of high quality.

Convertible bond markets

There has been limited development of convertible bond markets in Asia as a complement to equity financing. Convertible bonds provide investors with an option of exchanging these bonds for newly issued equity of the issuing company.[20] The

[19] It should be noted, however, that rights issues virtually disappeared in the United States market during the 1980s.

[20] The typical features of a convertible bond can be illustrated by the following hypothetical example. Company A has its shares listed on the Stock Exchange of Hong Kong with a current market price of $10 per share. A newly issued convertible bond carries a total issue size of $50 million and a coupon rate of 4 per cent, payable semi-annually. Each bond has a face value of $1,000 and a maturity of 5 years. If the investor in a bond holds the bond until maturity, A will repay the face value of $1,000 per bond in five years. Over this period, A will also pay bondholders a total of $40 per bond (i.e. 4 per cent of face value) each year in two equal payments of $20 every six months. Bondholders can choose to convert their bonds into common shares of A at the (fixed) conversion price of $13 per share. That is, the total number of shares that each bond can convert into (called the conversion ratio) is $1,000 ÷ $13 = 76.92 shares. Thus bondholders will gain if the stock price of A rises above $13 because they can convert into the common shares at the lower conversion price. Conversely, bondholders will be paid a fairly steady coupon payment of 4 per cent of face value should the stock price fail to rise above the conversion price.

Box V.2. Improving the financial infrastructure of stock markets

There are several ways in which stock markets in the ESCAP region can, or are, improving their infrastructure in order to enhance investor participation and to make the markets a more durable instrument of financial intermediation. A few examples are given below.

Clearing systems

The institution of a real-time settlement system can help reduce the risk for stock market participants; the exchange can monitor the status of its clearing members and each clearing member can impose an in-house risk management system to reduce the risk to its customers. The introduction of a continuous net settlement procedure for all markets in a country would allow a clearing house to continually monitor the positions of its clearing members in and across the products in the various markets. Over time, the combining of clearing houses across often segmented securities markets will improve operations and market efficiency. Examples of the benefits include the provision of consolidated margin requirements for the cash market and its derivative products (which would reduce hedging costs and promote better risk management of traders), the implementation of net money settlement procedures, and the provision for uniformity in technical trading requirements such as collateral accepted and underlying legal documents. For example, in the case of Hong Kong, China, three separate clearing houses had been operating (one for the cash stock market and two for the derivative markets in futures contracts and options, respectively) up to March 2000. In 2000, efforts were made to merge the three clearing houses to form a unified clearing and settlement system.

Dematerialization

Many investors in Asia have the tradition of withdrawing share certificates and depositing them in their safes. This practice leads to costs, such as printing, storage and processing, and the risk of loss or theft. A solution to this problem is to "dematerialize" the securities certificates (or keeping the certificates in a scripless form). Dematerialization refers to the procedure in which the ownership interest is recorded in an electronic format and no physical certificates are issued. While dematerialization offers operational advantages and saves costs, it also raises other concerns. As investors are unable to obtain their certificates in physical form, they must rely on their financial intermediaries or have access to a centralized securities registration system to receive corporate communications or distributions, exercise voting rights or prove their ownership of such shares.

Straight-through computerized trading system

Advancements in information technologies have provided a host of solutions to improving the securities trading process. An example of such improvements is a straight-through computerized trading system. Under such a system, investors can input their buy or sell orders from an access point (computer, mobile phone or other device) and the orders are then entered directly into the trading system of the stock exchange via the securities broker's trading system. In this way the time needed for the completion of the transaction and the subsequent settlement is significantly shortened.

general belief is that the conversion option allows the issuing firm to borrow at a rate below the market interest rate. In exchange for the lower interest income, convertible bond investors enjoy an upside potential when the issuing company performs well and its stock rises above the conversion price. Finance theory suggests that convertible bonds are suitable for high growth companies because they offer a solution to the information asymmetry problem between bondholders and shareholders. In essence, convertible bond issuance allows the issuing firm to take the risk and invest in profitable investments (thus resolving the agency problem to shareholders) and, at the same time, provides adequate compensation for the bondholders (in the form of upside potential in the convertible bond investment). From this standpoint, a convertible bond market appears to be suitable for the economies in the region which already have both stock markets and bond markets and in which there are sufficient growth opportunities.

The development of convertible bond markets in the region had begun in the 1980s. These instruments allowed foreign investors to hold equity-like securities when the local markets imposed restrictions on foreign stockholdings. As the equity markets began to open up to foreign investors, the attractiveness of issuing convertible bonds weakened. In general, convertible bonds are not popular

among domestic investors in the region.[21] After the financial crisis, even institutional trading of convertible bonds has been reduced. The key issue, as is the case for all capital market instruments, is the lack of credible credit assessment in the region, which makes it difficult to determine a fair price for the instrument.

Bond markets

Countries in the ESCAP region are characterized by underdeveloped longer-term investment (bond) markets. With the exception of the Republic of Korea, bond markets are very small as compared with bank loan and equity markets. The lack of a functioning bond market means that a domestic economy is vulnerable to sudden and short-term changes in investor confidence. When confidence dissipates, investors (local and foreign) do not have a more secure and stable investment alternative on which to hold. The ensuing flight to quality leads to withdrawal of funds from the country. The presence of a (high quality) bond market with sufficient market depth would thus enhance long-term economic development prospects. However, the current state of capital markets in the region is not favourable to the development of such markets. Factors accounting for the slow development include poor financial infrastructure, the lack of benchmark bonds, fragmented capital markets, the lack of competitive credit markets, a general low credit standing for Asian corporations, the lack of pertinent financial information of the borrowers, and the inadequacy of investor protection. In most of the countries, in fact, the financial sector itself is the dominant holder of government debt instruments because secondary markets are not fully developed. Without secondary markets for debt instruments it is difficult to conceive that a large number of investors would be attracted.

Table V.5 provides summary information on the market value of listed bonds in nine Asian countries. Japan has the most active bond market with a size that accounts for some 85 per cent of the entire Asian bond market. The Republic of Korea is the second largest market, approximately 6 per cent of that of Japan. Singapore is the only other major Asian debt market; all other markets in publicly listed bonds are very small. For example, in India and Pakistan, the government dominates the issuing of bonds but only a very small proportion of the stock of bonds is traded daily, most bonds being held to maturity, mainly by banks and other financial institutions to meet their statutory liquidity requirement. It should be noted, however, that in several economies (for example, Hong Kong, China; Indonesia; and the Philippines) bonds are only or mainly traded over-the-counter among investors (mainly banks and financial institutions) and as a result it is difficult to obtain reliable information on the actual size of the bond market.

In the aftermath of the 1997 crisis, bond trading and bond issuance declined significantly in the second half of 1997 and in 1998. Table V.5 suggests that the entire region (including Japan) suffered from a sharp decline in bond turnover. In particular, investors typically bought bonds with a high credit standing and refrained from investing in ones with a low credit standing, thus creating a polar development in the bond market similar to that in the stock market. Secondary market activity picked up in 1999 and the bond turnover appears to have recovered to pre-crisis levels in most developing countries, but not in Japan. Bond issuance began to pick up in 1999, but in many markets it has still not recovered to the pre-crisis levels. In addition, the bonds issued in 1997 and 1998 are of significantly shorter maturity. In other words, Asian bond markets are still unable to provide a stable source of long-term funds for corporations.

Domestic investors in the developing countries of the ESCAP region have generally exhibited a weak demand for long-term fixed income securities. This phenomenon is associated with the underdeveloped systems of institutional investors. In fact, it is often claimed that without the participation of a significant number of institutional investors, such as mutual funds, pension funds or insurance schemes which are independent of the banking sector, bond markets are not viable and their pricing is suspect. In turn, a lack of investor demand leads to illiquid markets and high transaction costs, and weakens the incentive for issuing bonds. In the case of Hong

[21] On the one hand, investors can hold equity directly. Under normal market conditions, the trading of common shares is significantly more active than that of convertible bonds and investors find it easier and less costly to realize profits or limit losses by holding common shares rather than convertible bonds. On the other hand, investors in convertible bonds are usually subject to a sizeable minimum transaction size. Furthermore, convertible bonds are often traded over-the-counter and retail investors may find it difficult to get access to pricing information.

Table V.5. Market value of listed bonds at year-end and listed bond turnover on Asian exchanges

(Millions of US dollars)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
Market value						
Hong Kong, China	..	..	..	..	110 438	98 910
Indonesia	444	405	339	109	50	21
Japan	3 539 282	3 886 535	3 821 540	3 600 291	4 472 648	5 263 913
Malaysia	3 865	3 497	3 444	1 788	1 310	1 753
Philippines	–	–	6	4	0	0
Republic of Korea	129 990	162 421	208 167	132 222	277 788	321 697
Singapore	153 232	150 539	161 239	171 626	182 946	198 939
Taiwan Province of China	30 320	31 813	36 750	32 919	36 578	44 284
Thailand	2 681	1 945	927	351	352	155
Turnover						
Hong Kong, China	0	47	41	23	14	18
Indonesia	–	–	–	–	–	–
Japan	167 759	260 841	206 668	155 623	72 638	53 875
Malaysia	879	375	278	908	139	1 032
Philippines	–	–	–	–	–	–
Republic of Korea	1 458	1 855	1 710	4 103	11 383	24 717
Singapore	7 003	3 977	2 840	3 883	876	3 909
Taiwan Province of China	303	70	365	683	1 227	1 683
Thailand	22	4	0	0	0	0

Source: International Federation of Stock Exchanges, available at <http://www.fibv.com/stats/ts4.xls> and <http://www.fibv.com/stats/ts5.xls> (13 November 2000).

Kong, China, for example, high-quality private bond issuers typically raise debt financing in Luxembourg where the institutional demand for fixed-income securities is comparatively high.

Thus one measure for enhancing bond market development is to adopt a nationwide retirement benefit system. For example, Hong Kong, China is launching a mandatory provident fund (MPF) scheme for all employees. Under this defined benefit scheme, employees need to contribute 5 per cent of their monthly income (subject to a certain ceiling) and the employer contributes another 5 per cent. The funds will be invested in qualified MPF programmes organized by approved MPF providers. There are investment guidelines for MPF providers, including the portion that is to be invested locally and the portion that should be invested in fixed income securities. In the long run, the funds from MPF programmes will likely increase the demand for bonds and promote bond market development. However, the MPF scheme is unlikely to show immediate results since it will take time for MPF contributions to grow to any significant size.[22]

Many governments of the crisis countries have recognized that their long-term debt markets are underdeveloped, their corporations over-leveraged, and a vicious circle of NPLs had developed. For many governments the development of a corporate bond market is a priority. For example, measures taken in Thailand have included the removal of the tax bias against bond holding and the development of a benchmark curve based on government issues. Starting from September 1999, the Bank of Thailand has been holding auctions of baht-denominated treasury bills so that yields for debt instruments of the

[22] It is estimated that the annual pension fund contributions would amount to more than HK$10 billion ($1.3 billion), or around 1 per cent of GDP in the initial years of operation, growing to around HK$60 billion ($7.74 billion) when the scheme matures.

Box V.3. Development of the Philippine bond market

Starting in 1995, the Philippine Bureau of the Treasury began to introduce improvements in market infrastructure for a bond market with a view to promoting a country-wide market for treasury securities. Measures included the launch of an electronic auction system in 1995 and the introduction of scripless government securities in 1997. These improvements paved the way for an efficient and transparent trading system for treasury securities.

In 1998, the Philippine Treasury introduced the Small Investors Programme to encourage Philippine citizens to hold (and trade) local government securities. In November 1998, the denomination of the treasury bills (short-term government securities with maturities within one year) was reduced. As a result, the basic traded size of these securities was reduced from 10 million pesos to between 25,000 and 100,000 pesos. In June 1999, this programme was extended to treasury bonds (maturities from 2 to 20 years).

The trading system for the Small Investors Programme includes a settlement bank (Landmark Bank of the Philippines) as a central point of trading activities. In essence, investors deposit funds in their accounts at the settlement bank. When they buy (sell) a particular issue of securities, the funds are deducted (added) from (to) their deposit accounts and the respective securities are added (removed) to (from) their treasury securities accounts. Thus investors can trade treasury securities in small sums in an efficient, electronic trading mode with low-cost, scripless streamlined settlement procedures. The Philippine Treasury also has plans to list treasury issues on a newly established Bond Exchange in 2000 to promote this initiative further.

same or lower maturities can be determined. More auctions are planned, but the secondary market liquidity is still very small. In the Republic of Korea, measures include reform of the bond-issuing procedure, introduction of new debt products (such as repurchase agreements), and reorganization of the secondary bond market. There have also been efforts to promote participation from a wider range of retail investors. The case of the Philippine treasury securities outlined in box V.3 is an example of the promotion of a local bond market with sufficient market depth. In South Asia there is quite a lengthy, but not very positive, experience with retail bonds which are not traded (there is hardly a secondary market). This experience indicates that unless the investment of the small savers is adequately protected, it is difficult to sell them bonds. Accordingly, financial intermediaries need to be registered, regulated and provided with adequate training in order for them to be able to generate investor confidence.

The development of a risk-free benchmark yield curve as the reference for the estimated rate of return on bonds is usually done by promoting a government treasury securities market. Its risk-free yield curve facilitates private issuance as investors normally price non-government securities based on a spread over the equivalent risk-free or government security with the same maturity. Several governments have used this technique (for example, Australia; Hong Kong, China; and Singapore)[23] and maintain benchmark curves using treasury securities even when there is no need for the government to raise funds.[24] Except for these economies, mid- and long-term benchmark government bonds do not exist; rather there are short-term benchmark government securities (such as the central bank issues in Thailand) or quasi-benchmark bonds such as guaranteed corporate bonds in the Republic of Korea. These are not a good substitute for longer-term government bonds which have very low risk. The Hong Kong, China case described in box V.4 provides an interesting example of the process of developing longer-term bond benchmarks.

Bond markets would clearly benefit from reforms in corporate governance, as good corporate governance enhances the protection of the legitimate interests of the holders of corporate bonds. The elements of governance requiring attention include corruption, lack of transparency in financial transactions, use of accounting methods which do not

[23] The Hong Kong treasury paper market provides a 10-year long yield curve, while the Australian Government paper market currently provides a yield curve of 12 to 13 year maturity.

[24] The benefits from a functioning benchmark bond market can be much larger than the costs incurred from having some government debt.

Box V.4. Development of a benchmark curve: the case of Hong Kong, China

Hong Kong, China made concerted efforts before the 1997 crisis to develop Exchange Fund Bills and Exchange Fund Notes (together termed as Exchange Fund Paper or EFP), and has significantly strengthened them in the wake of the crisis. As Hong Kong, China has had a fiscal surplus, the main objective of the EFP programme was to facilitate the development of the local debt market by increasing the supply of high-quality bonds and creating a reliable benchmark yield curve. The programme was launched in March 1990 with the issuance of 91-day bills. Over the years, the programme was expanded: 182- and 362-day bills were launched in October 1990 and February 1991, respectively, followed by two-year notes in May 1993, three-year notes in October 1993, five-year notes in September 1994, seven year notes in November 1995, and 10-year notes in October 1996. EFP was well received by the market and has provided a reliable Hong Kong dollar benchmark yield as a result of the regular issuing of EFP with varying maturity.

In September 1999, the Hong Kong Monetary Authority and the Stock Exchange of Hong Kong arranged to list EFN on the Stock Exchange of Hong Kong. Under this arrangement the board lot size was reduced to a face value of HK$50,000 ($6,410) in an effort to promote retail investor participation.

meet international standards, and unclear ownership structures. While the crisis countries have tackled some of these practices, the adoption of best practices should be expanded. Investor perceptions of intangibles such as corporate integrity, prevention of asymmetric availability of corporate information, and enforcement capabilities of securities market regulators are key determinants of an investor's interest in corporate bonds.

The "New Economy": capital markets for emerging firms

Since 1995, there has been accelerated development in the areas of technology, the media and telecommunications, principally in the developed countries. Such economic activities, which are generally described as IT-related activities, have contributed to a significant portion of economic growth in the United States and have stimulated the development of similar activities in other economies. Over the last five years the National Association of Securities Dealers Automated Quotation market (NASDAQ) has been the principal platform from which successful IT companies obtained their financing. A characteristic of NASDAQ is that a listing firm does not necessarily need to report operating profits when applying for a position. Encouraged by this development, efforts have also been made in Asia to develop NASDAQ-like markets.

The Republic of Korea was the first developing country in the ESCAP region to launch a market for emerging companies. In July 1996 KOSDAQ (Korean Securities Dealers Automated Quotation), modelled after NASDAQ, was founded. Companies listed on KOSDAQ had a dazzling performance in its first few years. The KOSDAQ index rose by about 300 per cent between the end of 1998 and the middle of 2000, outperforming the main board of the Korea Stock Exchange by a significant margin. At the same time, total market capitalization increased almost tenfold. The average daily trading value grew from KRW 5.5 billion at the end of 1998 to more than KRW 5 trillion in the first quarter of 2000. At the end of 1999 there are more than 480 registered companies on KOSDAQ, with a total market value exceeding KRW100 trillion. The Korea Securities Dealers Association reported that another 100 new firms were listed on KOSDAQ in 2000.

Three other economies (Hong Kong, China; Malaysia; and Singapore) have since introduced NASDAQ-like markets, generally known as growth enterprise markets (GEMs), and Japan launched the Mothers market with the same sort of structure. The Hong Kong GEM was established in November 1999. Eighteen companies were listed in the first three months of trading. By March 2000, market capitalization had already increased 15 times to HK$ 86.7 billion. Of the six companies that were listed on GEM in the first two months of 2000, five were

oversubscribed with subscription ratios ranging from 1.5 times (Far Eastern Polychem Industries Ltd.) to 669 times (TOM.com). The Stock Exchange of Hong Kong had predicted that the total market capitalization of GEM would reach HK$100 billion by November 2000. In reality, this target was achieved within four months of its launch.

It should be noted, however, that GEM markets are intrinsically much more volatile than their respective major boards. Since the listed companies do not usually have a trackable operating record or an earnings profile, the markets are susceptible to violent swings and tend to mirror the performance of NASDAQ. In addition, as there is a lack of accepted means of valuing technology shares, except based upon expectations which can change rapidly and substantially, investments in GEM stocks are generally very risky. As most of the GEM listed companies are related to the Internet market, it is also likely that a number of the companies lack the managerial capabilities, well-developed business plans or a solid revenue base to support their rapidly growing business operations.

The significant decline in NASDAQ since the second quarter of 2000 led to a sharp decline in performance and the financing activities of the GEMs. Compounding this negative factor, the winding up of some major Internet companies in the United States and Europe has made investors very cautious about holding GEM stocks. The rapid retreat of the GEM market means that firms that have to rely on accessing further equity financing may be prone to failure because of their inability to raise additional funds.

Policy issues: approaches to further capital market development

Despite the serious difficulties outlined above, establishing capital markets with sufficient depth should be achievable in several economies in the region for a variety of reasons. First, the savings rate in much of East Asia and South-East Asia has been high, at over 30 per cent. This high rate should provide sufficient funding sources to support mature capital markets. Second, economic growth is likely to continue to be significant in the region. The last two years have seen many Asian and Pacific economies demonstrating a remarkable recovery. As the regional economies continue to grow at a respectable rate, successful firms will emerge and asset quality in general will improve. Third, many governments in the region are paying serious attention to the potential contribution of domestic capital markets in the economic development process. Such enhanced awareness provides a good foundation for governments to work towards identifying and implementing means to enhance capital market development. Outlined below are issues that are pertinent to the basic framework needed for healthy markets to thrive.

(1) ***Coping with fragmented markets.*** The economies in the region each have their own language, culture, customs and legal framework. Hence, the market structure and its mode of functioning in one country cannot automatically be translated into that of a second country. This contributes to the existence of fragmented capital markets, making regional investment difficult and sometimes more risky than necessary. As few of the economies (notable exceptions being China, India and Japan) are large enough to provide economies of scale in information processing, capital market development will be difficult. Given this situation, it would appear more rational to work towards a common set of basic structures and standards so that the regional development of equity markets becomes possible and each economy can see the benefits from contributing to this process. However, the predominance of national interests and a view that markets in the region are competitive rather than complementary mean that this is at best a long-term proposition.

(2) ***Dealing with the lack of disclosure.*** Both the quantity and quality of information disclosed to investors are limited in most countries of the region. The consequence is that savers inherently assume that investments are risky and demand a steep risk premium. It would be beneficial to all if sufficient relevant information were accessible to investors, either through a mandatory or a voluntary process. The proposal made above to enhance corporate disclosure through enforcing disclosure by banks would certainly benefit the capital markets as well. The standards for such disclosure could also be harmonized

among countries. As information technologies continue to improve, regulatory bodies have to constantly review the disclosure guidelines to make sure that corporate managers utilize the most efficient and effective means of communication with investors.

(3) ***Varying accounting standards*** from place to place with some exceptions, such as Hong Kong, China; Malaysia; and Singapore which use British standards. It would be a very positive step if regional or subregional accounting and regulatory bodies could agree on a common set of accounting standards. Furthermore, efforts are needed to ensure that all investors have access to the same set of sensitive information at the same time.

(4) ***Reducing government intervention.*** Traditionally, governments in the region tend to offer subsidies to activities that fit their policy thrust. An example is the provision of low-cost housing finance which exists in many countries. By pursuing this course, the return on the relevant capital market instrument, for example, mortgage products in the case of housing, becomes distorted and can substantially deviate from the market rate of return. When the instruments involved are suitable to be part of the development of a viable capital market, such as securitization of home mortgages, the existence of a significant distortion in the rate of return makes this difficult. The reduction and ultimately elimination of such government intervention could contribute to the smoother development of viable capital markets.

(5) ***Developing benchmark securities.*** As discussed earlier, typically the fixed income securities issued in the region are short term in nature. Therefore, it is impossible to construct a good benchmark yield curve from which efficient bond pricing can be done. It would be desirable if high-quality bonds with longer maturities were available.

(6) ***Enhancing the role of credit-rating agencies.*** One solution to the information asymmetry problem affecting capital markets is to have the issuers of securities (stocks or bonds) analysed and rated by a credible credit-rating agency. The role of such an agency is to provide an objective analysis of the borrowing firm. Potential lenders can then derive valuable pricing information and assess the risk of holding the security issued by the firm. Since the early 1980s, many countries have set up their national credit-rating institutions. Table V.6 provides a listing of the domestic credit-rating agencies in South-East Asian countries. In some countries it is required by law that debt issuers be rated by a designated credit agency. However, the existing set-ups do not

Table V.6. Domestic credit-rating agencies in East and South-East Asia

	Credit-rating agency	*Year of establishment*
Indonesia	Pefindo Credit Rating Agency	1995
Malaysia	Rating Agency Malaysia Berhad	1990
	Malaysian Rating Corporation Berhad	1995
Philippines	Credit Information Bureau Inc.	1982
Republic of Korea	Korea Management Consulting and Credit Rating Corporation	1983
	Korea Investors Service	1985
	National Information and Credit Evaluation Corporation	1986
Thailand	Thai Rating and Information Services	1993

Source: S.G. Ree and Y. Shimimoto, *Mortgage-backed Securities Markets in Asia* (Asian Development Bank, 1999).

seem to provide sufficient information for lenders or to promote the bond and stock markets effectively. Most of the credit agencies are either government departments or affiliated to the government. Thus, when a state-owned enterprise issues a bond, the credit agency may be reluctant to give the enterprise a negative rating. In addition, the quantity and quality of financial and non-financial information may be inadequate for the credit-rating agency to provide a comprehensive and timely analysis of the borrower's situation.

In some countries borrowers tend to get around the mandatory credit-rating procedure by issuing alternative types of debt. For example, the majority of bonds issued in the Republic of Korea are guaranteed bonds backed by a holding company. In this way, the issuing (subsidiary) company need not obtain a credit rating and hence is not required to disclose the relevant pricing information.[25] In addition, national credit-rating agencies do not appear to provide the information on borrower quality required by international investors. In the more developed capital markets of Hong Kong, China; and Singapore, there is no local credit-rating agency and issuing firms tend to use the service of international agencies, such as Moody's or Standard and Poor's. International credit agencies actually play a significant role in the capital markets of the Asian and Pacific economies as their analyses of the risk profiles of the country, industries and specific firms[26] are often taken by international investors as an authoritative measure of a particular local market. In fact, a few countries have set up their domestic credit-rating agencies in collaboration with an international agency. For instance, in Indonesia, PEFINDO was established in 1994 on the initiative of the Ministry of Finance and the Bank of Indonesia under a partnership agreement with Standard & Poor's.[27] PEFINDO has rated some 200 companies involving about 250 debt securities. This partnership has contributed to PEFINDO gaining international credibility.

The options for future action in this area include establishing a regional credit-rating agency or, at least, coordination among national ones to work towards common credit assessment standards pertinent to the region and performance of unbiased analysis and disclosure. In general, rating agencies should operate according to a professional code of conduct and should be financially independent from both government and corporations. It may be desirable to invite the international credit agencies as founding members so they can participate in the process of setting up the criteria and assessment standards.

(7) ***Improving the regulatory framework.*** A prerequisite for both equity and debt market development is a good regulatory framework. The general framework should aim at legislating relevant laws, setting reporting and trading requirements for relevant financial institutions, and developing enforcement measures to implement the laws. Usually, a good regulatory framework should promote self-regulation and self-monitoring by financial institutions themselves; it should leave sufficient room for the market participants to act in a flexible manner. At the same time, the system should have measures to encourage good practices and punish offences. The underlying principles include increased transparency and disclosure, enhanced corporate governance and recognition of the accountability of regulators. The outcome of good regulation is a market infrastructure that promotes investor (especially creditor) protection, has an effective judicial system, and facilitates high-quality economic information. Table V.7 provides a summary of

---

[25] All publicly issued non-guaranteed bonds in the Republic of Korea are required to be rated by at least two credit-rating agencies and only those corporations rated A or higher may issue non-guaranteed bonds.

[26] These agencies employ both quantitative (including a set of comparative statistics of key economic variables) and qualitative measures (including openness of government policies and other non-quantitative areas) to help them arrive at a final decision on the risk profile. See *Survey 2000*, chap. V, "Review of mechanisms", pp. 190-193.

[27] Another new agency, Kasnik, Duff and Phelps, was licensed in 1997 but is not operational.

Table V.7. Indicators of a good financial infrastructure in East and South-East Asia

	Creditor rights[a]	*Judicial system effectiveness*[b]	*Quality of information*[c]
Hong Kong, China	High	High	High
Indonesia	Low	Low	Low
Malaysia	Medium	Medium	Medium
Philippines	Low	Low	Medium
Republic of Korea	Medium	Medium	Medium
Singapore	High	High	Medium
Taiwan Province of China	Low	Medium	Medium
Thailand	Medium	Low	Medium

Source: R.J. Herring and N. Chatusripitak, "The case of the missing market: The bond market and why it matters for financial development", *ADB Institute Working Paper No. 11* (July 2000), pp. 15-17.

Notes: The original paper provides a list of indicators for each of the three criteria for good financial infrastructure. This table simplifies the entries as high (all or most of indicators are above average); medium (mixed scores of above and below average); and low (all or most scores are below average).

[a] Indicators for creditor rights include: contract enforceability, automatic stay on secured assets, secured creditors paid first, restrictions on autonomous reorganization, management does not stay in reorganization, creditor rights, and legal reserve required to continue operation.

[b] Indicators for effectiveness of judicial system include: efficiency of judicial system, rule of law, corruption, bureaucratic quality, risk of expropriation, and risk of contract repudiation.

[c] Indicators for quality of information include: accounting standards, and index of restriction on the press.

the three areas of a good regulatory infrastructure and the rating of selected countries in the region in these areas. Other than Hong Kong, China; and Singapore, there is evidence of considerable room for improvement. As regulatory requirements vary widely in the region, closer cooperation among regional regulators is needed to work towards a common understanding on these. Such cooperative efforts will also enhance enforcement by filling the information gap, especially for cross-border transactions. It may also be possible over the longer term to explore the establishment of a common trading platform to allow investors to trade securities on a regional basis. This could especially help smaller, thinner and shallower markets to become part of a more viable market system or to allow firms from countries without markets to issue securities on the markets of neighbours rather than develop unviable markets of their own.

(8) ***Investor education.*** The percentage of savers (investors) holding equity is low in the Asian and Pacific region. The percentage of investors holding other types of securities is even lower. Educating potential investors is critical for increasing the general investor base and empowering investors to perform the analysis of risk and return in the investment process. Investor education is especially important for the promotion of bond markets since Asian investors exhibit a general reluctance to hold fixed-income securities. It should aim at building positive attitudes towards investing as an integral component of managing one's finances and as an important tool for planning retirement and other major consumption purchases, such as houses. It is hoped that the mutual funds being established will provide a good conduit for this exercise, and not be seen as a vehicle for cheating investors. Appropriate regulation and monitoring of mutual funds could go a long way in increasing

investor confidence. In fact, various forms of mutual funds, provident funds, insurance schemes and retirement schemes (institutional investors) can be the backbone of capital market revival or development.

(9) ***Venture capital funds.*** These are sometimes used to stimulate new and riskier investments in SMEs, and sometimes for investment in a country that does not have a stock market (such as Viet Nam until very recently). Venture capital funds are viewed by investors as viable instruments as the monies are not invested in one firm but spread out over many. They can be national or they can also involve external investors. However, they are inherently risky and buyers can be misled about the returns possible, seeing only the upside. Therefore, the tradeability of venture capital shares, say on a stock market, is important in order to get a market valuation of the risk and return. An issue which arises with venture funds is the choice of regulator and the type of regulation and transparency rules to which they should be subject without stifling them.

(10) ***Increased cooperation among stock exchanges.*** There is plenty of room for cooperation among both exchanges in the region and with those of the developed countries. Alliances with exchanges in the United States and Europe can form a market place for 24-hour trading. Furthermore, such alliances can promote technology innovation. For example, in 2000, seven NASDAQ listed stocks were to be listed and traded on the Stock Exchange of Hong Kong. The listing of these stocks is part of a pilot programme that will potentially develop into the linkage of the exchange with NASDAQ and other major international stock exchanges. Another notable joint venture is the alliance between Singapore International Monetary Exchange, Chicago Mercantile Exchange and the Marché à Terme Internationale de France. This alliance allows the development of joint trading and clearing systems. However, linkages among the exchanges in the region have always been weak. This may be due to differences in the cultural background. Another reason is that individual stock exchanges consider the other exchanges as competitors. One form of cooperation is to encourage the cross-listing of Asian stocks in the region. This development would probably be a long-term goal as most Asian corporations are relatively less known to investors outside their home countries. In addition, investors have to face different disclosure and regulatory standards across countries. Nevertheless, there are already some high-quality firms from ASEAN countries which are listed on the Singaporean stock market.

(11) ***Internet trading.*** The recent explosion of Internet stock trading offers opportunities for the development of and cooperation among stock markets in the region. In the United States, Internet trading has been established as an efficient and reliable means of securities trading. The emergence of Internet brokerage companies puts significant downward pressure on the commissions charged by securities brokers. The result is that more investors have the accessibility to trade and can trade at a lower cost. Such pressure can be especially intense for markets with regulated commission rates such as Malaysia or Thailand. It is expected that commission rates will ultimately be deregulated in most markets. Such a change, coupled with the increasing ease of trading using the Internet, will likely be associated with more investor participation. Table V.8 provides a profile of online trading in selected countries in the region. In most countries, personal computer ownership and Internet penetration are still at an early stage, but it is expected that the growth in Internet usage will be substantial in the next few years. The Republic of Korea is the most active Internet stock trading market, with over 50 per cent of stock transactions done over the Internet. Internet trading is also active in Taiwan Province of China, with about 15 per cent Internet trading. It is plausible that Hong Kong, China; and Singapore will also pick up the trend of Internet trading in the next two or three years. The Internet can provide a good basis on which national stock exchanges can cooperate, as investors can conveniently access pricing information in other markets. When a common trading platform across different markets is available, it can be expected that the integration of investor activities will speed up.

Table V.8. Online stockbroking, end of 1999

	Internet users (millions)	*Internet penetration as percentage of total population*	*Internet brokers*	*Commission rates*
Hong Kong, China	2.0	29.1	8	Regulated
Japan	14.0	11.0	33	Deregulated
Malaysia	0.8	3.7	..	Regulated
Philippines	0.6	0.8	..	Deregulated
Republic of Korea	6.7	14.3	21	Deregulated
Singapore	1.1	28.4	6	Partial
Taiwan Province of China	4.1	18.3	42	Deregulated
Thailand	0.8	1.2	..	Regulated
For reference: United States	58.0	21.0	100	Deregulated

Source: Lehman Brothers, *Asian Online Broking*, 25 October 1999.

MOBILIZATION OF GOVERNMENT FUNDS

Governments in the region have been, and still are, an important agent of development. While in most countries their role in owning and operating productive enterprises has been declining, mainly through the privatization of state-owned enterprises, they remain suppliers of crucial public goods of various sorts, of physical and social infrastructure and of law and order. The mobilization of sufficient resources for use by the government for these varied functions has always been rather problematic and many have run up sizeable fiscal deficits over several years. While countries in the region have not generally suffered prolonged bouts of hyper-inflation or fiscal profligacy through the rampant printing of monies, they have not yet reached a stage where regular payment of taxes is seen as a social responsibility. This tends to complicate the task of raising resources for the government.

Basically, mobilizing funds for use by governments is undertaken in three ways: through the levying of taxes, through the generation of non-tax revenues and through government borrowing from local or international capital markets. Most of the off-market resources are raised through taxes, with non-tax revenue being less than 5 per cent of GDP in most countries. Table V.9 which reports taxes and non-tax revenue as a percentage of GDP in selected countries, shows that in most countries taxes have been more or less the same percentage since the 1980s. Moreover, these percentages, as illustrated in table V.10, are relatively low by comparison with other countries. There is clearly room for enhanced revenue collection in almost all ESCAP members. This is also the conclusion of a recent OECD/ADB study.[28] However, it should be noted that the capacity of a country to raise tax revenue depends not only on tangible economic factors but also on a variety of non-economic factors, such as political will, administrative efficiency, and a culture of tax compliance, and as such it is almost impossible to prescribe a priori what proportion of GDP should be raised as taxes in any particular country.

Most tax reforms concern the simplification of tax regimes, changing the types of taxes levied towards indirect taxes and widening the taxpayer base. Other fiscal reforms include reducing fiscal deficits, privatizing some state enterprises, particularly in the countries with relatively large public sectors, making state enterprises more efficient and self-financing, and generally reducing the role of the government in the economy.

[28] OECD/ADB, *Sustainable Recovery in Asia; Mobilizing Resources for Development* (2000).

Table V.9. Proportion of tax and non-tax revenue in GDP

		1980	1985	1990	1995	1996	1997	1998	1999
South and South-West Asia									
Bangladesh	Tax	6.8	8.2	5.6	7.9	7.3	7.7	8.0	7.2
	Non-tax	1.1	0.6	0.9	1.9	2.1	1.8	1.4	1.8
Bhutan	Tax	5.0[a]	5.7	4.7	6.5	7.2	6.0	7.6	8.2
	Non-tax	1.8[a]	4.1	13.3	10.4	9.3	8.3	8.6	10.0
India	Tax	6.9	8.1	8.0	6.9	6.9	6.3	5.9	6.4
	Non-tax	2.2	2.9	2.6	2.7	2.7	2.9	3.0	3.1
Iran (Islamic Republic of)	Tax	6.9	9.1	7.2	6.9	8.3	9.4	11.3	..
	Non-tax	14.7	9.7	10.8	18.3	18.1	15.1	15.5	..
Nepal	Tax	6.5	6.8	7.0	9.0	8.7	8.7	8.6	8.5
	Non-tax	1.5	1.6	1.9	2.2	2.5	2.1	2.3	2.4
Pakistan	Tax	13.9	11.9	14.0	13.7	14.3	13.2	13.5	13.9
	Non-tax	3.1	5.1	5.4	3.5	2.9	2.4	2.8	3.7
Sri Lanka	Tax	17.8	19.3	19.3	17.9	17.0	16.0	14.5	14.9
	Non-tax	1.3	3.7	2.1	2.7	2.1	2.5	2.7	2.7
Turkey	Tax	17.3	14.5	11.6	14.0	15.2	19.1	..	..
	Non-tax	4.5	3.0	2.1	4.0	3.1	2.8	..	..
South-East Asia									
Indonesia	Tax	21.8	18.3	17.8	16.0	15.5	16.5	14.7	..
	Non-tax	0.7	1.5	1.0	1.7	2.0	1.6	1.1	..
Malaysia	Tax	22.6	21.6	17.8	18.7	18.6	19.0	15.9	15.1
	Non-tax	3.5	5.7	7.0	4.2	4.3	4.3	4.0	4.4
Myanmar	Tax	9.6	8.3	6.2	3.7	4.0	4.4	2.7	2.6
	Non-tax	6.6	5.5	3.4	2.7	2.9	3.3	3.5	2.8
Philippines	Tax	12.5	10.7	14.1	16.3	16.9	17.0	15.6	14.4
	Non-tax	1.7	1.3	2.1	1.4	1.7	2.0	1.6	1.4
Singapore	Tax	17.6	16.4	15.4	16.6	16.8	16.2	14.5	..
	Non-tax	5.9	11.2	11.5	9.9	12.7	8.4	10.3	..
Thailand	Tax	13.4	13.7	17.7	17.0	17.1	16.0	13.5	13.3
	Non-tax	1.1	1.5	1.2	1.6	1.5	1.9	2.0	1.9
Viet Nam	Tax	..	2.6	11.5	18.5	19.0	17.5	15.0	..
	Non-tax	..	13.7	3.2	3.5	3.0	2.9	3.1	..
East and North-East Asia									
China	Tax	12.7	22.8	15.2	9.8	9.7	11.0[b]	11.8[b]	12.4[b]
	Non-tax	11.4	−1.9	2.6	0.5	0.9	..	..	..
Republic of Korea	Tax	15.5	14.9	15.9	16.5	17.3	17.3	17.6	17.0
	Non-tax	2.2	2.0	1.7	2.2	2.8	3.0	3.9	5.0
Pacific island economies									
Fiji	Tax	18.2	20.6	21.9	21.7	21.2	21.9	22.3	..
	Non-tax	5.5	5.1	4.8	3.0	3.1	3.6	3.0	..
Papua New Guinea	Tax	14.1	17.9	20.1	20.5	22.2	23.7	19.8	..
	Non-tax	6.1	2.4	5.2	4.7	2.9	3.0	4.1	..
North and Central Asia									
Kyrgyzstan	Tax	..	..	14.9[c]	15.1	12.6	12.5	14.2	12.0
	Non-tax	..	..	0.6[c]	1.6	2.2	2.8	3.3	3.1

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries* (Oxford University Press) various issues; IMF, *Government Finance Statistics Yearbook* (Washington DC), various issues and *International Financial Statistics* (Washington DC), various issues; and World Bank, *World Development Indicators Database*, available at <http://www.worldbank.org/data/databytopic/GDP.pdf> (23 January 2001).

[a] 1981.
[b] Preliminary.
[c] 1993.

Table V.10. Selected Asian and non-Asian economies, per capita income and tax/GDP ratio

	1996		*1997*	
	Per capita GDP ($)	*Tax/GDP ratio*	*Per capita GDP ($)*	*Tax/GDP ratio*
India	380	6.9	397	6.3
Kenya	320	20.2	353	23.4
Indonesia	1 080	15.5	1 075	16.5
Syrian Arab Republic	1 160	19.2	1 193	16.5
Thailand	2 960	17.1	2 523	16.0
Costa Rica	2 640	23.5	3 174	23.5
Malaysia	4 370	18.6	4 476	19.0
Czech Republic	4 740	34.1	5 204	32.7
Republic of Korea	10 610	17.3	9 621	17.3
Greece	11 460	19.7	11 177	19.6
Singapore	30 550	16.8	32 106	16.2
Germany	28 870	29.4	25 516	26.8

Sources: World Bank, *World Development Indicators,* 1998 and 1999 (Washington DC) and *World Development Report 1998/99* (Washington DC); IMF, *Government Finance Statistics Yearbook 1999* (Washington DC, 1999) and *International Financial Statistics,* February 2000 (Washington DC); and ADB, *Key Indicators of Developing Asian and Pacific Countries* 1999 and 2000 (Oxford University Press).

Taxation is used as the main policy instrument for transferring resources to the public sector. It can also assist in creating an atmosphere within which the private sector operates in conformity with national objectives. It has been argued by multilateral institutions, among others, that the tax system should be used only to raise finances that are sufficient for meeting the minimum necessary level of public expenditure, such as to preserve territorial integrity, to maintain law and order, to provide various public goods and to regulate undesirable activities. However, governments have traditionally used tax resources to finance some of its other development or political agenda.

The tax system favoured by multilateral organizations typically is composed of a broad-based sales tax, such as value-added tax (VAT), a relatively low level of import duties for protective purposes only, and simplified personal income and corporate profit taxes. A sales tax, being a tax on consumption of domestic and/or imported products, helps in reducing consumption and, if combined with an excise duty on luxury goods, can also help in reducing conspicuous consumption. While direct taxes are both equitable and elastic, they can reduce incentives to work and, possibly, to save and/or invest. However, empirical evidence is not conclusive regarding their impact on either labour supply or savings. The net effect of a tax change on total savings depends on the relative marginal propensities to save of different groups on the one hand and an increase in public investment or reduction in fiscal deficit on the other. Obviously if the reduction in private savings exceeds the increase in public savings, aggregate savings will fall.

VAT has been introduced in most of the Asian and Pacific countries and usually the tax rate has been uniform, with unprocessed food and exports being exempt. The tax does not usually distinguish between domestic production and imports. VAT is considered neutral as the tax burden falls equally heavily on different products and as such avoids the cascading effects of conventional sales or turnover tax. While it is often argued that VAT is subject to

less evasion compared with income tax, various studies do not show a better compliance. Experience with VAT taxes has demonstrated that a destination- and consumption-based tax has been the easiest to administer.

Import tariffs and export duties have been a major source of government revenue for many developing countries. However, high rates of trade taxes and dispersion in the implied effective protection rates lead to production inefficiencies and can create an anti-export bias. East and South-East Asian countries have been able to reduce significantly their dependence on trade taxes, imposing VAT instead. South Asian countries have also started rationalizing their tariff structure. While some of them, such as Bangladesh, have been able to introduce VAT, others, such as Pakistan, are still struggling to do so.

It is generally believed that high income and corporate tax rates result in an adverse incentive for work effort, saving and investment. Accordingly, it is often suggested that income tax rates be reduced to improve compliance and lessen the burden of tax administration.[29] In most of the ESCAP members, average income and corporate tax rates have progressively fallen, taxable income slabs have been narrowed and the minimum threshold of income to be taxed, increased. Obviously if the maximum marginal tax rates have to be reduced and the total tax revenue has to be defended, then the middle rates will have to be increased. Alternatively the loss of revenue may be compensated by imposing indirect taxes.

While investors, indigenous or foreign, rely on their judgement of the fundamentals of an economy rather than on the incentives offered, most developing countries have been providing fiscal incentives, including reduction in the corporate income tax rates, tax holidays, accelerated depreciation allowances, deduction from social security contributions, specific deduction on gross earnings for income tax purposes etc. While these may be redundant, a country that does not offer fiscal incentives may lose FDI to the countries that do. Clearly, these tax incentives should be harmonized rather than left to compete with each other.

Land and/or property taxes are levied in many countries with private ownership of land. While land taxes often include agricultural land, property taxes are mainly an urban phenomenon. In addition, the authority to set the rate and collect these taxes is sometimes delegated to local government units in order to provide them with their own revenue collection mechanism.

Two recent studies on tax reforms and their effects in India and the Republic of Korea[30] illustrate the enormous difficulties with implementing tax reform. They show the incentives for the government to continue to add taxes rather than rationalize when they face a resource shortage, the administrative complexities of tax collection, the problems of vested interest groups and the difficulty of balancing equity and revenue generation considerations. However, it is interesting that in India tax collection has never been more than 15 per cent of GDP, that income and profit taxes have always been less than a quarter of tax revenues and that after reform only 2 per cent of the population actually file tax returns. In the Republic of Korea, tax revenues have grown to around 20 per cent of GDP and income and corporate taxes account for just over one third of the amount raised. In India, trade-related taxes still account for almost 40 per cent of revenues; in the Republic of Korea the figure is less than 5 per cent. Both have made efforts to widen VAT-type taxes to include the service sector. The taxing of the informal or unregistered sector has proved to be a daunting task, particularly in India where the sector is quite large. The division of tax collection matters between the national government and state and local governments in both countries is a bone of contention; as in most countries, taxes on property are the main source of revenue generation at the subnational level.

---

29 A cross-country regression over the period 1975-1995 shows that direct taxes are negatively associated with household savings, though the elasticity is only 0.09. Panel data also show the same result, though the elasticity rises to 0.16. Indirect taxes had no impact on household savings behaviour. Tim Callan and Christian Thimann, "Empirical determinants of household savings; evidence from OECD countries", *IMF Working Paper No. WP/97/181*, pp. 22-23.

30 M. Govinda Rao, "Tax reform in India: achievements and challenges" and Ilho Yoo, "Experience with tax reform in the Republic of Korea", *Asia-Pacific Development Journal*, vol. 7, No. 2, December 2000.

There are government-operated lotteries in many countries of the region, mainly at the national level but also at the state level. There are also varieties of prize bonds, mainly in Islamic countries. In both, deposits for months or years can be made. This makes them a form of savings mobilization. Alternatively they may be considered a method of government fund-raising by an administrative route easier than tax collection. As governments have no way of directly taxing the informal sector, a lottery may be seen as a viable alternative. However, any type of prize scheme can be easily misused, spawning illegal and secondary markets and so diverting resources from the original intent. As lotteries and prize bonds are, in effect, an alternative to imposing taxes on the less well-to-do and informal sectors but with questionable equity implications, the use of the funds raised needs to be transparent. The funds could be earmarked for certain specified uses, such as for social development, education or health facilities, just as road taxes are often earmarked for infrastructure development and some petroleum taxes for environment protection.

As many governments in the region often run into deficit, its impact on overall national savings becomes a moot issue. However, it is difficult to ascertain the impact of a fiscal deficit on savings a priori. As long as there is slack in the economy, an increase in public expenditure through multiplier effects on national income would tend to raise aggregate savings. However, if the fiscal deficit results in inflation and destabilizes the economy, it may lead to lower private savings. The savings would fall further if interest rates were kept low with a view to reducing the cost of government borrowing. Governments in fast-growing economies have been able to devote a large part of their expenditure towards development expenditure, such as the provision of economic and social infrastructure, and this has had a positive impact on private savings.

The method of financing the fiscal deficit also has significant implications for private savings. In small countries the borrowing of a government from its domestic capital markets creates distortions in the domestic financial system and this limits its feasibility. However, in larger countries with more developed capital markets, government borrowing could help the market by setting benchmark curves for returns on bonds, for example.

While resource mobilization by the government is important, the impact on economic growth depends on how resources are used by the public sector. If the result is a higher level of unproductive expenditure, this could pull down the growth rate. If, on the other hand, there is a higher level of investment in socially desirable activities, it is likely that economic growth will be promoted.

Policy issues

On the fiscal side, there is clearly room for further reform of tax policies, to simplify the rules and the administration, to close loopholes and to encourage the general population to pay taxes. The last item would be easier to tackle if the government budget practices were transparent, if it were clear to all that the richer segments of a society were paying an equitable share of taxes and if public expenditure were perceived as visibly beneficial to the society at large. Given the comparatively low ratio of taxes to GDP in the region, there should be room for governments to raise more money.

Some of the proposals for further tax reform, which take into account the growing importance of the service and financial sectors, include:

- ***Indirect taxes*** to be expanded by targeting the growing services sector and socially and environmentally undesirable activities
- ***Incidence of taxes to fall equitably*** on labour and owners of financial capital and other assets
- ***Tax base to be extended*** to cover incomes from activities that are not currently taxed including innovative financial instruments, but excluding the subsistence sector

It is possible to ***increase non-tax revenues*** that account for a very small part of government resource mobilization. This can be done through:

(1) ***Increasing the fees for services provided***, such as those for education and medical treatment, but these may have negative equity consequences as the better-off pay for private services anyway

(2) ***Unbundling fees*** and so charge the better-off full price and the poorer segments, only part, thus subsidizing their use of the service

(3) ***Privatizing state enterprises*** – this is usually a one-off injection of funds and has problems in its own right

(4) ***Charging contributions*** from those in the financial or commercial sector being regulated or supervised by the government, such as members of stock markets or banks, in sufficient amount to pay for the regulatory services provided. This has been done recently in the Republic of Korea and some South-East Asian countries, relieving governments of the extra financial burden needed to support better regulation/supervision or corporate governance. There are, however, inherently difficult tradeoffs between revenue yields, equity and regulatory independence.

Increasing the harmonization of tax policies between countries should be considered as part of a regional cooperation scheme. This would reduce distortions in savings and investment decisions and allow for progress in financial sector cooperation.

Fiscal policy measures that increase the transparency and clarity of budget allocations and investment decisions of the government would assist in increasing the confidence of those paying taxes that their money is being well spent. Therefore, one of the major modalities for enhancing resource generation by the government is to improve the handling of the expenditure side of its budget. These could include enhancing the transparency of budgets in line with the IMF Code of Good Practices on Fiscal Transparency, bringing extrabudgetary items into the budget and conducting regular public expenditure reviews. Improved consistency between revenue mobilization efforts and development policies would also make an important contribution to generating the needed resources in the most efficient manner. In addition, transparency and consistency in the rules governing government borrowing from local capital markets would increase the comfort of those investing in these markets.

Governments have a direct and important responsibility to establish or modernize their *regulatory institutions for the financial sector,* to make sure that these institutions receive adequate funding and professional staff, that the staff have access to training on modern financial instruments and that they are independent enough to exercise their functions in an impartial manner. The institutions must be backed with a judicial system willing and able to enforce the penalties they impose on those breaking the regulations. Whether a country has separate regulators for the banks, stock market, bond markets, futures markets institutions, insurance sector, accountants and auditors etc. or one super-regulator is a matter of choice, but there must be good coordination among these to ensure that regulatory arbitrage is not conducted. The institutions should all be adopting modern international norms[31] and taking advantage of regional and international meetings and training events to learn and contribute to the revision of these norms.

While governments are central to the issue of domestic resource mobilization, in fact in many countries today they are more of a facilitator of the private sector than a direct party to these efforts. In order to play their role properly, they need to keep their own house in order and use their ability to raise and use funds with discretion and a clear purpose.

---

[31] See *Survey 2000,* chap. V, "Review of mechanisms", for more on this topic.

VI EXTERNAL PRIVATE RESOURCES

There is a growing pool of private international capital from which countries in the ESCAP region can mobilize resources for their development, diversify risks and stabilize their macroeconomic performance. Besides adding to the financial resources available, there are indirect benefits of foreign resource inflows that include enhanced knowledge, spill-over effects, improved resource allocation, and strengthened domestic financial markets. There are basically two types of external resources: foreign direct investment and other forms of external private capital inflows (bank loans, international securities issues and foreign participation in local capital markets). These two types are inherently different as FDI involves participation by foreigners in actual productive activities whereas private capital inflows take a purely financial form. Therefore, they are discussed separately below.

FOREIGN DIRECT INVESTMENT

There has been a dramatic shift in the attitude of developing countries towards FDI in recent years. The change has become particularly visible since the mid-1980s. Most developing countries have adopted a much more favourable view of FDI. The need for reliance on FDI has been reinforced by the declining trend in ODA (see chapter VII). Meanwhile, the changing nature of the activities of transnational corporations led to a more benign perception of their role. Many corporations moved into manufacturing activities in developing countries with greater possibilities for forward and backward linkages. Many of them became engaged in export-oriented manufactures, complementing the national development objectives of achieving improved balance of payments and greater industrialization simultaneously. Transnational corporations were being increasingly looked upon as sources not only of capital, but also of production, management and marketing technologies. Thus, many developing countries started liberalizing their FDI policy regimes on the basis of the new perception of commonality of interests. The developing countries of the ESCAP region are no exception to this general trend.

The above factors have been complemented by other supportive changes in the global economic scene. These changes, involving greater "componentization" of production, convergence of demand patterns and reduced costs for cross-border transport and communication, have created favourable conditions for a greater number of developing countries to attract FDI.[1]

Against the above background, this section seeks to describe briefly the trends and features of FDI flows to the ESCAP region and to discuss some of the related policy issues.[2]

Trends and features of FDI in the ESCAP region

Table VI.1 presents data on FDI inflows to the ESCAP region. The individual economies listed in this table have been selected on the basis of inward FDI of $1 billion or more in 1999 and ranked in descending order of inflow in the same year.

As part of the global explosion of flows to developing countries, there has been a dramatic increase in FDI in the region, rising from an annual average of under $12 billion during the period 1985-1990 to over $97 billion in 1999. A remarkable feature of this growth is the consistency in its upward trend, with just a minor blip in 1998 when there was a small decline over the preceding year because of the financial crisis. However, even in 1998 some of the

---

1 *Survey 1997*, pp. 5-6.

2 The chapter does not deal with the impact of FDI on various economic objectives for which a country may seek FDI.

Table VI.1. Foreign direct investment inflows, 1985-1999

(Millions of US dollars)

	1985-1990 Annual average	*1995*	*1996*	*1997*	*1998*	*1999*
All developing economies	24 736	111 884	145 030	178 789	179 481	207 619
Developing ESCAP economies	11 869	73 216	89 047	95 332	91 271	97 100
Share in all developing economies	48.0	65.4	61.4	53.3	50.9	46.8
China	2 654	35 849	40 180	44 236	43 751	40 400[a]
Hong Kong, China	1 597	6 213[a]	10 460[a]	11 368[a]	14 776	23 068
Republic of Korea	705	1 357	2 308	3 088	5 215	10 340
Singapore	2 952	7 206	8 984	8 085	5 493	6 984
Thailand	1 017	2 000	2 405	3 732	7 449	6 078
Malaysia	1 054	5 816	7 296	6 513	2 700	3 532
India	169	2 144	2 426	3 577	2 635	2 168
Viet Nam	30	2 349	2 455	2 745	1 972	1 609
Kazakhstan	..	964	1 137	1 321	1 152	1 587
Subtotal	10 178	63 898	77 651	84 665	85 143	95 766
Share in developing ESCAP economies	85.8	87.3	87.2	88.8	93.3	98.6

Sources: ESCAP, based on UNCTAD, *World Investment Report 1997* (United Nations publication, Sales No. E.97.II.D.10) and *World Investment Report 2000* (United Nations publication, Sales No. E.00.II.D.20).

[a] Estimates.

crisis-hit countries, such as the Republic of Korea and Thailand experienced large increases in FDI inflow for reasons to be explained below. On the whole, FDI can be considered to be a much more stable source of external private capital in comparison to other sources examined later in the chapter.

One feature of FDI inflows that is strikingly obvious from table VI.1 is the high degree of concentration in a small number of economies. Nine economies listed in the table accounted for over 98 per cent of FDI inflows into all developing economies of the region. Confining attention to these nine economies, it would appear that the degree of concentration has been rising over time. However, it should be noted that the composition of the top recipients slightly changes over time, leading to minor variations in concentration. For example, if Kazakhstan and Viet Nam were dropped from the 1985-1990 period and replaced by Indonesia and the Philippines, nine economies (the first seven economics in table VI.1 plus Indonesia and the Philippines) would account for about 94 per cent of annual average inflows to all developing countries of the region. At any rate, it is obvious that the overwhelming majority of developing countries in the region receive a paltry sum of FDI.

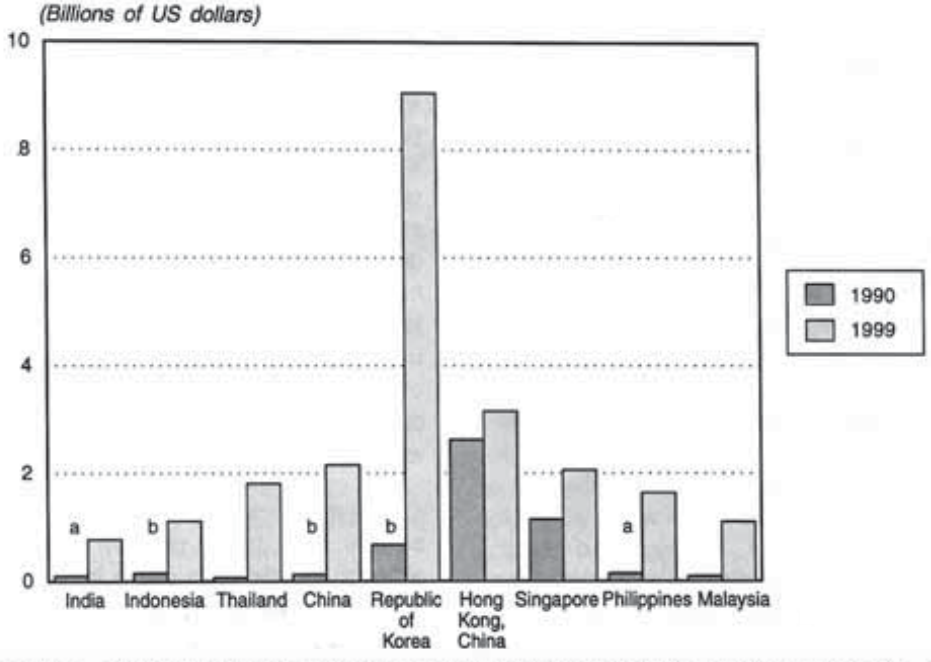
However, in some of the smaller economies, even a relatively small sum of FDI can be of considerable significance to financing for development. For instance, in Armenia in 1998, FDI accounted for over 70 per cent of gross domestic capital formation. In many such instances, the apparently large share of FDI in financing investment is attributable to low levels of investment itself; in the case of Armenia in 1998 the investment/GDP ratio was only 9 per cent.

There are two other features of FDI flows into the region to which attention should be drawn. One of these relates to the origin of flows. In recent years, much of FDI into the region has been driven by intraregional flows. For instance, the majority of FDI into Cambodia, China, Lao People's Democratic Republic and Viet Nam have been from other Asian economies.[3] Viewed from the perspective of individual countries, such flows add to investible resources. However, there is no net addition to the pool of resources available to the region as a whole.

[3] UNCTAD, *World Investment Report 1999* (United Nations publication, Sales No. E.99.11.D.3).

Finally, there has been an increase of FDI through mergers and acquisitions (see figure VI.1), particularly after the Asian crisis when some countries adopted a more liberal policy stance towards this mode of entry. In the case of the Republic of Korea, an overwhelming proportion of FDI in 1999 was in the form of mergers and acquisitions. This raises some questions about the developmental impact of FDI, but they are not addressed here.

Figure VI.1. Selected developing ESCAP economies: cross-border merger and acquisition sales



Source: ESCAP, based on UNCTAD, *World Investment Report 2000* (United Nations publication, Sales No. E.00.II.D.20).

[a] 1993.
[b] 1991.

Measures to attract FDI

The preceding paragraphs have briefly discussed the trends and features of FDI flows into the region. From the point of view of resource mobilization, the issue of overriding importance is to increase the access of a larger number of developing countries to capital markets. The following discussions seek to address this issue.

Motivations underlying FDI

Measures to attract FDI have to be conceived with a clear understanding of its determinants and its location in a particular country. A vast literature has emerged seeking to explain why transnational corporations engage in production abroad and the considerations that dictate their choice of particular locations. FDI is essentially an effort on the part of a transnational corporation to internalize control over production. Some variables which prompt a company to consider internalization as an advantageous option relate to costs of quality control and supervision, transport and marketing costs, restrictions on intra-firm transactions etc.

Once a firm decides upon internalization as an advantageous option, it has to be sure that it can compete effectively in the foreign market with either existing or potential domestic, as well as other, foreign firms. This implies that a transnational

corporation wishing to undertake FDI must have certain ownership-specific advantages. These advantages are usually conferred by a firm's control over technology, marketing networks, product quality or other attributes of a proprietary nature.

The considerations of ownership and internalization advantages influence the decision as to whether or not to undertake FDI. The next step in the process is for the company to choose a particular location from among alternative choices. This choice is contingent on the advantages offered by one location relative to others. These advantages relate to, inter alia, availability of natural resources and raw materials, cost and quality of labour, adequacy of infrastructure, size and growth prospects of the host country, and policies pursued by the host country.

It should be stressed that the different elements of locational advantage or disadvantage are of differing degrees of importance to different transnational corporations. For example, the availability of natural resources would be a crucial determinant for a company whose primary motivation in undertaking FDI was to secure the supply of a particular resource. For a company which seeks to capture the domestic market, the size and growth prospects of the host economy are likely to be the primary considerations in preferring one location over another. For companies seeking to enhance competitiveness, the availability and cost of labour with the requisite skills would be important elements in locational choice.

In many instances, the decision to relocate production abroad is prompted by developments within the home countries of transnational corporations. These fall in the category of "push" factors. An illustration is the explosion of Japanese FDI in East Asia and South-East Asia in the late 1980s that was significantly caused by the 1985 Plaza Accord leading to a major appreciation of the yen.

Finally, it should be noted that purely fortuitous elements may also pay a role in the decision to choose a particular location. To some extent, there exists a "herd instinct" among transnational corporations. If some are already operating in a country, others tend to follow suit. Mention could also be made of ethnic connection as an element in the fortuitous category. For example, the presence of large numbers of people of Chinese descent in several countries in East Asia and South-East Asia has been cited as an explanatory factor for intraregional FDI among these countries.

Overall economic policies

The brief analysis of the motivations behind FDI makes it clear that the role of national policies in attracting FDI is limited to influencing locational advantage. In discussing the role of national policies in this context, it is useful to distinguish between broader economic policies and FDI policies per se. There is a considerable measure of support for the view that overall economic policies exert a significant influence on FDI inflows. Macroeconomic stability is prerequisite for all investments, both domestic and foreign. It is widely acknowledged that high and variable rates of inflation act as a disincentive to investment. A simple reason is that uncertainties generated by high and fluctuating rates of inflation in respect of cost, revenue and profit calculations discourage the long-term commitment of resources.

Among other aspects of broader economic policies, the trade regime is crucially important, although the direction of the impact is not unambiguous. In some of the early explanations of FDI, a high rate of import duty and other protective devices were cited as an important cause of domestic-market-oriented investment.[4] However, it should be noted that in so far as a restrictive trade regime affects the import of inputs and technology, even domestic-market-oriented investment may be adversely affected. In the case of export-oriented FDI, the overall incentive structure generated by the macroeconomic policy of a country, as well as its trade regime, has a dominant impact.

A number of other aspects of development policies may either complement or counter the impact of FDI policies. Among these are policies related to the development of human resources and physical infrastructure. What needs to be stressed is that a careful analysis of the locational

[4] Koichi Hamada, "The effect of foreign direct investment on the pattern of trade: is investment a substitute for trade", *Review of Asian and Pacific Studies,* No. 14, 1997.

advantages which attract FDI will clearly reveal that many of the elements are not directly related to FDI policies. Therefore, efforts to attract FDI should be anchored in an overall framework of policies that create a propitious environment for market-friendly, private-sector-led development.

FDI policies

The discussion so far clearly suggests that the liberalization of FDI policies is but one of a number of determinants of investment inflows and, therefore, liberalization is not always followed by an upsurge of FDI. Nevertheless, the importance of liberalization cannot be overemphasized. Highly restrictive conditions can effectively shut the door to foreign investment. Policy evolution in the developing countries of the region clearly reflects an awareness of this lesson.

The highlights of the latest available information on policy regimes relating to inward FDI in selected countries are presented in the annex to this chapter. Most countries have brought about a significant degree of liberalization in their FDI policy regimes. The key components of such regimes are access to sectors, extent of foreign ownership of an enterprise, the requirements and procedures of approval, incentives, controls on foreign exchange transactions and performance requirements. The trend towards liberalization is reflected in all these respects.

One controversial element among FDI policy regimes is the provision of a number of fiscal and financial incentives, sometimes granted across the board to all foreign investments, but often linked to some performance criteria, such as export of a specified proportion of output, transfer of technology or training of the local workforce. In some cases, the incentives are intended to increase investment in specified areas of a country, such as less developed territorial units or export processing zones. The incentives have taken the forms of tax holidays, accelerated depreciation, preferential import duty on the import of machinery, refund of duties paid on the import of raw materials, favourable tax treatment for reinvested profits, generous tax allowances for income earned in the host country by foreign technicians, rebates on domestic sales and excise taxes, access to domestic credit at preferential rates of interest and, in a few instances, even a guaranteed rate of return on investment. Other incentives include the provision of subsidized infrastructural facilities (particularly in designated industrial estates, export processing zones, technology parks or the like).

The question of the impact of incentives on FDI inflows has received extensive attention in the literature.[5] The major conclusions of this literature are summarized below.

(a) There are strong reasons to suspect that individual countries might have incurred excessive cost (for example, in terms of foregone revenue) for too little stimulus to FDI inflows. Much of the observed inflows might have taken place anyway in the respective countries in response to an improved macroeconomic environment or other improvements in the locational advantages;

(b) The quality of investments might have been compromised by the nature of the incentives. The primary emphasis of the incentives has been on cheapening capital, leading to inappropriate, capital-intensive modes of operation even in countries where employment generation deserves a greater priority;

(c) Even though the sensitivity of total FDI flows to incentives is rather low, individual investors may be more sensitive at the margin. Once a transnational corporation has reached a point of deciding to invest in one of a small number of comparable countries, the incentives may tilt the balance towards a particular location;

(d) There may be a limited rationale for incentives in situations where the social return to FDI exceeds the private return. This happens when positive externalities result from such factors as the transfer of technology, the diffusion of knowledge and the upgrading of skills of workers who are mobile.[6] However, it is not easy to identify the exact sectors or activities where such externalities are important or to measure the extent of incentives needed to bridge the gap between the private and the social rates of return.

---

[5] See UNCTAD, *Incentives and Foreign Direct Investment* (United Nations publication, Sales No. E.96.11.A.6).

[6] *Survey 1997.*

Institutions

Foreign investors in any country have to come in contact with a large number of government institutions for various purposes. These may include approval to set up business, acquisition of land for factory or office buildings, access to infrastructural facilities such as energy and telecommunications, permission for the import of raw materials or equipment that fall in-restricted category, clearance for employment of expatriate nationals, certifications of entitlement to fiscal or other incentives, repatriation of profits, dividends or capital etc. The locational attraction of a country is, therefore, partly determined by the efficiency of the relevant institutions.

Many developing countries typically put in place one or two key institutions that play a central role in promoting FDI inflow. Thus, the primary responsibility for attracting FDI in Bangladesh rests with the Board of Investment and the Export Processing Zones Authority. In China, a similar role is performed by the Ministry of Foreign Trade and Economic cooperation. In India, some key institutions are the Foreign Investment Promotion Board, the Secretariat for Industrial Approvals, the Reserve Bank of India and the Development Commissioners of free trade/export processing zones. In Malaysia, the Malaysian Industrial Development Authority is the principal arm of the government to attract and assist foreign investors. The Authority is assisted by an advisory services centre. In the Republic of Korea, the two key institutions are the Korean Investment Service Centre and the Trade-Investment Promotion Agency. The important institutions in Singapore are the Economic Development Board and the Trade Development Board.

Simultaneously with greater liberalization of FDI policy regimes, most countries have tried to improve the operational efficiency of various institutions dealing with FDI. The measures taken in this regard include the establishment of one-stop service centres, simplification of approval procedures, greater delegation of authority to the relevant institutions and personnel improvements.

Nevertheless, these institutions operate with varying degrees of effectiveness in different countries. Some of the problems identified from a recent ESCAP study[7] in respect of institutional arrangements for attracting foreign investors and facilitating their operations are the following:

- The authority given to an institution may not be commensurate with the functions that it is expected to carry out
- Despite efforts in all countries to simplify approval procedures, there still occurs considerable delay in some countries
- The process of administering incentives may be complex
- The decision-making process is not always transparent
- There is sometimes a lack of definitional clarity of the criteria for approval
- In some instances, there is also a lack of or inadequate in-house technical capability in the institutions responsible for approving FDI proposals or certifying entitlement to incentives. In consequence, the concerned institutions are required to rely on ad hoc teams drawn from other organizations to undertake the necessary investigation and evaluation functions.

Regional cooperation

It is obvious that the primary responsibility for bringing about improvements in locational determinants of FDI rests with individual countries. Moreover, the impact of regional cooperation on FDI inflows is not necessarily unambiguous; it depends on the nature and form of such cooperation, the character of FDI projects, and conditions in participating countries.[8] Nevertheless, there are several areas in which regional cooperation can play a facilitating role to enhance FDI inflows. Some of these are indicated below.

---

[7] ESCAP, Foreign direct investment in selected Asian countries: policies, related institution-building and regional cooperation", *Development Papers No. 19* (United Nations publication, Sales No. E.98.11.F.62).

[8] Magnus Blomström and Ari Kokko, "Regional integration and foreign direct investment: a conceptual framework and three cases, *Policy Research Working Paper 1750* (Washington DC, World Bank, 1997).

Market size is an important determinant of FDI. Regional cooperation in trade can be an important means to encourage FDI inflow as liberalization of intraregional trade effectively expands the market size for potential investors. This also assumes greater importance because of the growing trade-investment nexus reflected in the "flying geese" pattern of trade and investment in the region. There already exist several trade-related regional and subregional cooperation arrangements in the Asian and Pacific region. These initiatives have brought about a certain degree of liberalization of trade among the relevant member countries. Nevertheless, there is considerable scope for further improvements that could contribute towards greater FDI inflows as well.

In contrast with the number of regional trading arrangements, there are very few investment arrangements. A major exception is ASEAN. The existing subregional economic cooperation arrangements in the region could consider the adoption of principles similar to those embodied under the agreement on the ASEAN Investment Area. Furthermore, common dispute settlement mechanisms could be developed within the framework of subregional cooperation arrangements.

It has been noted before that individual countries might have suffered unnecessary revenue losses from competitive fiscal incentives. Regional cooperation, particularly within the framework of subregional cooperation arrangements, could contribute to the harmonization of investment incentives among member countries.

A newly emerging trend in intercountry economic cooperation, particularly in East Asia and South-East Asia, involves the establishment of subregional economic zones, variously known as growth triangles, growth quadrangles and growth areas. These zones are typically aimed at exploiting the complementarities among contiguous areas of member countries as a means of attracting FDI, particularly export-oriented FDI. A significant feature of most of these zones is that the private sector, which wants to take advantage of the natural economic complementarities among neighbouring cross-border areas, is the major player. The role of the government is to primarily minimize the costs and risks of cross-border trade and investment flows by providing, inter alia, the necessary infrastructure and enabling regulatory framework. There is considerable scope for improving the effectiveness of the existing zones as well as for establishing new ones to attract FDI through intensified cooperation among member countries.

Several developing economies in the region are emerging as foreign investors. Some of them have adopted explicit policies to promote outward FDI. Cooperation among the countries of the region, both within the framework of existing subregional cooperation arrangements and across them, could give a further boost to intraregional FDI flows.

Another area in which regional cooperation could potentially play an effective role in facilitating FDI relates to information flow. There is a case for a regional institutional arrangement that could be an effective channel for flows of company-related information, such as names, telephone, fax and telex numbers, line of business, major products and services; country-specific information on foreign investment laws and regulations, investment incentives, application and approval procedures, and services provided by national investment promotion agencies; and industry-specific information relating to specific industries in which each country wishes to promote FDI. Such an arrangement could also undertake investment matchmaking services as well as investment promotion services, particularly to promote FDI by SMEs.

The importance of the effective functioning of institutions responsible for promoting FDI deserves special mention. The impact of policies on the desired outcome is mediated by institutions engaged in implementing policies. Regional cooperation could enhance the effectiveness of institutions through the exchange of experiences in respect of powers and functions of different institutions, organizational hierarchies, mechanisms for coordination and measures to improve the technical expertise as well as the motivation of personnel.

* * * * *

The discussion above has concentrated on national measures to attract FDI and on the areas where regional cooperation could be of help. The home countries of transnational corporations, particularly the developed countries, could also adopt a

number of measures. These relate to, inter alia, the dissemination of information about investment opportunities in developing countries, especially the ones that receive meagre flows; financial and fiscal support to outward investors; insurance schemes; and greater market access that would be of particular relevance to export-oriented FDI. Some developed countries already have in place measures in one or more of these areas. All developed countries could emulate best practices regarding such measures and devise others.

OTHER PRIVATE CAPITAL FLOWS

External private capital flows into developing countries have several dimensions: loans from overseas commercial banks; bond and equity issuance by developing country governments or corporations on overseas markets; external private participation in local capital markets; and other financial instruments that provide access to external funds. Table VI.2 reports on the overall situation with regard to net external private capital flows to developing countries

Table VI.2. Private capital flows to emerging markets, 1992-1999

A. Net

(Billions of US dollars)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3
Asia	9.0	21.8	11.8	14.2	12.9	3.5	−17.9	−5.6
Five crisis-affected Asian countries[a]	6.4	17.2	9.9	17.4	20.3	12.9	−6.0	6.3
Bank loans and other	21.0	28.3	−57.3	97.4	24.9	−44.0	−76.7	−92.5
Asia	−3.9	1.7	4.7	44.1	38.1	−60.4	−82.9	−71.3
Five crisis-affected Asian countries[a]	15.3	7.0	17.4	49.2	37.1	−43.6	−28.2	−41.1

Source: IMF, *International Capital Markets* (Washington DC, September 2000).

[a] Referring to Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.

B. Gross

(Billions of US dollars)

	1996	*1997*	*1998*	*1999*	*2000[a]*
Emerging market	218.4	292.5	150.2	173.2	128.2
Asia	118.5	128.6	35	62.9	54.9
Capital markets[b]	127.7	179.1	90.6	110.2	74.2
Asia	62.3	69.7	17.4	42.4	28.7
Loan commitments	90.7	123.2	60	63	53.8
Asia	56.2	58.9	17.7	20.5	26.1

Source: IMF, *World Economic Outlook* (Washington DC), October 1999 and September 2000.

[a] Up to June.
[b] Comprising bond issues, other fixed income and equity issues.

for 1992-1999.[9] The ESCAP region did not have a very important share of net portfolio investment flows; Latin American countries dominate this category, possibly because their approach to raising resources emulates that of the United States. In fact these net flows for the ESCAP area were negative in both 1998 and 1999. With regard to bank loans, the net position of countries in the ESCAP region has been more important relative to all emerging markets, particularly since 1995. But again there has been a negative net flow since 1997, showing more repayment than new money. It is interesting to note that the five countries affected by the crisis often have net positions larger than those for the region as a whole. Until 1997 they were drawing in more capital flows (both portfolio investment and bank loans) than the other countries. However, since 1997 they have in fact had a better (less positive or negative) net position than the region. This illustrates that they are still considered relatively more creditworthy than many other countries. The figures reported on gross private financing in part B of table VI.2 show that the region received over 50 per cent of the total flows in 1996, with this share falling to 23 per cent in 1998, the year after the crisis. However, it has risen again to about 42 per cent, or the same as in 1997. There have been gross portfolio investment inflows to the region throughout the period, these being larger than bank loans in 1996 and 1997, revealing a shift away from reliance on bank loans towards bonds and equity. However, since the crisis portfolio investment has fallen considerably, showing the move away from investment in emerging markets and the more stringent conditions being applied in bond markets. The pattern for loan commitments is very similar, falling off considerably after the 1997 crisis. However, whereas portfolio investment recovered in 1999 only to drop again in 2000, bank loans showed a slow but steady recovery. While these data exhibit some general patterns, they cannot show whether the recipients of the private lending were governments or corporations, or even individuals for bank loans. Therefore, it is not possible to know the uses made of the funds: balance of payments, productive investment, consumption or speculative activities.

Currently access to external private capital funds is concentrated in a handful of countries in the region. Yet private flows are becoming the principal source of external finance worldwide, and are likely to remain so for the foreseeable future. Therefore, a discussion on their rationale, composition, advantages and problems, as well as related policy issues, is certainly warranted. The contribution of external private capital flows to financing development can be both direct and indirect. Bank loans have the distinction of being a fungible form of finance, not tied to any specific firm or sector. They can be tapped by both domestic enterprises and foreign-owned enterprises in any area of activity. These can, of course, include speculative activities as well as productive ones. Some other forms, such as venture capital, primary equity issues (on the domestic or international capital markets), and corporate bonds can make a valuable and direct contribution to the financing of investment. Other forms, such as purchases by foreigners of securities on domestic capital markets or of government bonds and other financial products, have an impact on domestic wealth, savings and therefore investment. The positive wealth effect generated by purchases through the increase in asset prices can encourage an increase in consumption by domestic wealth holders or an increase in their savings if they decide to invest in other securities or assets. In addition, portfolio asset purchases from residents can increase bank liquidity and encourage a credit boom. The rise in domestic consumption can have a stimulating effect on the economy if it leads to an increase in investment through secondary effects. However, the credit boom can increase opportunities for financing speculative activities or increase inflationary tendencies and so the economy may lead to suffer a setback.

External private capital flows bring ancillary benefits through the addition of liquidity in domestic financial markets, thus favouring their development. They can also encourage the development of financial intermediaries, strengthening the financial infrastructure and deepening the process of financial intermediation. There can be an improvement in corporate governance as foreign investors tend to

[9] The available data on which to base the discussion in this section are very scanty and inconsistent. IMF and BIS started collecting data on private flows only recently and their figures do not tally. The IMF-BIS-OECD-World Bank working group on debt tables has agreed on the content but most countries are yet to report consistently, if at all. The BIS data are based on reporting banks and other financial institutions in developed countries. One major problem is that while commercial banks have some systematic reporting mechanisms, other financial markets do not necessarily have these for private flows. In addition on stock markets, for example, participation of external private capital can vary significantly from one day to the next and so reporting averages is not very helpful. Therefore, the analysis should be viewed as indicative of trends and not of absolutes.

demand better transparency and disclosure. They can, in addition, increase the amount of risk capital available for new enterprises. On the negative side, the costs of external private finance can outweigh its benefits when there is high volatility in inflows and outflows. It is hard to predict when and where private capital will flow and its use runs the risk of unexpected withdrawal.

Bank loans

Almost all ESCAP members have relied on bank lending for financing their economic development. This is true in terms of domestic resources as well as international ones. In particular, loans in foreign exchange provide finance to governments to overcome balance-of-payments problems and, as such, they are very useful to governments that are short of foreign exchange. Such flows also enable banks to lend money to private-sector firms. However, cross-border bank lending behaviour is fundamentally different from both FDI or securities investment. Although loans are made for both the long term and the short term (less than one-year maturity), short-term loans are often lent on the implicit understanding of being rolled over indefinitely; when a bank continues to receive a positive interest rate spread, its loans are usually rolled over. However, once a bank suspects that the credit (default) risk is very large, any interest rate spread or innovative use of risk derivatives[10] will not be sufficient to keep it making loans. In fact, it was the reversal of short-term loans rather than portfolio equity investment which was behind the Asian currency crisis in 1997.

As shown in table VI.2, loan commitments from the private sector to the ESCAP region were high in the mid-1990s, around $56 billion or over 60 per cent of the total commitments to developing countries in 1996, falling to a low of $18 billion or 30 per cent in 1998 just after the financial crisis, and then increasing to almost half of total commitments. Table VI.3, which presents information on total and short-term bank loans as reported by banks to BIS,[11] reveals two interesting facts. First, bank loans flow mainly to a few countries: China; Hong Kong, China; India; Indonesia; Republic of Korea; Singapore; Thailand; and Turkey account for over 80 per cent of the total. However, compared with other forms of private capital flows, a large number of countries throughout the region receive bank loans. Second, there is a relatively high percentage of short-term loans. Regionwide, over 60 per cent of loans made in 1998 and 1999 were short-term ones, and this trend is fairly widespread over all countries, illustrating the point made earlier about the specific modalities of this type of borrowing.

In terms of the origins of bank lending, Japanese banks lend mostly to Asian countries while American banks mostly lend to Latin American countries.[12] Among the Asian economies, Japanese banks have a large share in Thailand (54 per cent), Indonesia (39 per cent) and Malaysia (36 per cent), while European banks, collectively, have more than a 40 per cent share in China, India, Malaysia, and Taiwan Province of China. During the 1990s there was a rapid expansion of loans from European banks in both Asia and Latin America. During the period 1993 to 1997, in aggregate, European banks increased their share of lending to Asia by 6 per cent, while the Japanese banks decreased their lending by 8 per cent. In China, Indonesia, Malaysia, Republic of Korea, and Taiwan Province of China, European banks increased their share markedly at the expense of Japanese banks, while in the Philippines, European banks increased their share at the expense of the United States banks.

In order to assess the vulnerability of a country to potential problems with bank lending, such as a sudden refusal of rollovers, the ratio of short-term lending to the foreign reserves is often used as an indicator. If the ratio is higher than 1, it implies that if all banks refused to roll over the short-term loans, foreign reserves would be exhausted. Among Asian countries, the ratio in 1997 exceeded 1 in Indonesia (1.6), the Republic of Korea (2.1) and Thailand (1.4). These three countries needed IMF assistance later in that year. In 1998, the economies where the ratio was larger than 1 were Hong Kong, China; Indonesia; Singapore; and Turkey, and close to 1 in the Philippines and Thailand. In 1999, the ratio was greater than 1 only in Pakistan and Singapore and

[10] Risk derivatives are innovative tools used by banks and other financial institutions to break up and sell off risky investments that they hold.

[11] These figures are significantly different from those reported by IMF. This is partly because of a larger coverage of countries and partly as a result of difference in the origin of the figures being reported.

[12] For information on the origins of bank loans, see Takatoshi Ito, "Capital flows in Asia", National Bureau of Economic Research Working Paper No. 7134 (May 1999) pp. 13-14.

Table VI.3. Loans in foreign currency from overseas commercial banks, 1998-1999

(Millions of US dollars)

	1998		1999[a]	
	Total loans	% of short-term loan[b]	Total loans	% of short-term loan[b]
Developing economies of the ESCAP region[c]	588 973	64.3	561 440	63.1
South and South-West Asia	61 078	51.3	72 885	49.8
Afghanistan	39	12.8	22	36.4
Bangladesh	231	62.3	218	49.1
Bhutan	0	0	0	0
India	19 301	40.1	22 616	37.4
Iran (Islamic Republic of)			8 900	59.5
Maldives	32	28.1	29	34.5
Nepal	50	58.0	54	75.9
Pakistan	5 027	44.9	5 710	43.0
Sri Lanka	721	47.9	1 282	53.2
Turkey	35 677	58.4	34 054	56.6
East and North-East Asia	277 422	62.2	258 159	63.1
China	58 236	53.7	51 935	46.7
Hong Kong, China	131 413	71.5	120 994	72.6
Democratic People's Republic of Korea	338	70.7	735	26.7
Republic of Korea	65 293	45.3	63 626	53.6
Macau	1 122	78.5	1 323	91.4
Mongolia	55	56.4	60	41.7
Taiwan Province of China	20 965	79.1	19 486	77.6
South-East Asia	249 957	69.8	229 767	67.4
Brunei Darussalam	335	9.6	491	81.1
Cambodia	33	93.9	193	68.4
Indonesia	44 827	52.7	43 792	49.6
Lao People's Democratic Republic	10	10.0	37	21.6
Malaysia	20 826	44.5	18 649	42.3
Myanmar	222	62.6	606	21.9
Philippines	16 160	53.7	16 521	49.6
Singapore	125 125	86.5	113 045	85.5
Thailand	40 749	58.2	34 736	54.8
Viet Nam	1 670	43.4	1 697	38.5
Pacific islands	516	48.6	629	39.4
Fiji	21	66.7	15	80.0
French Polynesia	36	94.4	57	91.2
Kiribati	1	100.0	15	100.0
Nauru	11	54.5	16	12.5
New Caledonia	14	78.6	19	78.9
Papua New Guinea	392	39.3	432	22.5
Samoa			30	90.0
Solomon Islands	2	0.0	2	100.0
Tonga	12	50.0	15	6.7
Tuvalu			1	100.0
Vanuatu	27	92.6	27	88.9

Source: BIS, "International banking and financial market developments", *BIS Quarterly Review* (Basel), various issues.

[a] Referring to June.
[b] Referring to consolidated international claims (of BIS reporting banks) of maturity up to and including one year.
[c] Excluding North and Central Asian countries.

close to 1 in Hong Kong, China; Indonesia; and Turkey. Therefore, it appears that most countries are now paying attention to keeping this ratio within reasonable bounds.

Bank lending is likely to remain an important, if not the only, channel of access of many countries to international financial markets. For this reason, the new agreement on the Basle capital adequacy framework and the attitude of major banks to the financial (banking) situation in developing countries is crucial. It is interesting to note that as countries start using international bank loans to a significant degree, there is an incentive for them to become members of BIS.[13] They can then participate in global economic reviews, in discussions on banking system regulation and norms of behaviour, exchange experiences, and receive considerable information and training useful for their monitoring exercises. In fact, BIS has, since the Asian crisis, started to publish more information on the composition and maturity of debt, including short-term private debt, for developing countries.[14]

Bond and equity issues on international markets

A few developing countries in the region have accessed finance through the international capital markets by issuing government or corporate bonds or shares. Table VI.4 reveals that 80 per cent or more of bonds were issued by only seven economies, China; Hong Kong, China; Malaysia; Republic of Korea; Russian Federation; Thailand; and Turkey, with Hong Kong, China and the Republic of Korea

Table VI.4. Bonds and equity issued on international markets by ESCAP economies, 1997-1999

(Billions of US dollars)

	Bonds			*Equity*		
	Dec. 1997	*Dec. 1998*	*Dec. 1999*	*1997*	*1998*	*1999*
Total Asia	170.0	186.0	197.5	18.6	7.9	27.5
South and South-West Asia	19.8	20.3	22.9	1.4	0.9	0.9
India	6.0	5.7	4.7	1.0	0.1	0.9
Turkey	13.8	14.6	18.2	0.4	0.8	0.0
East and North-East Asia	101.8	103.5	106.4	14.7	3.2	18.4
China	14.9	14.6	14.1	9.4	1.1	3.3
Hong Kong, China	32.0	31.8	39.3	3.1	1.2	5.6
Republic of Korea	49.4	50.6	46.7	0.6	0.5	6.9
Taiwan Province of China	5.5	6.5	6.3	1.6	0.4	2.6
South-East Asia	42.3	43.7	50.4	2.4	3.8	8.2
Indonesia	6.5	5.7	3.5	1.1	0.0	1.2
Malaysia	12.7	12.2	14.3	0.4	0.2	0.0
Philippines	8.2	9.1	12.6	0.3	0.5	0.2
Russian Federation	6.1	18.5	17.8	0.1	0.0	0.0
Singapore	3.2	4.9	7.2	0.6	0.8	5.1
Thailand	11.7	11.8	12.8	0.0	2.3	1.7

Source: BIS, "International banking and financial market developments", *BIS Quarterly Review* (Basel), various issues.

[13] BIS members in the ESCAP region are China; Hong Kong, China; India; Malaysia; Republic of Korea; Singapore; and Thailand.

[14] For more information on BIS, see *Survey 2000*, pp. 177-186.

accounting for almost half. It is not clear from this table whether the bonds issues were sovereign issues or corporate issues, but it is clear that to access the market, there needs to be an international credit rating of sufficient grade to attract investors. Table VI.5 provides a summary of the sovereign risk credit ratings of developing economies in the ESCAP region by the two major international credit-rating companies. Only four economies have A or better ratings (China; Hong Kong, China; Singapore; and Taiwan Province of China). Three that used to have A ratings (Malaysia, Republic of Korea and Thailand) are now in the B range. This group is almost coincident with the listing of the major bond issuers. Furthermore, there are only 19 out of 47 developing countries in the region with ratings. Whereas there is no agreement on the validity of these ratings and some dissatisfaction with the ways in which the rating

Table VI.5. Sovereign risk credit rating of economies in the ESCAP region

	Standard & Poor's		*Moody's January 2001*
	date of change	*rate*	
China	21 July 1999	BBB	A3
	14 May 1997	BBB+	
Fiji			Ba2
Hong Kong, China	31 August 1998	A	A3
	14 May 1997	A+	
	13 February 1995	A	
India	22 October 1998	BB	Ba2
	1 October 1996	BB+	
Indonesia	2 October 2000	B-	B3
	17 April 2000	SD	
	31 March 1999	CCC+	
	30 March 1999	SD[a]	
	15 May 1998	CCC+	
	11 March 1998	B-	
	27 January 1998	B	
	9 January 1998	BB	
	31 December 1997	BB+	
	10 October 1997	BBB-	
	18 April 1995	BBB	
Iran (Islamic Republic of)			B2
Kazakhstan	28 July 2000	BB-	B1
	16 September 1998	B+	
	5 November 1996	BB-	
Malaysia	11 November 1999	BBB	Baa2
	15 September 1998	BBB-	
	24 July 1998	BBB+	
	17 April 1998	A-	
	23 December 1997	A	
	28 March 1996	A+	
Pakistan	21 December 1999	B-	Caa1
	29 January 1999	SD	
	3 December 1998	CC	
	12 October 1998	CCC-	
	14 July 1998	CCC	
	1 June 1998	B-	
	3 August 1995	B+	

(Continued on next page)

Table VI.5 *(continued)*

	Standard & Poor's		Moody's
	date of change	*rate*	*January 2001*
Papua New Guinea	25 January 1999	B+	B1
Philippines	21 February 1997	BB+	Ba1
	30 May 1995	BB-	
Republic of Korea	11 November 1999	BBB	Baa2
	25 January 1999	BBB-	
	18 February 1998	BB+	
	22 December 1997	B+	
	11 December 1997	BBB-	
	25 November 1997	A-	
	24 October 1997	A+	
	3 May 1995	AA-	
Russian Federation	8 December 2000	B-	B3
	27 January 1999	SD[a]	
	16 September 1998	CCC-	
	17 August 1998	CCC	
	13 August 1998	B-	
	9 June 1998	B+	
	4 October 1996	BB-	
Singapore	6 March 1995	AAA	Aa1
Taiwan Province of China	24 June 1998	AA+	Aa3
Thailand	8 January 1998	BBB-	Baa3
	24 October 1997	BBB	
	3 September 1997	A-	
	2 May 1996	A	
Turkey	25 April 2000	B+	B1
	13 December 1996	B	
Turkmenistan			B2
Viet Nam			B1

Sources: Standard & Poor's sovereign ratings service, available at <www.standardpoor.com/ratings/pdf/sovereigns/012001_sovhis.pdf> (29 January 2001) and Moody's Investors Service rating list available at <http://www.moodys.com/moodys/cust/staticcontent/2000400000333838/SovRatList.pdf> (29 January 2001).

[a] SD = selective default.

agencies have performed their function,[15] having a rating is a prerequisite for accessing this type of finance. Therefore, such access will be denied to many countries and companies until they are able to obtain a satisfactory rating. This in itself will only pose a problem if international bond issues are seen as a useful means of raising finance. Given that bond finance is by nature long term and so not easily reversible, countries and companies which desire to increase the percentage of longer maturity financial inflows and have weak domestic bond markets may need to consider this alternative.

Portfolio equity issue from the ESCAP region on overseas stock markets is relatively minor to date. Most of this is undertaken by reputable companies with good international credit ratings from

[15] For a discussion on the rating agencies see *Survey 2000*, part two, pp. 190-193. Sovereign risk credit ratings are also used by banks to determine country limits for loans. However, having a rating is not a necessary condition for accessing a bank loan.

countries also with good ratings. As can be seen from table VI.4, over 80 per cent of the issuings originated in five economies: China; Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China. Given the strict rules applied to companies wishing to list their shares on international stock markets in terms of disclosure and performance, this form of finance is likely to remain minor for the foreseeable future. While governments have used innovative ways to promote foreign portfolio issues by their corporations, the ideas in chapter V on enhancing the use of domestic stock markets within the region may be more feasible for most countries.

Foreign private participation on local capital markets

The determinants driving portfolio investors to take an interest in the markets of developing countries are complex, involving the interactions of factors related to the external environment, investors' strategies and specific host-country determinants. As many developing countries and countries in transition embarked during the 1990s on a process of financial market liberalization, the number of markets to which international investors are able to allocate their savings has grown substantially. In parallel, the tremendous growth of assets for investment managed by institutional investors in OECD countries has flooded international capital markets with liquidity. For example, in 1998, total net assets of OECD pension funds were estimated at around $11 trillion (14 per cent of which were placed in cross-border investments), while total assets of mutual funds in the world exceeded $8 trillion (with United States funds alone accounting for more than $5 trillion). Accompanied by rapid financial innovation, the combination of these events produced changes in investor strategies as well as a re-allocation of funds towards emerging markets. There are two key factors that explain the increased interest of international investors towards emerging markets as a group, at least until the recent Asian crisis: potentially higher returns and the benefits of diversification.

Once the decision is taken to invest in emerging markets, the allocation of funds to specific markets depends on host-country determinants. These country-specific determinants can be divided between economic determinants and policy/regulatory determinants. Economic determinants are not directly linked to policies aimed at attracting external portfolio inflows. Instead, they are a reflection of the general health of the economy, and the potential for firms operating in the country to earn profits and obtain a satisfactory return on investment. Investors will typically focus on the following factors: the rate of economic growth (the higher the better); the degree of exchange rate stability (the more stable the better); the degree of macroeconomic stability; the level of foreign exchange reserves; the degree of soundness of the domestic financial system; the robustness of local stock and bond markets (amount of liquidity, depth and breadth); and the level of real interest rates. Some of these factors are of more importance to equity investors and others to fixed-income investors. For example, high economic growth rates and the liquidity of the stock market are of particular importance to portfolio managers specializing in equity investments. On the other hand, the degree of bond market liquidity and the level of real interest rates will be of particular importance for fixed-income investors.

Although the amount of portfolio capital invested in emerging markets has increased dramatically over the 1990s, the distribution of these flows has remained highly concentrated in countries which are associated with sound macroeconomic policies and relatively high growth rates. In Asia, which accounted for over a half of cumulative external portfolio investment between 1990 and 1997, a few economies (China; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore; and Thailand) account for nearly all of such inflows. All of these economies had liberalized access to the local capital markets in the early 1990s. The Republic of Korea, by contrast, maintained a strict upper limit on foreign holdings of each stock issue, 20 per cent at the end of 1996. This had the effect of limiting the amount of external inflows into the country's stock market until very recently. At the end of 1997 the limit was lifted as part of the effort to recover from the crisis.

The other set of determinants to which foreign investors pay particular attention includes policy and regulatory frameworks in individual emerging markets. These are the factors over which domestic governments have a direct influence. The main

determinants in this group are: the ease of repatriating dividends and capital; the rate of the domestic capital gains tax; the soundness of stock and bond market regulation; the quality of domestic accounting and disclosure standards; the speed and reliability of the settlement system; the availability of domestic custodians and brokers; and the degree of protection of investor rights. It is not possible to isolate any single factor as being the most important, although some tend to carry more weight than others. For example, the degree of investor rights protection and the ease of repatriating dividends and capital are often cited as being closely watched by potential investors.

Until the Asian crisis occurred, there was a strong argument for investing in emerging markets, based on the idea that their GDP growth was much higher than in OECD countries and that local companies, through higher earnings, share in such growth. Over the period 1988-1997 the relatively strong performance of some emerging markets compared with OECD markets lent some support to this thesis. As the reform process took hold in a number of Latin American countries and strong growth persisted in Asian emerging markets, the relative risk of investing in these countries was perceived as being increasingly smaller. In particular, this was evident in the continuous narrowing of spreads on emerging market bonds for East Asian and South-East Asian countries compared with United States treasuries over the period 1993-1997.

As markets started attaching a lower relative risk to emerging market investments, it was argued that including this asset class in the overall portfolio would lead to higher risk-adjusted returns.[16] However, the benefits of diversification in the context of emerging markets have turned out to be lower than what was widely expected in the early 1990s. Globalization and the increasing international integration of local financial markets have increased the correlation between individual emerging markets as well as between emerging and developed markets. Although a high cross-market correlation does not entirely erase diversification benefits, it makes them much weaker, thus reducing the attractiveness of emerging markets.[17] In particular, the Asian crisis and the contagion effect to other emerging markets, as well as to the mature markets, have cast doubt on the benefits of investing in emerging markets.

Most global investors are found to invest between 2 and 5 per cent of their portfolio in emerging markets, which is well below the 20 per cent mark that was advocated as being the optimal allocation in the early 1990s. In a recent survey[18] 9 out of 10 investors cited as their primary motivation for investing in emerging markets the belief that by doing so they could achieve improved portfolio returns. Yet, 6 out of 10 investors reported that including emerging markets in their portfolio had resulted in decreased overall returns, two are uncertain of the benefits and only two investors report improved returns. Since the outbreak of the Asian crisis, 9 out of 10 investors reported that emerging market investments decreased their overall returns and one was uncertain. A further blow to the diversification hypothesis comes from the fact that 40 per cent of investors report that including emerging markets as an asset class had raised the volatility of their returns even prior to the Asian crisis. This percentage increases to 60 per cent when the period of the Asian crisis is included.

---

16 The concept of lowering the risk-adjusted returns of a global portfolio by including emerging markets as a significant part of invested assets came from the extension of the single market capital asset pricing model, which states that the risk of an investor's portfolio can be minimized by holding a diversified portfolio of shares.

17 The signs of increasing correlation were observed as early as 1994, when the United States Federal Reserve Board engaged in a series of monetary tightening measures. This caused a sharp fall in the price of United States treasuries, provoking a severe bond bear market. The steepness and rapidity of the fall in United States bond prices is partly attributed to the unwinding of large leveraged positions by hedge funds. There was a corresponding collapse of prices in emerging market debt instruments. It has been widely asserted that owing to rising interest rates in the United States, a number of leveraged investors had to sell securities across the board in order to meet the margin calls in United States markets where they sustained heavy losses. This in effect led to a domino effect, and all markets experienced a sharp correction in 1994. Even without the leverage effect, the attractiveness of international fixed income and equity instruments would have diminished and downward pressure on prices would have occurred. The decline in bond prices subsequently led to a decline in equity prices in mature and emerging markets. In fact, in percentage terms, the index of a number of emerging equity markets suffered a larger drop than did the United States equity market.

18 UNCTAD, "Comprehensive study of the interrelationship between foreign direct investment and foreign portfolio investment" (UNCTAD/GDS/GFSB/5), p. 12.

While most investors do not believe that the theory of benefits by diversifying into emerging markets has been disproved, many of them plan to reduce, or have reduced, their positions in emerging markets. It appears that the Asian crisis has cooled the ardour of international investors towards investing in emerging markets, although it is too early to judge whether this is a short-term phenomenon or if it reflects a shift in attitude that will shape investment decisions for years to come. As investors are questioning the real benefits that they can reap from diversifying their investments into emerging markets, there is a strong probability that the flow of portfolio investment will not be sustained at the same level as occurred between 1993 and 1996. Because of abundant liquidity on international capital markets, there will continue to be interest in emerging market investment, but investors will likely be more demanding of the quality and security of assets in which they invest.

There is, thus, a question which emerging markets need to answer. Are they willing to live with the inherent volatility of foreign participation in their markets? This is central as the investments made in emerging markets are quite minuscule for the investors but may be large for the receiving market. Therefore, any sudden changes in their size may disrupt the market completely. It is interesting to note that up to the crisis, foreign participation in liberalized stock markets averaged somewhere around 20 per cent. There is evidence that this share has fallen; in Thailand it currently averages around 12 per cent of buying and selling. While there is a need for added liquidity in markets to increase their robustness, there is not a need to add volatility at the expense of the health of the market. India has approached this dilemma in another fashion. It has encouraged investment in its stock markets by expatriate Indians through investment funds where funds have to be kept for a specified period of time. However, this option can be seen as restrictive and may not be feasible in smaller markets in the region.

Similar problems will face local bond markets when they develop sufficiently to attract foreign interest. External buying and selling adds depth and liquidity to the market, but also adds instability as the external investors are making a marginal investment, not necessarily one in which they have a long-term interest.

Innovative financial techniques

Developing economies can adopt some innovative methods to leverage additional private sources of finance. For example, multilateral financing agencies have started to provide joint financing with the external private sector and so provide increased leverage for countries and firms to tap international capital through loans and bonds. This has been done quite extensively for infrastructure projects and natural resources development. In addition, venture capital funds are being used to provide external private finance to SMEs through the grouping together of financial resources and the spreading of risks over a number of companies. These funds are usually either country-specific or industry-specific in terms of investment destination. Venture capital funds in developed countries tap into the pool of institutional investors, particularly pension funds. However, investment through venture capital funds into developing countries is relatively small, and, as this was based on the same theory of diversification as investment in emerging market stock markets, it may suffer the same fate.

The area of structured finance offers new opportunities for developing countries to increase access to and reduce the cost of finance. It has mainly been used to date for large natural resource projects, especially for energy and minerals, but its scope has been widened to include soft commodities and other products. Box VI.1 provides an analysis of structured finance and its possible uses in the region.

Another route is to encourage the use of financial derivative markets to hedge currency and interest rate exposures that arise with cross-border flows of capital. The fact that a company uses hedging instruments often provides a degree of comfort to potential investors and makes them more willing to lend money or to do so at a more preferred rate of interest.

While there are access constraints facing countries in the use of innovative instruments, many of them would appear to be attractive to countries now excluded from international financial markets. Therefore, their use needs to be explored seriously and assistance given to help countries determine when and where they can avail themselves of new, feasible and affordable ways of mobilizing resources

Box VI.1. The potential of structured finance[a]

What is structured finance and for what areas is it relevant?

Structured finance is a technique whereby specific assets from which regular, predictable cash flows can be derived are segregated from the other assets of the same owner and provided as security for the purpose of raising finance. The objective of the segregation is to cause the earnings from these specific assets to be out of reach of other creditors in the event of the insolvency of their owner. As for all loans, a single bank or a syndicate of banks can be the providers of the finance to be raised. For structured finance deals, however, the potential pool of financiers can be enlarged by the issuance of liquid, marketable securities (for example, notes, bonds or other marketable debt instruments) backed by the expected cash flow from the specific assets. This form of structured finance is known as "asset-backed securitization".

A key element which distinguishes structured finance is the automatic payment of principal and interest from the cash flows generated from the specified assets. For a deal to materialize, these assets must be capable of generating a sufficient cash flow and arrangements need to be in place for the necessary part of the cash flow to be securely channelled for the repayment of the loan obligations before any part of it reaches the borrower. As a consequence, a main feature of structured finance, which differs from traditional bank or asset-based lending, is the manner in which risks are evaluated when granting the loan. In traditional finance, risk analysis concerns the general financial health of the borrower, in other words, the borrower's asset and liabilities as represented by the balance sheet. The concern of structured financiers is with all aspects of risk specific to the transaction involving the specified assets, starting from the production or realization of the assets, their storage (when applicable) through to their sale or preservation of the future value of the assets and, finally, the safe receipt of the sales proceeds. Their concern is a simple one, namely, to ensure that their loan is repaid with a competitive rate of return.[b]

The versatility of the technique is such that the areas relevant for structured finance are wide-ranging and cover the entire gamut of receivables financing. While use of the finance raised need not be limited to investments related to the specified assets, this is often the case as then there is a direct link with the cash flow generated. In many instances, structured finance is used for investment in the production, processing and/or marketing of export commodities of various types, including minerals, raw materials such as timber, and agricultural commodities such as coffee.

Advantages for developing countries

Developing countries face serious problems of non-availability of investment finance and, when the finance is available, it may be insufficient or involve high costs, or both. Some developing countries are, however, rich in commodity resources. For such developing countries, structured finance solutions can be a lifeline for investment in these resources, provided that a sufficiently attractive international market exists for their outputs. Perhaps the greatest advantage of structured finance to a developing country is securing finance at a more competitive cost basis, often longer-term financing and a higher quantum of funds.

Constraints on use

Unfortunately, the development of a structured finance deal entails far more complex work than a usual loan. It involves more parties in the chain of negotiation and requires the exercise of greater vigilance. There is, thus, a demand for specialized expertise which most countries do not possess themselves, but have to locate and access. In fact, there is no reason to develop such expertise for a technique used on an infrequent basis. However, expertise alone is not enough; there must also be experience, contacts and information. Thus, awareness of the possibility of the use of structured finance arrangements and the attendant risks and constraints is needed, particularly in the relevant government departments.

In addition, the host country's legal, tax and accounting systems, transport networks, warehousing and other supporting infrastructure must be sufficiently developed and able to support the construction of a structure acceptable to a financier. Its securities, derivative and debt markets must be sufficiently developed with strong, respectable regulatory mechanisms in place to offer the financiers the degree of comfort and confidence they need. All these translate into a longer gestation period before a deal materializes, and a higher transaction cost.

The process of structured finance involves having a credit rating on each specific deal, usually by a major, internationally recognized credit-rating agency. This may be higher than the credit rating of the country, and can be done even if the country does not have a published credit rating. The resultant rating will clearly be related to the general credit-worthiness assessment of the country.

---

[a] Based on a contribution by David Hew, Lawyer and Secretary-General of the Asia Pacific Countertrade Association, Singapore.

[b] In the case of asset-backed securitization, there is the added complexity of the issuing of liquid, marketable securities. However, the basic concern is similar, namely to ensure that the public or private investors are repaid with a sufficiently attractive rate of return.

Actual applications

Some actual applications of structured finance in trade and project finance[c] are as follows:

(a) The financing of a buy-back structure where the purchase of processing machinery, plant and equipment is financed and repaid from the sales proceeds of the end products processed from the machinery, plant and equipment;

(b) A tolling structure where the cost of processing primary (hard or soft) commodities into semi- or wholly-processed products is financed in part or in whole by the sale proceeds arising from the sale of the semi- or wholly-processed product;

(c) The financing of an investment project to develop a commodity resource through the use of the commodity as the underlying unit of obligation. Such a transaction usually involves long- or medium-term debt instruments coupled with hedging and the use of an escrow account as part of the loan structure. An example, though not of an Asian origin, is the Mexicana de Cobre deal. In this project to develop a copper resource, a syndicated fixed rate loan from BNP Paribas of $210 million was repaid via fixed monthly deliveries of copper, with the risks and benefits arising from price changes assumed by Mexcobre. An Asian example is the Karnaphuli Fertilizer deal in Bangladesh where a syndicated loan of $423 million has been provided and is to be repaid from part of the sale proceeds of the urea. The required amount of the proceeds are paid into an escrow account maintained specifically for this purpose;

(d) The short-term financing of the costs involved in exporting a commodity. An example is a structured commodity finance transaction in Kenya. Producers of coffee had obtained, under a traditional finance deal, a three-month loan where the loan quantum was only 50 per cent of the value of the coffee, which is also the security provided. Interest was charged at the London Interbank Offering Rate (LIBOR) plus 15 per cent. By introducing structured finance techniques, the quantum of the three-month loan increased to 80 per cent of the value of the coffee provided as security and the interest charged was reduced to LIBOR plus 2.5 per cent. While the initial transaction costs for setting up the structured finance transaction increased, this cost is amortized over time as the same financing structure is replicated every three months.

[c] Actual examples of asset-backed securitization are many and range across a spectrum of assets, such as commercial and residential mortgages, credit card receivables, automobile loans and most forms of consumer or credit receivables finance. There seems to be no end to the widening of the asset class to which asset-backed securitization techniques can be applied as it now includes intangible assets, such as royalties and fees earned from intellectual property rights.

Potential applications

The versatility of the structured finance technique lies in its application to a wide spectrum of asset classes. Virtually any asset can be the subject of structured finance provided it fulfils the following characteristics:

- It is an asset or a pool of assets with a predictable and stable cash flow from which to service principal and interest
- The assets can be provided as security to "back" the stream of cash flow generated from its sale
- The financiers must be able to forecast the performance of all the parties in the host country (both private and government) material to the transaction and to gauge the likelihood of payback

Perhaps the greatest drive behind the increasingly widespread use of structured finance techniques is the growing realization of its risk-neutralizing and returns-enhancing attributes, which over time far exceed the high upfront transaction costs.

Caveats

While the above presents a very positive picture of the potential of structured finance for developing countries, there are a few caveats to be kept in mind.

1. Each structured finance deal implies tying the use of export proceeds. If a high percentage of a country's export receipts become "tied" to pay back such loans, the country itself loses macroeconomic flexibility and becomes increasingly vulnerable or hostage to the international financiers providing the funds. Therefore, a government must know, if not be party to, every structured finance deal, proposed or negotiated, that uses assets of the country as security.
2. As structured finance deals are rated for creditworthiness, if a country has a bad rating or is generally not considered a good risk, then the probability of successfully negotiating a structured finance deal is low, or the implied costs negate its usefulness. Therefore, there is still a need to improve the general credit assessment of a country.
3. Any default on a restructured finance deal is a very serious matter, perhaps worse than default on an international bond, given the lower interest charges involved. Therefore, there is a need to be absolutely sure about the liability (amount and timing) of returns from the assets used.

Nevertheless, such a technique does offer a selective, reliable way of raising more finance at lower costs. It seems necessary, therefore, for the relevant government authorities to become familiar with the technique and to be able to judge its appropriateness in their particular country situation.

to support their development efforts. However, the level of awareness of and expertise in the use of these instruments in most developing countries is quite low. There is first a need to increase the general awareness in both the government finance ministries and in the business community of the tools available, their uses, their advantages and the inherent risks. Then, depending on the size of the economy and the potential use, assistance is needed to train local experts or to provide expertise when the need arises on an ad-hoc basis. Providing expertise is most appropriate when the use is envisaged to be occasional and so investment in developing local expertise is more costly than employing an outside team.

Policy issues

External private capital flows to selected economies in the ESCAP region in forms other than FDI have been sometimes quite large, exceeding 10 per cent of GDP in many cases. These flows inherently carry with them potentially enormous benefits as well as very large costs and risks. From a purely financial point of view, both FDI and external private capital flows can contribute to filling the financing gap needed to complement domestic savings. This contribution is in fact supported by the economic success of countries in East Asia and South-East Asia. Excluding capital-exporting countries such as Singapore, there is a reasonably significant correlation between capital flows and growth: the correlation coefficient between the capital flows as a percentage of GDP and average annual GDP growth rates over the period 1993-1997 was found to be equal to 0.36.[19] However, on the negative side, external finance can become a real burden for the host economy if the cost of such finance exceeds the benefit derived and weighs heavily on the balance of payments. Such cost takes the form of interest and dividend payments in the case of external private capital. A negative impact can also arise when foreign flows displace domestic savings through a substitution effect. Furthermore, volatility or rapid reversal of flows can be detrimental to economic development as it increases risks and uncertainties and induces high instability in macroeconomic variables.

Therefore, the first policy issue facing most governments in the region is whether or not to encourage external private capital inflows. Most will want bank loans. In order for this to be useful, they need to pay attention to the health of their domestic banking system through which the loans will be channelled. Some may wish to issue bonds on overseas markets. For this an international sovereign risk credit rating is usually needed. Others may wish to take advantage of innovative techniques on an occasional basis. However, the dilemma comes mainly with the participation of overseas investors in domestic capital markets. This is a welcome addition as inflows but unwelcome as outflows. The conditions needed to maintain overseas investors' confidence are very stringent and may pose a significant constraint on domestic macroeconomic policy-making beyond the capacity of many governments. Therefore, the opening of domestic capital markets to foreign participation of any significant extent is a risky proposition until countries reach a certain maturity in their macroeconomic structures and policies.

It should be noted that the volatility of external private capital flows is characterized by a high frequency in the reversibility of flows, or by a high variability in the volume of inflows. Reversibility and variability result from the fact that capital flows are very sensitive to changes in their determinants. The volatility of capital flows can contribute to an unstable investment environment detrimental to growth and development through at least three channels. The first is through unexpected changes in the availability of finance and the consequent changes in its cost and in asset prices. This will induce high variability in expected profits, making investment planning difficult. The second is through the effects of compensatory adjustments in monetary, fiscal and exchange rate policies in response to rapid changes in the availability of external finance. Finally, capital volatility has an impact on consumption and, consequently, on growth.

Volatility can be explained by the interplay of different factors which influence the risks of and returns to investment. These factors include changes in macroeconomic fundamentals; the degree of volatility of local stock markets; domestic and external financial factors (such as exchange and interest rates) and liquidity of international capital markets; investment cycles; contagion; asymmetric

[19] Ibid., p. 12.

information flows; and the strategies and behaviour of portfolio investors. While international financial markets are inherently volatile, the volatility of capital flows to individual emerging market countries tends to be even larger because of the small percentage they represent in the investment portfolio in developed countries, the boom-bust cycles of investment in developing countries and contagion. Under conditions of ample liquidity on international capital markets, private capital tends to overflow into a few countries that appear to have strong fundamentals (high GDP and export growth, a high level of domestic savings and macroeconomic stability). Excess capital flows induce real currency appreciation and excess liquidity in the domestic financial system. Excess liquidity encourages asset bubbles and more speculative investments. As excess capital inflows induce persistently high current-account deficits, investors change their perception of the creditworthiness of the recipient countries. This change in perception is reinforced by the existence of weak domestic financial systems. The resultant sudden and sharp withdrawal of capital is often triggered by a speculative attack on the currency, which is perceived as being overvalued.

Sharp fluctuations in capital flows cause major disruptions to domestic financial systems, not only through drastic changes in liquidity, but also through changes in asset prices. Changes in asset prices can rapidly transmit the shock waves to other markets, for example from foreign exchange markets to capital markets, and from a class of securities of one particular country to the same class of securities of another country. Through the contagion process, a loss of investor confidence in one country that is having severe economic difficulties leads to a loss of confidence in other countries. Contagion tends to hit countries that have similar economic structures or policy characteristics, that belong to the same region, or that are simply affected by panic reactions by investors despite the existence of good fundamentals.

The amplitude of the ebb-and-flow movements of capital flows is influenced by the herd behaviour of investors. This herd behaviour is in turn often the consequence of asymmetric information, which makes investors react in concert to the same source of information, such as that provided by international credit-rating agencies. In addition, investment strategies such as benchmark performance, leveraged investment, and the pursuit of short-term capital gains add to the overreaction by investors to any change in fundamentals or in financial factors (whether internal or external to recipient countries).

Fluctuations in capital flows may also result from factors over which the recipient countries do not have control. Such factors pertain to changes in policies or in the investment environment of capital-exporting countries. For example, a change in United States monetary policy can feed directly into a change in asset prices in emerging markets.

The conclusion that external private capital flows are more volatile than FDI has been empirically confirmed by a study[20] comparing the coefficient of variation of FDI and external private capital flows. Comparing the coefficients of variation of equity securities and debt securities reveals debt securities to be more volatile than equity securities in 19 out of the 29 cases. The higher volatility of external private capital inflows can also be seen from comparing the quarterly changes in these two types of flows during the period 1993-1998 in the countries that have gone through a severe financial crisis (Indonesia, Republic of Korea and Thailand). The FDI data show much less fluctuation and flows are always positive, except in the case of Indonesia during the fourth quarter of 1997 and the first quarter of 1998. On the other hand, the data for external private capital registered net outflows during critical crisis periods, for example, for Indonesia from the third quarter in 1997 to the second quarter in 1998, and for the Republic of Korea during the fourth quarter in 1997 and the first quarter in 1998. The data also suggest that external private capital flows are capable of rapid recovery; periods of net outflows have tended to be rather short, no more than two or three years.

There are four major policy areas for developing countries in relation to the above problems with external private capital flows of any sort. First, the approach to the liberalization of the capital account needs to be one of caution and proper sequencing. External private capital flows often increase rather sharply following the opening of capital accounts. However, when the domestic financial system is weak, the flow of funds, particularly through bank

[20] Ibid., p. 18.

loans, may not be used in the most productive ways in the country. In the presence of imperfect and asymmetric information, free capital mobility is likely to amplify existing distortions, create situations of moral hazard, encourage excessive risk-taking, and generate serious and costly banking crises. In the absence of strong financial supervision in either lending or borrowing countries, there is a high risk that private capital flows will be misallocated and so cause major disruptions to economic growth and development in the receiving nations. Developing countries should thus be careful not to liberalize their capital accounts before they put in place effective regulatory and supervisory regimes for their financial systems.[21] It may be argued that the relaxation of controls on international private capital movements should take place only towards the end of market-oriented reform.

It is frequently said that the governments in East Asia and South-East Asia undertook rapid financial and capital account deregulation in the 1990s without addressing the concomitant need to strengthen their supervisory capacity. Thus arose a systemic risk posed by the growing possibility that the massive pre-crisis inflows of private capital might fail to earn enough returns to service the foreign debt being generated. Recent events have led to a serious reconsideration and now it is generally agreed that capital account liberalization should be undertaken with some caution and with appropriate sequencing. Many developing countries have domestic conditions which are not ripe for capital-account liberalization at present. However, they should prepare for it if they wish to attract external private capital flows.

Second, countries need to review the consistency of their monetary, exchange-rate and capital-account policies. When the size of capital inflows becomes larger than current-account deficits, there is pressure on the currency to appreciate. If the currency is pegged,[22] the pressure to appreciate can be countered by intervening in the foreign exchange market through purchases of foreign exchange, leading to an increase in the level of foreign reserves. Foreign exchange market interventions can be sterilized or left unsterilized. Unsterilized intervention will increase the monetary base, resulting in lower interest rates. The stimulating effect of lower interest rates may cause inflation, particularly if the economy is already at full capacity, which is often the case for emerging market economies that attract massive capital inflows. Sterilized intervention implies domestic open market operation to keep the monetary base constant (in levels or in proportion to GDP in a growing economy). In practice this means that the interest rate will increase. This is likely to produce more capital inflows in the form of portfolio investment, and so defeat the objective of the exercise. Thus, for a small open economy, it is impossible to have simultaneously a free flow of capital, a fixed exchange rate, and independent monetary policy. The typical policy response to this is to float the exchange rate, as has been done in Indonesia, Philippines and Thailand. Another response is to adopt some mild forms of capital controls on short-term inflows, such as raising the reserve requirements on bank deposits by non-residents or imposing withholding taxes on short-term instruments held by non-residents. Many emerging markets, including notably Malaysia, have adopted some form of market-based capital controls. While the debate on fixed versus flexible exchange rates is far from resolved, and many countries are opting for some middle ground in terms of a managed float, the main point is to have consistency between the various policies so that unintended risks do not build up to crisis proportions.

Third, there needs to be more prudent management of external private capital inflows by the financial authorities of a country in order to minimize considerably the risks involved. This means that the magnitude, maturity and volatility of the various kinds of external private capital need to be closely monitored. The lack of sufficient monitoring and inadequate portfolio management led to serious currency and maturity mismatches that helped foment the serious 1997 financial crisis in East Asia and South-East Asia. The importance of developing and managing a target foreign-capital portfolio composed of, inter alia, commercial bank borrowing, equity investment, bond investment, foreign participation in local capital markets and FDI cannot be overstressed.

---

[21] As discussed in chapter V, the primary need is to have an appropriate and consistent set of macroeconomic policies, including appropriate exchange rate regimes.

[22] Stability in the exchange rate is often considered to be important for nurturing exporting industries and inviting FDI inflows.

Fourth, for countries that decide to encourage external private capital flows, there are two specific policy initiatives that can help to induce larger and more stable flows. The first is to strengthen the domestic financial and corporate sectors by expediting financial and corporate restructuring, modernizing the financial management techniques and reforming corporate governance. The second is to encourage the move to flows with longer maturity than bank loans or equity participation. This can be done through the issuance of longer maturity private debt securities, such as bonds, on international financial markets. This will require an internationally recognized credit rating for both the country and the corporations involved. It can also be approached through opening local bond markets to foreigners to buy bonds in the local currency. The development of viable local or subregional bond markets is thus a priority but, as outlined in chapter V, it is difficult to accomplish.

Both FDI and external capital inflows in the ESCAP region remain highly concentrated in a small number of countries. The problems facing these countries are substantively different from those which are not recipients of these flows. For them, maintaining larger and more stable flows is a priority and policy responses will be required to be in line with international norms and market requirements. For the other countries, decisions on the choice of types of flows to be encouraged are needed first and then the policy packages to attract these have to follow. There is no guarantee, of course, that they will be able to attract investor interest on a sustained basis, even if the policies of countries become consistent with prevailing international norms. They also need to be able to demonstrate a functioning domestic economy and an attractive and competitive production base. Therefore, for many countries in the region, official flows of various kinds will remain important for the foreseeable future.

Annex.

INWARD FOREIGN DIRECT INVESTMENT POLICY REGIMES IN SELECTED ASIAN AND PACIFIC COUNTRIES: HIGHLIGHTS

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
Azerbaijan	No major sectors are closed to foreign investors	Foreign investors may do business and invest through the purchase of companies, buildings and securities, by acquiring rights to land and natural resources use, or through the establishment of: Joint ventures with Azerbaijani partners, taking the form of open or closed joint stock companies (regulated by the law on joint stock companies); full or limited partnerships, or limited liability companies; wholly foreign-owned companies in Azerbaijan; or branch or representative offices The privatization law (1993) allows for foreign participation in privatization	The Registration Department of the Ministry of Justice is responsible for registering all Azerbaijani legal entities, including those fully or partly owned by foreign companies	Tax incentives that reduce corporate taxes on foreign shares of profit	15% dividend withholding tax applied to foreign investors when dividend transferred out of Azerbaijan	Law on Protection of Foreign Investments (1992) provides for equal treatment with national investors in terms of protection against nationalization Nationalization is possible under exceptional circumstances to prevent harm to the people and damage to the state interests of Azerbaijan, in which case, foreign investors are entitled to compensation
Bangladesh	FDI allowed in all sectors other than arms and defence, nuclear energy, forestry, security, printing and mining, and air transportation and railways (reserved for the public sector)	Except for reserved sectors, private-sector investment has been kept open without any ceiling	No prior permission needed to set up industries	Tax holiday given to industries for 5 years in developed areas and for 7 years in less developed areas Accelerated depreciation in lieu of tax holiday	Free repatriation of proceeds from the sale of equity along with capital, profits and dividends from FDI (in the industrial sector), as long as FDI has been registered with the Board of Investment	

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
				Preferential import duty on import of machinery for export-oriented industries Tax incentives on royalties, technical assistance fees and interest on foreign loans Favourable income tax treatment for foreign technicians	Free inflows and disinvestment outflows of non-residents' portfolio investments. However, non-residents are not allowed to buy money market instruments or treasury bills. Likewise, residents' portfolio investments abroad are not allowed, while outward direct investments are permitted on a case-by-case basis. Short-term borrowing abroad by residents is only allowed for export purposes and requires special permission by Bangladesh Bank, whereas long-term loans need approval by the Board of Investment and can be only for industrial purposes Banks' borrowing abroad requires special prior approval by Bangladesh Bank	
China	List of industrial sectors contains "encouraged", "restricted" and "prohibited" categories of FDI The Provisional Regulations for Guiding the Direction of Foreign Investment, released June 1995, and updated January 1998, indicate where the Chinese Government would like to channel foreign investment: agriculture, infrastructure,	Foreign banks allowed to open branches and to engage in local currency business Foreign participation in trading joint ventures allowed	The central government has delegated to provincial governments the approval authority of all FDI projects that are encouraged by the state and are not subject to central planning Approval and registration procedures have been streamlined and a number of restrictions have been lifted	Technology transfers by foreign enterprises to China can be exempted from business tax and if approved, from corporate income tax Imports of technology in relation to projects listed in the Industrial Catalogue for Foreign Investment can be exempted from import duties	The yuan renminbi has been convertible on the current account since end-1996, however, approval of the State Administration of Foreign Exchange is still necessary for "capital account" foreign-exchange transactions, such as the receipt and payment of foreign loans or the disposal of capital assets	China has signed bilateral investment protection agreements with 93 countries, including 2 agreements signed in 1999

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
	industrial raw and semi-finished goods, high technology, energy conservation and environmental protection. The regulations give the State Development Planning Commission responsibility for regularly publishing a Foreign Investment Catalogue, for use by the Ministry of Foreign Trade and Economic Cooperation			FDI enterprises are encouraged to reinvest in the central and western part of China. Re-investment projects with foreign-owned equity over 25% can enjoy the preferential treatment for FDI enterprises		
Fiji	The Foreign Investment Act, 1999 lays down the guidelines by which a foreign investor can invest in Fiji The following activities are prescribed for Fiji citizens only: Tourism Fishing Various services The above list is to be reviewed every 2 years by the Permanent Secretary for Commerce, Business Development and Investment	Joint ventures are encouraged in order to stimulate local entrepreneurship Foreign investment in forestry and fishing must have at least 30% local equity and various services at least 51% local equity	A foreign investor must not carry on business activity in Fiji unless granted a foreign investor certificate A foreign investor in banking must have a licence under the Banking Act A foreign investor carrying on business as a foreign exchange dealer must have a licence under the Exchange Control Act	In its 2001 budget the government has introduced a new investment taxation regime in order to attract foreign investments	Exchange control is administered by the Reserve Bank of Fiji through the Exchange Control Act. The rationale of exchange control in Fiji is to maximize and preserve the country's external reserves by having a firm control over foreign receipts and payments The prior approval of the Reserve Bank is required for the remittance of dividends and profits by companies upon provision of the latest audited accounts. Companies are allowed to remit the current year's profits and two years' retained earnings if not previously remitted. Remittance for offshore principal loan repayments requires the prior approval of the Reserve Bank	

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
India	The government has vastly expanded the list of foreign investment categories eligible for automatic approval by the Reserve Bank of India	100% FDI allowed in 100% export-oriented industries, units in free trade and export processing zones and power sector In June 2000 the government allowed 100% FDI in Internet services and business-to-business e-commerce ventures Up to 51% in 35 high priority industries Up to 50% in mining Minority share in all other cases	Automatic approval in 35 high priority industries and mining Case-by-case approval in all others	Tax holiday Income tax concessions Excise and customs duty draw backs Sales tax rebates Unconditional access to domestic credit	Foreign enterprises have the freedom to remit profits and repatriate capital, subject to foreign exchange considerations The rupee has been fully convertible on the current account since 1994, but all foreign-exchange transactions are subject to specific permission by the Reserve Bank of India, that is, anything not specifically authorized is prohibited. New rules effective June 2000 raised the ceiling on withdrawal of foreign exchange for a host of current-account transactions, including private and business travel abroad	All undertakings (Indian or foreign) have to conform to the general requirements of the government's industrial policy
Kazakhstan	Kazakhstan's generally liberal investment regime means that no sectors of the economy are closed to investors. However, major projects in oil and gas, power generation, and telecommunications are scrutinized closely Foreign and domestic investments in "priority sectors" (infrastructure, light industry, agriculture, housing, social investment in health/education, cultural facilities, tourism, investment in Astana) are encouraged	Although foreign capital is allowed to participate in most areas, there are some limitations in respect to the service sector: The total registered charter fund of all banks with foreign participation may not exceed 25% of the overall registered charter fund of all banks in Kazakhstan	The National Bank may grant exceptions on a case-by-case basis to foreign banks to enter the market, regardless of the limitation of 25% of ownership	The Foreign Investment Law does not provide investment incentives; however, tax incentives might be granted on a case-by-case basis by the Agency of the Republic of Kazakhstan for Investment. Created in 1997 and restructured in 1999, it is charged to promote investment, both foreign and domestic, in priority sectors, and to offer investment incentives:	The Foreign Investment Law, enacted in December 1994 and amended in the summer of 1997, provides guarantees to enterprises with foreign participation (at least 35% or $1 million) against expropriation, profits repatriation, currency convertibility, and equal protection under Kazakhstani law	The Foreign Investors Council provides foreign investors an institutional platform to express their needs and wishes to government officials

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
		The maximum foreign participation permitted in insurance and reinsurance organizations is 50% At present agricultural land is not privately owned. However, the government intends to privatize land and put restrictions on foreign ownership (only allowed to lease land)		Tax holidays up to 5 years and 50% reduction in the profit tax for another 5 years State grants of land, buildings or other facilities to the enterprise Release from customs duties for importing goods needed to implement the investment project The Law on Special Economic Zones (Astana, Kyzl-Orda, Lisakovsky, Zharirem-Atasuy) offers tax incentives		
Malaysia	Opening all industries to ASEAN by 2010 and to all investors by 2020, subject to the exceptions provided for in the agreement on the ASEAN Investment Area	Manufacturing industries are open to both foreign and local investors. 100% foreign equity is allowed and no export conditions are imposed. However, there are a few activities where joint ventures between foreign and local investors are required (plastic packaging, paper packaging, injection moulded components, wire harness, printing, steel centres and metal fabrication, stamping and electroplating). Further, industries affecting national security, public health and the environment are subject to restrictions Foreigners are allowed to own industrial land	The Malaysian Industrial Development Authority under the Ministry of International Trade and Industry has the primary responsibility	Incentives to encourage investments in high-tech industries, human resources development, R and D, regional development, software development, IT and multimedia development, and infrastructure development. The incentives are available to both domestic and foreign investors	All payments in foreign currency to non-residents for the repatriation of profits, dividends, interest, rental and commissions by foreign direct investors are freely permitted	Malaysia has concluded Investment Guarantee Agreements with 66 countries and organizations

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
Nepal	Foreign investment is allowed except in various service, tourist and defence-related industries. However, no restriction exists for the transfer of technology to these industries	Nepal encourages foreign investment as joint venture operations with Nepalese investors or as 100% foreign owned enterprises. The broad areas open for foreign investment include manufacturing industries, energy-based industries, tourism industries, mineral resource-based industries, agro-based industries and service industries	By the Department of Industry, if industries with fixed assets of up to 500 million rupees or by the Industrial Promotion Board, if below this limit	Tax incentives depending on the type of industry, for example export promotion; other national priority industries are granted higher tax exemption	Foreign investors who have received permission to invest in convertible foreign currency are permitted to repatriate the following outside Nepal at the prevailing exchange rate: Amounts received by sale of the whole or any part of the equity investment Amounts received as profits or dividends of foreign investment Amounts received as payment of principal and interest on foreign loans Amounts received under an agreement for the transfer of technology Foreign experts are permitted to remit up to 75% of their earnings in convertible currency	Nepal has signed Reciprocal Encouragement and Protection of Investment Agreements with France, Germany and the United Kingdom
Papua New Guinea	Certain business activities are reserved for locally owned or joint-venture enterprises (the reserved list). Business activities relating to manufacturing and construction were removed from the list in 1995, but from 1995 to 2000, only little progress in removal of further activities from the list	Private entities may freely establish, acquire and dispose of interests in business enterprises, subject to laws requiring registration and certification of companies	A foreign enterprise (one that is 50% or more owned by non-citizens, or is controlled by non-citizens) must be certified by the Investment Promotion Authority before it may conduct business	Incentives that involve the exemption from or deferment of tax liability for investors include an export-income incentive; a pioneer-industries scheme; a rural-development incentive; a wage subsidy; tax relief for staff training costs; and import-duty exemptions and draw-backs. All of these incentives are subject to conditions	Residents are required to repatriate foreign exchange receipts within six months of export, and are not permitted to retain foreign exchange earnings from any source without approval of the Bank of Papua New Guinea. Income from outward capital investment must be brought onshore as received	

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
Philippines	Planned liberalization of key industries: Telecommunications Shipping Aviation Mineral exploration Automotive industry Retail trade sector Banking sector Government-owned/ controlled corporations Planned deregulation of the oil industry Opening all industries to ASEAN by 2010 and to all investors by 2020, subject to the exceptions provided for in the agreement	Foreign equity of only up to 40% in the telecommunications, transport, agriculture on public land, and real estate sectors	May be required from the Board of Investments or the Export Processing Zone Authority or Subic Bay Metropolitan Authority	The incentive structure is being rationalized in order to focus fiscal incentives on industries that can significantly contribute to the attainment of the overall programme for national economic development: Enhanced income tax holiday Deferred imposition of the 2% minimum corporate income tax Double deduction for research and development Investment tax allowance Accelerated depreciation	Offshore financial market (foreign currency deposit unit market) in Manila, provided with regulatory and tax advantages over the domestic market. It functions as a vehicle to encourage worker remittances and foreign exchange deposits Free repatriation of the entire proceeds of the liquidation of the foreign investment in the currency in which the investment was originally made at the exchange rate prevailing at the time of repatriation Free remittance of earnings from the investments in the currency in which the investment was originally made and at the exchange rate prevailing at the time of remittance	Freeport regimes (Clark, Subic, Cagayan and Zamboanga) The government has signed Bilateral Investment Guarantee and Protection Agreements with 30 countries and has initiated a similar agreement with 5 other countries
Republic of Korea	Restrictions on FDI only apply in cases where national security, public order, public health, environmental preservation, or social morals are threatened As of January 2000, 99.4% business classifications open to foreign investment	Foreign equity ownership ceilings eliminated and hostile mergers and acquisitions by foreigners liberalized in May 1998	System of notification	Tax incentives to attract FDI under Special Tax Treatment Control Law	The guarantee of overseas remittance of dividends is protected in accordance with the Foreign Investment Promotion Act Overseas remittance of the dividends of stocks and equity owned by foreign investors, of the proceeds from	As of February 1999, the Republic of Korea has signed Bilateral Investment Guarantee Agreements with 50 countries

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
					sales thereof, of the principal and interest paid from long-term loan contracts, and of commissions and royalties paid pursuant to technology inducement contracts, guaranteed under the above Act Restrictions on the introduction of long-term loans by foreign investors were abolished in April 1998	
Singapore	All industries are open to foreign investment. Telecoms has historically been off-limits, but it is now changing with the privatization of Singapore Telecom (only exception is for reasons of national security)	In general 100% equity allowed Foreign institutions may hold stakes of up to 70% in local brokerage firms which are members of the Stock Exchange of Singapore (SGX-ST). However, ongoing reforms in the financial services sector are expected eventually to permit 100% ownership in local SGX-ST member companies	Every business must be listed with the Registry of Companies and Businesses Banks, finance companies, stockbroking firms, insurance companies etc. must secure licences from the Monetary Authority of Singapore Firms that intend to manufacture goods listed in the Control of Manufacture Act must obtain a licence from the registrar of manufacturers	Pioneer status: exemption from corporate tax for up to 10 years	No exchange controls: Funds can flow freely into and out of the country. No restrictions on Singapore dollar borrowing by non-resident firms, if the funds are used for economic activities in Singapore. Banks may also extend up to S$5 million in credit facilities to non-residents to finance investments in shares, bonds, deposits and commercial properties in Singapore (amounts above S$5 million require prior approval of the Monetary Authority). Capital inflow and repatriation (including repatriation of reinvested profits) is freely allowed in any currency	Singapore has signed investment guarantee agreements with 22 countries (besides participation in the ASEAN Investment Agreement) The business registration procedure for foreigners was streamlined in June 1999. A foreigner wishing to work does not have to produce an Employment Pass at the point of registration. Instead an Approval-In-Principle letter may be offered for registration purposes

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
Sri Lanka	Foreign investment is not allowed in: Money lending Pawn broking Retail trade with a capital investment of less than $1 million Personal services other than for export or for tourism Coastal fishing The export sector, tourism and infrastructure projects such as telecommunications, transport, housing and hospital projects enjoy preferential treatment	Total foreign ownership allowed in most areas Some activities have limits on foreign equity, either set on a case-by-case basis or by an automatic limit of 40% (depending on the activity)	Equity limits and approval decided by government agencies and/or the Board of Investment	The Board of Investment is empowered to offer special incentives for firms involved in: The manufacture and export of non-traditional products and services; The manufacture and supply of fabric and other accessories for the garment industry; The development and export of computer software (minimum investment $250,000) These incentives include preferential tax at 15% a year for a period of 20 years, duty-free imports of project related goods etc. The Board of Investment also offers: Tax holiday of five years for the growing and processing of agricultural products Preferential tax at 15% for infrastructure projects, the operation of resort hotels and hospitals etc. for 7 to 15 years	No restrictions on the repatriation of earnings and capital, or foreign exchange transactions relating to current account payments	The safety of foreign investment is guaranteed by the Sri Lankan constitution and through bilateral agreements with 20 countries

(Continued on next page)

Annex *(continued)*

	Access	*Ownership*	*Approval*	*Fiscal incentives*	*Exchange control*	*Other relevant aspects*
Thailand	The new Foreign Business Law, 2000, opens up several service and manufacturing business segments that were previously closed for reasons of national security, cultural importance or perceived vulnerability to outside competition. In exchange for the access, foreign firms will have to fulfil stringent requirements on technology transfers and management expertise Opening all industries to ASEAN by the year 2010 and to all investors by the year 2020, subject to the exceptions provided for in the agreement on the ASEAN Investment Area	For a period of 10 years from 1998, foreigners can buy, subject to the approval of Bank of Thailand, more than 50% stake in Thai commercial banks If over 50% of sales are for export, foreigners may hold the majority. If over 80% are for export, foreigners can own 100%. For projects in agriculture, fishery, mining as well as manufacturing for the domestic market, at least 51% Thai ownership is required	May be required from the Board of Investment, particularly for incentives	Major tax incentives include tax holidays, exemption or reduction of import duties on machinery and raw materials	Non-residents may lend in foreign currency to residents without restriction. Both capital and loans can be freely transferred into the country and must be surrendered to an authorized bank or deposited in a foreign currency account with an authorized bank within 7 days Repatriation of investment funds and repayment of overseas borrowing in foreign currency can be remitted freely upon submission of supporting evidence Securities, promissory notes, and bills of exchange may be sent abroad without restriction	The present incentive scheme is geared towards encouraging industrial decentralization. The magnitude of the incentives depends on the location of an investment project
Turkey	Nearly all sectors have been opened to foreign investments Exception: radio and television companies (in which foreign firms may hold no more than 20% of equity) and the transport of passengers within Turkish territorial waters (reserved for Turks)	No limitation on equity ratios The foreign investment law forbids investments that would create or become part of a monopoly	Foreign investors are subject to approval. The authorized approval agency for foreign investments, including capital increases, is the Undersecretariat for Treasury, General Directorate of foreign Investment	Foreign investors have access to incentive schemes on the same basis as local enterprises The government has liberalized oil-exploration rules and reduced import controls to make joint ventures more attractive to local operators	Free transfer of profits, fees and royalties as well as repatriation of capital	Turkey has signed agreements for the promotion and protection of FDI with 56 countries and is in various stages of negotiations with a number of others

Sources: ESCAP, based on IMF, *Staff Country Report,* various issues; UNCTAD, *World Investment Report 1999* (United Nations publication, Sales No. E.99.II.D.3); and national sources.

VII OFFICIAL FLOWS

Official development assistance has long been a cornerstone of international development cooperation. In recent years, its importance in global capital flows has significantly declined. In part, this is due to a fall in the absolute volume of ODA flows to developing countries. The decline in the relative importance of ODA is more importantly due to a dramatic surge in private capital flows. However, as noted in the preceding chapter, private capital flows tend to remain concentrated in a limited number of countries. The vast majority of developing countries are dependent on ODA for access to external capital. The objective of this chapter is to examine the trends in ODA flows to developing countries of the region and to draw attention to some policy concerns in this respect.

The chapter is organized as follows: the rationale underlying ODA is analysed first; this is followed by an examination of the trends in ODA flows to developing countries of the region, with a particular focus on the disadvantaged economies (least developed countries, Pacific island countries and the economies in transition); selected policy issues are then discussed.

RATIONALE

The rationale for ODA can be examined from the perspectives of both the donor and the recipient countries. From the perspective of the donors, there are at least three considerations which suggest that they should remain committed to the provision of adequate ODA. These relate to moral obligation, enlightened self-interest and global externalities.

The moral obligation stems from the persistent inequity in global development. One sixth of the world's population earns 78 per cent of world income, while three fifths, located in the poorest 61 countries, get only a 6 per cent share. An inevitable consequence of this grave inequality is widespread poverty. As noted in chapter III, around 800 million people within the ESCAP region lived in a state of dire poverty with less than $1 a day in 1998. In a rapidly globalizing world, characterized by extensive interactions among peoples through vastly improved transport and communication linkages, the knowledge of the existence of grim inequity and abject poverty is bound to weigh heavily on the moral sensibilities of the well-to-do. The moral obligation has been enshrined in the United Nations Millennium Declaration adopted by the Heads of State and Governments in September 2000 in New York. The Declaration recognized a collective responsibility to uphold the principles of equity at the global level. More specifically, it contains a commitment that the proportion of the world's people whose income is less than $1 a day would be halved by 2015.

There is also an enlightened economic self-interest on the part of the donor countries in providing assistance to the developing countries. A substantial part of ODA would most likely be directly spent by the recipient countries on importing essential consumer goods, intermediate inputs and capital equipment from the donor countries. In addition, when growth in the recipient countries accelerates as a result of development assistance, they can absorb an increasing flow of imports from the donor countries. It is also well known that among the major determinants of attractiveness of a country for FDI are the level of income and its growth prospects; physical infrastructure; and economic and social stability. In so far as ODA contributes to improvements in these determinants, the recipient countries could become attractive for investment by investors from the donor countries. Moreover, foreign private investors' confidence is bolstered when a country receives ODA.

Self-interest may also be relevant in the area of security. Internal conflict in some developing countries, as well as the large-scale exodus of people and the spillover of crime, including the export of drugs, could be avoided if the development of the poorer countries could be accelerated. ODA obviously has a role to play in this context.

Another rationale for ODA lies in the provision of global public goods. Some examples are the control of epidemic diseases and environmental damage whose adverse effects cannot be contained within national boundaries. Concerns of this nature can be addressed effectively only through international cooperation, as no individual country is likely to make adequate provision for them because of associated externalities.

From the perspective of the recipient countries, there are many justifications for ODA. As with any other external capital inflow, ODA helps bridge the well-known gaps faced by many developing countries. In the first place, such countries suffer from a savings-investment gap with limited potential and capacity to raise domestic savings to finance the level of investment required to bring about reasonable improvements in living standards. Second, their exports, often characterized by a lack of diversification and heavy reliance on primary commodities, are unable to meet import needs, giving rise to a foreign-exchange gap.

ODA has certain distinct advantages over other forms of external capital inflow. The capacity of many developing countries to attract FDI is severely constrained by structural handicaps. These include the small size of their economies owing to their small population or low level of per capita income or both, geographical features (landlocked or small island countries), poor physical infrastructure and a low level of human resources development. In addition, FDI, which is motivated primarily by commercial considerations, cannot be expected to finance investment in people, institutions or good governance where returns on investment are usually not direct and may have a long gestation period. Investment in basic education, primary health care and many other aspects of social development can hardly be expected to be financed by foreign or, for that matter, even local private investors. ODA can play a critical developmental role in these areas.

Similarly, the preconditions that need to be satisfied to attract foreign portfolio capital do not exist in many developing countries. Such flows usually require open capital-account regimes, well-developed capital-market institutions and effective regulation and prudential supervision of the banking system.

Furthermore, many developing countries cannot attract bank loans at reasonable cost. They would have either no access because of perceived lack of creditworthiness or the cost of such access would be unbearably high.

In sum, foreign private capital in the form of FDI, portfolio investment or bank credit is not much of an option for many developing countries. ODA is essential for them to be able to bridge the savings-investment gap and the foreign-exchange gap. Moreover, private flows generally tend to be volatile and sudden outflows can have devastating economic and social consequences. In contrast, ODA is usually a more stable and predictable source of capital inflow that can be immensely useful for fostering growth momentum.

Finally, the conditionalities associated with ODA, if properly designed and owned by policy makers in the recipient countries, can be potent instruments to encourage policy and institutional reforms. Where such reforms appear unpopular, owing to either transitional costs imposed on society at large or their adverse effects on entrenched vested interests, the potential deprivation of ODA can be used by the recipient countries' policy makers as an argument for pushing the required reforms.

TRENDS IN AND CURRENT DISTRIBUTION OF ODA

In 1970, the General Assembly set a target for ODA at 0.7 per cent of the GNP of developed countries.[1] Even during the 1990s, very few donor countries achieved this target. Among the 21 member countries of the OECD Development Assistance Committee (DAC), only four (Denmark, the Netherlands, Norway, and Sweden) met the target (table VII.1). The five largest donors of 1998 in terms of

[1] International Development Strategy for the Second United Nations Development Decade (General Assembly resolution 2626 of 24 October 1970), para. 43.

Table VII.1. Net ODA from member countries of the Development Assistance Committee as a percentage of GNP, 1990-1998 (ranked by 1998 figures)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Denmark	0.94	0.96	1.02	1.03	1.03	0.96	1.04	0.97	0.99
Norway	1.17	1.13	1.16	1.01	1.05	0.87	0.85	0.86	0.91
Netherlands	0.92	0.88	0.86	0.82	0.76	0.81	0.81	0.81	0.80
Sweden	0.91	0.90	1.03	0.99	0.96	0.77	0.84	0.79	0.72
Luxembourg	0.21	0.33	0.26	0.35	0.40	0.36	0.44	0.55	0.65
France	0.60	0.62	0.63	0.63	0.64	0.55	0.48	0.45	0.40
Belgium	0.46	0.41	0.39	0.39	0.32	0.38	0.34	0.31	0.35
Finland	0.65	0.80	0.64	0.45	0.31	0.32	0.34	0.33	0.32
Switzerland	0.32	0.36	0.45	0.33	0.36	0.34	0.34	0.34	0.32
Ireland	0.16	0.19	0.16	0.20	0.25	0.29	0.31	0.31	0.30
Canada	0.44	0.45	0.46	0.45	0.43	0.38	0.32	0.34	0.29
Japan	0.31	0.32	0.30	0.27	0.29	0.28	0.20	0.22	0.28
Australia	0.34	0.38	0.37	0.35	0.34	0.36	0.28	0.28	0.27
New Zealand	0.23	0.25	0.26	0.25	0.24	0.23	0.21	0.26	0.27
United Kingdom	0.27	0.32	0.31	0.31	0.31	0.29	0.27	0.26	0.27
Germany	0.42	0.40	0.38	0.36	0.34	0.31	0.33	0.28	0.26
Portugal	0.25	0.31	0.36	0.28	0.34	0.25	0.21	0.25	0.24
Spain	0.20	0.24	0.27	0.28	0.28	0.24	0.22	0.23	0.24
Austria	0.25	0.34	0.30	0.30	0.33	0.33	0.24	0.26	0.22
Italy	0.31	0.30	0.34	0.31	0.27	0.15	0.20	0.11	0.20
United States	0.21	0.20	0.20	0.15	0.14	0.10	0.12	0.09	0.10
Total DAC	0.33	0.33	0.33	0.30	0.30	0.27	0.25	0.22	0.24

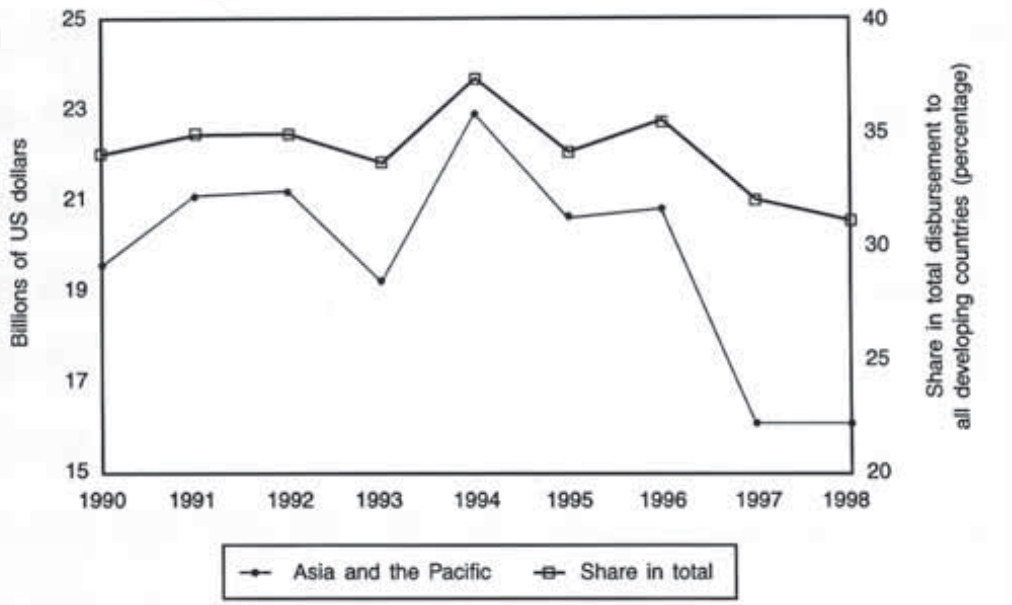
Sources: OECD, *Development Cooperation Report*, various issues and *DAC Journal*, various issues.

absolute amount (Japan, the United States, France, Germany and the United Kingdom) fell considerably short. Of significant concern is the declining trend in ODA as a proportion of GNP in most donor countries. The decline has been particularly sharp in the United States whose contribution to ODA as a proportion of GNP has more or less consistently fallen over the 1990s, reaching 0.10 per cent in 1998, less than one half of the 0.21 per cent achieved in 1990. In the process, the United States has become a distant second largest donor, with Japan emerging as the largest donor. For DAC countries as a group, the proportion of ODA to GNP fell from 0.33 per cent in 1990 to 0.24 per cent in 1998.

This trend had its inevitable impact on the flow of ODA to the ESCAP region. The total net disbursement of ODA to the region peaked at $22.9 billion in 1994 and fell to $16.1 billion in both 1997 and 1998, the lowest figure during the 1990s (figure VII.1). This also represented the lowest-ever share of the region in total disbursements to all developing countries.

It could be argued that the decline in the share of the ESCAP region in the flows to all developing countries is justified by the fact that a number of countries achieved tremendous economic progress during the last decade. They gained access to private sources of external finance with ease. The argument undoubtedly has a degree of validity. However, it is worrisome that the decline in the quantum of flows to the region and its share has not spared the least developed countries. Some of them suffered a

Figure VII.1. Net ODA disbursements to developing countries of the ESCAP region, 1990-1998



Source: ESCAP, based on OECD Development Assistance Committee, *Statistical Reporting Systems*, online databases available at <http://www.oecd.org/dac/htm/dacstats.htm>.

drastic decline in terms of per capita net ODA receipts during the 1990s (table VII.2). Of the 13 least developed countries in the region, only three (Cambodia, Lao People's Democratic Republic and Tuvalu) recorded an increase, while all the others experienced a notable decline, amounting to as much as 50 per cent for Myanmar.

Table VII.2. Least developed countries in the ESCAP region: percentage change in net ODA receipts per capita between 1990-1992 and 1996-1998

Decline			*Increase*
0 to 25 per cent	*25 to 50 per cent*	*50 per cent and over*	
Bhutan	Afghanistan	Myanmar	Cambodia
Maldives	Bangladesh		Lao People's Democratic Republic
Nepal	Kiribati		Tuvalu
Solomon Islands	Samoa		
	Vanuatu		

Source: United Nations, based on OECD Development Assistance Committee, *Statistical Reporting Systems*, online databases available at <http://www.oecd.org/dac/htm/dacstats.htm>; and United Nations, *Monthly Bulletin of Statistics*, online available at <http://www.un.org/depts/unsd/sd_databases.htm>.

At this point, it is worthwhile to examine briefly the economic characteristics of the ODA dependent economies in the region. There were 18 countries with an ODA/GDP ratio of 2 per cent or more according to the available data in 1998 (table VII.3). All these countries are either least developed or landlocked or small island economies located far from the world's metropolitan centres and main shipping routes, or economies in transition. From the point of view of attracting private capital, they suffer from varying combinations of a number of structural disadvantages. These include small population size and low levels of per capita income. Only island countries with very small populations had a per capita income level exceeding $500 in 1998. The total GDP in the country with the largest population, Bangladesh, was less than one half that of Singapore. The other structural disadvantages included poor physical infrastructure, particularly transport and communications; inadequate human resources development; vulnerability to natural calamities; and the poor state of institutional development. The inherent unattractiveness of these countries for private capital is reflected in paltry volumes of FDI, with the exception of a few natural resource-rich countries, such as Azerbaijan and Papua New Guinea, or the ones with comparatively large populations, such as Bangladesh, Cambodia and Viet Nam.

Table VII.3. Developing countries in the ESCAP region with an ODA/GDP ratio of 2 per cent or more[a]

	ODA (millions of US dollars)	*ODA/GDP (percentage)*	*Population (millions)*	*Per capita GNP (US dollars)*
Kiribati	17.3	38.3	0.1	1 170
Lao People's Democratic Republic	281.4	22.3	5.0	320
Mongolia	203.5	19.5	2.4	380
Vanuatu	40.6	18.0	0.2	1 260
Samoa	36.4	16.7	0.2	1 070
Tonga	25.6	14.8	0.1	1 750
Solomon Islands	42.6	14.2	0.4	760
Bhutan	55.7	14.0	0.6	470
Kyrgyzstan	216.1	12.7	4.8	380
Cambodia	337.1	11.7	11.4	260
Papua New Guinea	361.1	9.6	4.3	890
Nepal	404.3	8.5	21.8	210
Armenia	138.5	7.3	4.0	480
Maldives	25.0	6.8	0.3	1 130
Viet Nam	1 162.9	4.3	75.4	350
Bangladesh	1 251.1	2.9	126.2	350
Fiji	36.5	2.3	0.8	2 210
Azerbaijan	88.7	2.3	7.6	480
Total ODA	4 724.4			

Sources: ESCAP secretariat calculations based on World Bank, *World Development Indicators 2000, World Development Indicators*, various issues, and *World Development Report 1999/2000* (Oxford University Press, 2000); ADB, *Key Indicators of Developing Asian and Pacific Countries, 2000* (Oxford University Press, 2000); and OECD, *Geographical Distribution of Financial Flows to Aid Recipients 1994-1998* (Paris, 2000).

[a] All data relate to 1998.

SELECTED POLICY ISSUES

Aid fatigue

The declining trend in ODA has been demonstrated above. In part, this is due to the perceived need of donor countries to improve their fiscal balance. When a donor government faces domestic pressure to reduce fiscal deficit or balance the budget, perhaps the least unpopular way of bringing about a cut in government expenditure is to reduce the level of ODA. In part, the declining trend is probably attributable to the unwillingness of the donor countries' taxpayers to fund ODA because of the notion that they were making a large sacrifice. However, the per capita ODA contribution from DAC donor countries averaged only $66 a year in the period 1996-1997, declining from $75 a decade earlier.[2] The present level of per capita contribution is a miniscule proportion of per capita income in most donor countries. The level of per capita income was as high as $32,380 in Japan and $29,340 in the United States in 1998. Looking at the issue from the regional perspective, the total amount of ODA received by substantially aid-dependent countries in the Asian and Pacific region was $4.72 billion in 1998 (table VII.3). If this amount were to be doubled, it would again be a very small proportion of the GNP of the donor countries, which amounted to some $22 trillion in the same year.

It is not, perhaps, unreasonable to assume that the taxpayers in donor countries are not very much aware of the quantitative smallness of their contribution. One way of dealing with aid fatigue may, therefore, be for the governments of donor countries to educate the public in this regard. In addition, the donor governments could undertake serious efforts to make the public better informed of the mutuality of interests discussed earlier.

Aid, savings and growth

To some extent, the aid fatigue in donor countries may also be due to the perception that much of the aid is misappropriated by corrupt officials and does not serve the purpose of promoting growth in the poor countries. To an extent, this perception may have some validity. A portion of aid may be either misappropriated outright or misused for projects which make no lasting contribution to economic growth.

The effect of foreign capital inflow generally, and of aid in particular, has been subjected to considerable empirical investigation since the 1960s. The results are mixed, with some showing that aid contributes positively to savings, investment and economic growth while others show contrary results. A recent article[3] that surveyed the relevant literature concluded that empirical estimates of the effects of foreign aid varied widely with the samples, model specifications and empirical methods. The extent of resource interchangeability was the critical determinant of the extent to which foreign aid was channelled into higher domestic consumption or savings and investment. A more recent study[4] notes that aid has had a greater positive impact on growth in good policy environments. This study also noted that there was no significant tendency for bilateral aid to favour good policy. In contrast, multilateral aid was allocated in favour of good policy. Furthermore, the study observed that many recipient countries had, in fact, improved their policy environment in recent times. It was, thus, ironic that the amount of aid was diminishing while the effectiveness of aid was improving because of policy improvements by the recipient countries.

The impression that aid may be counterproductive for economic growth does not seem to have much of prima facie validity in the ESCAP region. Several reasons can be cited to substantiate this. A number of countries in East and South-East Asia that were substantially dependent on ODA in earlier years have been able to achieve remarkable growth in the 1980s and 1990s and have ceased their dependence on ODA. A recent ESCAP study[5] which examined the effect of aid on economic

---

[2] United Nations, "The path to increased official development assistance", paper for the Executive Committee on Economic and Social Affairs, p. 7.

[3] Klaus Schmidt-Hebbel, Luis Servén, and Adrés Solimano, "Saving and investment: paradigms, puzzles, policies", *The World Bank Research Observer*, vol. 1, No. 1 (February 1996), pp. 87-117.

[4] Craig Burnside and David Dollar, "Aid, policies and growth", *The American Economic Review* (September 2000), pp. 847-868.

[5] ESCAP, *Enhancing Effectiveness of Aid* (United Nations publication, Sales No. E.99.II.F.63).

growth in selected least developed countries of the region found that aid made a significantly positive contribution to economic growth. Moreover, it is worth mentioning that, irrespective of what happened to ODA flows, the domestic savings/GDP ratio in most of the least developed countries of the region has shown an upward trend during the 1990s.

It should be emphasized that the above findings do not absolve the recipient countries of their responsibility to strengthen efforts to maximize the benefits of ODA through, inter alia, allocation to sectors and activities that promise the highest social return and speedier utilization. The experience in several least developed countries in the region has been that large amounts accumulated in the aid pipeline because of delayed disbursement. The cooperation of donor countries should be sought, where needed, to expedite disbursement.

Terms and conditions of aid

In addition to the quantity of aid, one of the concerns from the viewpoint of the recipient countries relates to the financial terms on which aid is offered so that servicing liability does not become onerous. These terms have to do with the grant element, grace period, maturity and interest charged. ODA, by definition, contains a substantial grant element and by the late 1990s, the grant element had reached over 90 per cent for DAC donor countries as a group. The average maturity of bilateral ODA loans was close to 30 years, the grace period was slightly less than 10 years and the interest rate was less than 2.5 per cent.

Another important concern relates to the requirement, sometimes imposed by the donor countries, that the procurement made out of aid finance should be sourced from the donor country. This is known as tied aid. Most DAC members have obtained short-term economic benefits to their economies from aid procurement. However, since the recipient is not permitted to search for the lowest cost equipment, materials or services, but is forced to accept the prices of firms from the donor country, the tying of aid is subject to criticism as a potential source of aid and trade distortions. Developing countries should have a free choice of the most appropriate and economic source of supply, and should be allowed to reap the benefit of international competitive bidding in bilateral, as well as in multilateral, aid. Since untying aid might lead to a decline in costs, donors should continue their efforts either to untie aid or to make the prices of the tied aid commodities competitive.

There remains considerable scope for improvement. As of 1996, some 30 per cent of the bilateral ODA of all DAC countries remained tied.

Another issue of considerable concern to some recipient countries, particularly the disadvantaged ones, relates to the use of ODA for local and recurrent cost financing. Some of these countries face a problem in utilizing ODA expeditiously as they are not able to make budgetary provisions to meet local currency costs of aid-funded projects. In some instances, the potential benefits of aid-funded projects are not fully realized because of the inability of the recipients to provide for the required recurrent costs. For example, if schools or hospitals are built with aid finance without adequate provisions for teachers or doctors to keep them fully operational, the benefits would be undermined.

It is recognized that the recipient countries should make the best efforts to meet local and recurring costs to demonstrate their commitment and to avoid perpetual dependence on ODA. However, in some instances, they may have to be allowed to make use of ODA for such costs.

Aid coordination[6]

ODA is administered by many different agencies in both donor and recipient countries. The presence of many multilateral or bilateral agencies is not an unalloyed benefit. A multiplicity of programmes, if uncoordinated, can work at cross purposes and impede aid effectiveness. Different donor agencies have often argued for different types of programmes and different types of supporting domestic policies.

In recognition of the above problems, efforts have been made at different levels to improve aid coordination. Some donor countries have reorganized their aid agencies. For example, Sweden

6 This and the following section are based on United Nations, "The path to increased official development assistance", op. cit.

reduced the number of its development cooperation agencies to two: one to handle long-term cooperation with the poorer developing countries and the other to manage aid activities in the industrial and infrastructure sectors. The United States has overhauled the Agency for International Development, simplifying its structure and focusing its efforts toward achieving sustainable progress in the areas of economic growth, population, health, environment and democracy. The European Union decided to simplify the organizational structure of its aid programme, develop an overall policy statement to guide assistance, raise management efficiency and increase coordination with member States. The Canadian International Development Agency has sought to build a coherent overall approach to aid management internally and externally, involving on the one hand, more interaction with other Canadian Government departments and on the other hand fostering development of mechanisms whereby participants from donor and beneficiary countries could formulate activities collectively in a more effective manner. Norway is also emphasizing increased policy dialogue with aid recipients, as well as the gradual transfer of responsibility for planning and implementation of programmes to local counterparts.

At the international level, efforts are being made to promote the overall coherence and efficiency of assistance to a country through programmes agreed with recipient governments. The leadership role in this coordination function has typically been taken by the Bretton Woods institutions, particularly the World Bank. In many cases, the World Bank takes the lead in convening donors in a country in order to commit jointly to an assistance programme, such as through the Consultative Group mechanism. In the case of some least developed countries, the convening of donors for aid programmes is organized by UNDP, in a comparable process of Round Tables.

Moreover, beginning with the need to coordinate its own programmes more effectively with those of other donors in each borrowing country, the World Bank has recently introduced the comprehensive development framework as a coherence-enhancing device. In addition, the United Nations system is in the process of establishing the United Nations Development Assistance Framework (UNDAF) to become a country-driven, collaborative and coherent planning framework for the development operations of the United Nations system at the country level.

At the same time, recognizing that the political responsibility for coordinating development assistance lay with the aid-receiving countries, the international community has helped them to strengthen their capacity to take charge of international aid programmes effectively. For many years, national capacity-building has been at the heart of the assistance strategy of UNDP and continues through the development of UNDAF. It is also reflected in many of the programmes of technical assistance undertaken by the United Nations and increasingly by the World Bank as well.

Along with the well-justified international effort to improve policy coherence, managerial control and operating efficiency of ODA, there is also a danger. It might not serve the development of a country if there was donor unanimity on a global development policy as that policy might not suit a country's particular stage of development. Indeed, authorities in developing countries should have the capacity to develop and the opportunity to "sell" their project proposals to potential donors, just as entrepreneurs have to sell their ideas to investment bankers. Even after half a century of development cooperation, not enough is known about a process as complicated and differentiated as development to let the advocates of a particular approach in any one institution control the debate or the kinds of development policies that can be supported through ODA. The political authorities in developing countries have to be informed decision makers and this means that capacity-building for programme development, assessment, choice and oversight in developing countries is crucial to development.

The focus on poverty eradication

While ODA remains a heterogeneous mixture of expenditures disbursed by a variety of donors and institutions, the attention of ODA donors has increasingly focused on the social aspects of development, and especially the eradication of poverty. Poverty, of course, is not the exclusive focus, as appeals are still made to support sustainable development, which is a broad concept.

However, the 1995 World Summit for Social Development, held in Copenhagen, appears to have struck a responsive chord in the donor community

and in the global public, putting poverty and social development at the centre of the policy agenda. Indeed, poverty eradication cuts across most of the arguments for ODA discussed in the previous section. Moreover, a truly pro-poor development strategy, one that seeks to speed the integration of poor people – women and men, rural and urban – into the economic mainstream, is a most promising strategy for successful development.

Thus, some donors have sought to refocus their aid policies on poverty eradication. The Netherlands, for example, has recently concentrated its aid on fewer countries, based on the degree of poverty and on the quality of the recipient governments' economic and social policies and governance. Danish aid policy has also given priority to targeting aid towards the poor and the integration of the needs of women, children and the elderly within the broader aim of combating social exclusion and promoting social integration. Austria has set up a central office to monitor and oversee development activities geared towards poverty alleviation.

Despite an unquestionable change in the rhetoric and donor management reforms, progress towards the Copenhagen goals, including re-allocation of expenditures by donors, in particular, bilateral ODA, has been limited so far. Bilateral ODA commitments for the social sector, which peaked in 1995, declined annually until 1997 before recovering slightly in 1998. However, as overall commitments fell faster, the share of the social sector within the total rose, reaching 30 per cent in 1998. Notwithstanding this, ODA for basic social services, the main focus of the Copenhagen commitments, still accounts for only 10 per cent of the total.

The focus on poverty is now being given greater attention by IMF, as reflected in the agreement of the Interim and Development Committees in September 1999 to incorporate poverty reduction strategies into IMF programmes, supported by the Enhanced Structural Adjustment Facility, the Fund's concessional lending arm for low-income countries. To emphasize the change, the facility was renamed the Poverty Reduction and Growth Facility. Poverty reduction is also to become an intensified focus of the International Development Association (IDA), the concessional lending arm of the World Bank.

In this context, IMF and the World Bank are introducing a new process to implement the greater focus on poverty reduction. The process can also be seen as an effort to devolve responsibility for aid programmes and policies to recipients, albeit in a donor-guided way. It envisages that all countries borrowing from IDA and the Poverty Reduction and Growth Facility of IMF will prepare "poverty reduction strategy papers" in collaboration with IMF and the World Bank. The papers are to be country-driven, emphasizing the participation of civil society.

That the views of all relevant stakeholders are to be taken into account can be considered desirable. But many questions will have to be dealt with in the implementation. How is the selection of stakeholders made? Who represents the stakeholders? When there are differences of views among stakeholders, who resolves them? To what extent are the governments genuinely committed to the strategy outlined in the paper?

Debt relief

The effectiveness of current aid programmes can be seriously undermined by the accumulated debt burden. Debt-service payments subtract from the volume of disbursements available for developmental purposes. The international community recognized the serious debt predicament for a number of low-income countries, mostly in Africa. In 1996, the Debt Initiative for Heavily Indebted Poor Countries was launched. The Initiative was further enhanced in 1999 to provide deeper, broader and faster assistance to eligible countries.[7]

Notwithstanding the broad support for the enhanced Initiative, by the end of April 2000, the required financing for the Initiative could not be met; about 60 per cent of the contributions pledged had either been received or were being contributed according to an agreed schedule. From the ESCAP region, only one country, Myanmar, is expected to reach the decision point by 2001 or later for consideration under the enhanced Initiative. In this context, it is crucial that the resources pledged for

[7] For a detailed discussion of the eligibility criteria under the enhanced Initiative, see IMF, *Annual Report 2000* (Washington DC, 2000), pp. 50-55.

the Initiative are truly additional and do not detract from normal ODA flows to the countries of the region. They are not entitled to debt relief because they have performed well. The better performance should not deprive them of their legitimate ODA claim, which is justifiable on the basis of severe structural deficiencies. There is no doubt that many countries outside the Asian and Pacific region are in dire need of, and eminently deserve, substantial debt relief. But, such relief, if it involves diversion of ODA from countries which have succeeded in avoiding a heavy debt burden through good economic management, can be viewed as a perverse incentive of the international aid system.

VIII INTERNATIONAL SYSTEMIC ISSUES

REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

Following the reduction in ODA flows, national efforts to mobilize external resources from the private sector have assumed much greater importance, as discussed in the preceding chapters. Such efforts, in turn, inevitably imply closer integration with the international financial system. However, that system has been beset by serious bouts of instability over the last 20 years, with adverse consequences for the developing countries as a group, involving sharp reductions, or reversals, in the flow of resources or significant increases in costs, or both. Following the collapse of the Bretton Woods regime, for instance, at least three such episodes can be listed: the debt crisis of the early 1980s, the Mexican default of 1994-1995 and the Asian financial and economic crisis of 1997-1998. A stable international financial environment is thus a prerequisite for national efforts to raise external resources for development.

Since 1997, it has also become apparent that the sharp volatility in exchange and interest rates experienced by developing countries is often caused by swings in sentiment in the international financial markets. In many instances, the swings are unrelated to the macroeconomic fundamentals of these countries. In other words, international financial integration has generated new complexities in the conduct of economic policy in developing countries.

One serious consequence of international instability is that it generates unhealthy uncertainty at various levels. While uncertainty about the future is an unavoidable element in economic decisions, widespread and endemic uncertainty can seriously undermine not only the policy-making ability of national institutions but also the ability of individual savers and investors to take rational decisions about the future. Risk aversion is intensified and decision-making time horizons become shorter. Reform of the international financial system is thus integral to the question of having a stable flow of both domestic and external resources for financing development.

The international financial system comprises not only the international financial institutions, both public and private, and the financial markets, but the host of agreements, norms, codes of practice and conventions that govern the functioning of these institutions and markets. All the different features mentioned here have both national and international dimensions. National dimensions can be dealt with more easily. However, national action can satisfy the need for stability only partially; action is also needed at the international level in terms of coordination, setting standards and overcoming the informational asymmetries that exist between national jurisdictions.

International systemic reform therefore requires initiatives on many fronts. The principal objective of this chapter is to highlight the central issues that would have to be confronted in the pursuit of reform. The issues in reform are examined primarily from the standpoint of crisis prevention, that is, to ensure that the system is less prone to the periodic bouts of serious instability witnessed in recent years. The discussion of reform, or what also goes under the rubric of reform of the international financial architecture,[1] looks first at the context within which issues pertaining to systemic reform have arisen, then at the rationale for reform and the objectives sought to be achieved by reform and, finally, at an outline of action that might be considered at the international, regional and subregional levels to improve the role of the international financial system in meeting the external financing needs of developing countries.

---

[1] For an earlier discussion on this subject, see *Survey 1999*, chap. I, pp. 17-21.

CONTEXT, RATIONALE AND OBJECTIVES OF REFORM

One of the striking developments of the last two decades has been the phenomenal increase in private long-term, cross-border financial flows to the developing countries. These flows went up by a factor of nearly six between 1986 and 1996. Short-term flows substantially raised further the quantum of private flows to the developing countries. After 1997, there was initially a diminution in both long-term and short-term flows following the crisis and a flattening-out in 1998 and 1999. ODA rose slightly, but private flows are several times the level of ODA even at their reduced volume.

However, even at the relatively high volumes of 1997, private financial flows to developing countries pale into insignificance when compared with the size of cross-border flows of private capital as a whole. For instance, net issuance of debt securities alone by the developed countries amounted to $1.2 trillion in 1999, 48 times the amount for the developing countries. Cross-border claims of BIS reporting banks on the developed countries amounted to a further $500 billion, while cross-border transactions in bonds and equities in the United States alone, that is, purchases and sales between residents and non-residents, amounted to nearly 180 per cent of United States GDP.[2] Similar volumes of such transactions apply to several other developed countries.

What these orders of magnitude imply is the huge impact that relatively minor shifts in such flows into or out of the developing countries could have on them. Exchange rates and capital markets in the developing countries would become far more volatile, and acutely vulnerable to quite small changes in overall investor sentiment, producing shifts between countries or regions. Such changes could have major disruptive consequences, not merely for variables such as the exchange and interest rates but also for the real economy and eventually for the social sectors. More seriously, through contagion and spillovers, they could envelop entire groups of countries in financial, economic and social instability.

The 1997 crisis in Asia is a case in point. As the financial crisis developed and exchange parities depreciated, GDP contracted, inflation increased and unemployment soared. Public expenditures on health and education were frozen or reduced as national budgets came under pressure. These effects were felt not merely in the countries directly affected by the crisis but also in others where, too, the pace of GDP growth slowed sharply through trade and financial market linkages. The increase in unemployment led to an increase in both absolute and relative poverty, insecurity, a rise in crime, mental stress, industrial unrest, racial and ethnic strife and political instability. Most of these effects are visible in varying degrees even today, more than three years after the onset of the crisis.[3]

The national systems of financial regulation and supervision in the developing countries, however well-designed and well-implemented, are simply not able to cope on their own with the impact of such bouts of externally generated financial instability. A more effective system of international financial sector management, built upon new modes of international financial cooperation, is clearly required.

International cooperation has its greatest justification when meeting challenges that transcend national boundaries. Obvious examples are the environment, fighting disease and combating drug-smuggling. The control of money-laundering is a new challenge requiring enhanced cooperation between national financial systems. Likewise, lessening international financial instability can also be justified as a new, and perhaps more formidable, challenge needing international cooperation. Cooperation to address the reform of the international financial architecture is needed in two interrelated situations: first, when the coordination and harmonization of actions and procedures lead to greater legitimacy, efficiency and effectiveness than uncoordinated national initiatives, for example, in setting standards and norms; and second, when individual countries lack the incentive to act because they cannot capture the full rewards from doing so, for example, in gathering and disseminating relevant market information.

---

[2] Bank for International Settlements, *70th Annual Report*, June 2000, pp. 90, 112 and 120.

[3] *Survey 1999*, chap. III, "Social impact of the economic crisis", pp. 113-134.

Reform of the international financial architecture can be best justified by looking at it as a public good.[4] Public goods normally imply that consumption by an agent will not reduce the amount available for others. At the same time, public goods are non-excludable in the sense that a provider cannot prevent agents who have not paid for the goods from benefiting; hence the need for the collective provision of public goods.

In international finance, as in many other activities, reliable market information is the key to good decision-making. Individual market participants have neither the resources to collect the information that they need in order to make decisions nor, were they to do so, any incentive to share it with others, who would be freeriders. But the international financial system is diffused. It has no central or apex body for collecting all the relevant information, or for oversight and regulation. The responsibility for carrying out these tasks is divided between national and international bodies and between public and private sector bodies, and is often performed inadequately and in an uncoordinated manner.

Systemic risk, on the other hand, crosses national boundaries and straddles institutional functions and legal systems. Informational asymmetries are significant and risks difficult to assess. In the present institutional structure the public good function is clearly under-provided. Despite these drawbacks, the volume of internationally mobile capital has multiplied, as observed earlier. At the same time, the complexity and diversity of the activities of the financial industry have strained the national supervisory capacity for overseeing its activities. Following the 1997 crisis, some progress has been made in improving and strengthening national financial system operations and regulation, and in some areas of regional or subregional cooperation, but at the international level the system still lacks a credible and coherent framework of oversight and supervision.

[4] See United Nations, "Towards a stable international financial system, responsive to the challenges of development, especially in the developing countries", report of the Secretary-General (A/55/187/Add.1), paras. 4-6.

Keeping this background in view, the objectives of international systemic reform are essentially the following: (a) to prevent relatively isolated bouts of instability in national financial markets from developing, through contagion, into full-blown sub-regional or regional crises, such as through reducing gaps in information, improved monitoring and surveillance and better early warning systems; (b) to establish institutions that embody formal or informal cooperative arrangements with mandates for the containment or resolution of crises when they occur, through such means as providing pools of liquidity; (c) to have agreed and transparent conventions and norms for national financial systems, such as capital adequacy and loan loss provisions in banks; (d) to have established mechanisms for debt workouts; and (e) to have mechanisms for limiting access to external funds for over-borrowed countries and corporate entities. The purpose of these reform objectives is to establish a framework that promotes stability in the international financial system and one in which private and public sector resources and institutions can combine to sustain long-term development in the developing countries.

Containing contagion

A major recent problem has been the transfer of financial market and macroeconomic instability from one country to another. This has both national and cross-border implications. A striking feature of the 1997 crisis in Asia was the speed with which it spread from Thailand to other countries in the region. In fact, the collapse of investor confidence and the scramble for liquidity led to a severe tightening of credit conditions, not only for developing countries but also for some borrowers in the developed countries.

Exchange rate policy

A common feature of the countries affected by contagion was an explicit or implicit commitment to defend their existing exchange rate parities. The reasons for the commitment were wide-ranging. One of these was a desire to preserve the momentum of growth against a justified fear that forsaking the parity could cause a large devaluation which would unleash a massive surge of corporate insolvencies, given their large foreign-currency-denominated borrowings. These insolvencies would,

in turn, generate adverse knock-on effects on the financial sector. Preserving the bilateral parity with the United States dollar was taken to be a key element in avoiding those risks. The degree of success achieved in defending a particular exchange rate parity was, however, dependent upon the availability of net foreign exchange reserves, more particularly the ratio of usable reserves to short-term debts. Thus, while Indonesia, the Republic of Korea and Thailand suffered large exchange rate depreciations as their short-term debts far exceeded their reserves, both Hong Kong, China and Singapore were able to stave off speculative pressure in this regard, albeit at considerable cost as interest rates had to rise substantially.

When faced with unrelenting pressure, several countries were forced to abandon fixed exchange rate parities. This was due partly to the fear emanating from the potential exhaustion of foreign exchange reserves that defending an existing parity might involve, but more to justified reluctance on the part of the governments concerned to maintain high interest rates for long enough to fend off the pressure and the loss of output and employment this would entail in the intervening period.[5]

As of now, the debate regarding the merits and demerits of fixed versus flexible exchange rates remains unresolved. Fixed exchange rates are inherently more susceptible to speculative attack. On the other hand, a floating parity deprives investors, especially cross-border investors, of an anchor for decision-making. A balance between them is not easy to strike. A number of countries have shifted, or are considering doing so, to inflation-targeting as a result. Public confidence in the new regime will take time to build up. In the meantime, investors need to be better educated in the policy trade-offs involved in the shift and the reasons why the shift is desirable.

Another characteristic of contagion is that the globalization of financial markets involving many relatively new investors may have reduced incentives for information-gathering. They may have strengthened herd behaviour as expectations are formed on the basis of imperfect and asymmetric information. Furthermore, at the onset of a crisis, investors customarily reassess risk in all countries and may, in the process, adopt more demanding criteria even for those countries whose fundamentals have remained unchanged. In such a situation, panic can set in among investors on the grounds that an ill-informed decision was taken initially and has now to be corrected. Contagion, therefore, can occur even when the underlying fundamentals of countries are sound. In such a situation, neither ample reserves nor a "realistic" exchange rate parity would be a sufficient guarantee that a crisis could be contained or confined to a particular country.

Economic and financial surveillance

Two broad conclusions follow in terms of systemic reform: (a) the need for greatly improved multilateral surveillance and much-improved data dissemination; and (b) the need for some form of temporary standstill provision for short-term capital repatriation. The second is particularly important, for once a crisis begins it is usually the increased pressure generated by the repatriation or cancellation of lines of short-term funds, something akin to a bank run, that makes devaluation unavoidable, destabilizes the entire economy and adversely affects growth.

Given its central position in the international financial system, IMF already plays a major role in the context of information and data dissemination.[6] Under its Articles of Agreement, IMF carries out surveillance over the monetary and exchange rate policies of its members and makes policy recommendations. The results of such surveillance are then made available to the public, with the consent of the country concerned, in the form of Public Information Notices (PINs). In addition, IMF has been taking steps to establish best practices through its SDDS (Special Data Dissemination Standard) and GDDS (General Data Dissemination System). These systems were established prior to the Asian crisis, in 1996 and 1997 respectively, with the objective of assisting countries to tap the international capital markets. In the wake of the crisis in Asia,

[5] World Bank, *Global Development Finance 2000*, chap. 5.

[6] For a full analysis of existing economic and financial monitoring and surveillance mechanisms, see *Survey 2000*.

IMF has been seeking to extend SDDS and GDDS as well as to strengthen codes of good practice in fiscal transparency and in monetary and financial policies. However, since both SDDS and GDDS are voluntary standards, the country coverage remains limited.

It has to be remembered, however, that from the perspective of the countries concerned, conforming to new and more exacting standards of data collection is an expensive proposition, and uses up scarce manpower with few, if any, countervailing benefits in the short term. Other bodies, such as OECD, BIS, and ADB, are now producing and publishing economic and financial information more regularly, organizing regular seminars and workshops with the objective of strengthening the collection of relevant statistics and developing a set of early warning indicators for economic and financial surveillance. These are largely ad hoc responses. What has to be remembered is that progress in these areas is incremental as national statistical agencies fear a "data overload" while national regulators grapple with the conceptual difficulties of building models suitable for early warning systems.

In addition to the above, private-sector bodies, such as the international credit-rating agencies and the Institute of International Finance, a body set up by international banks following the 1982 debt crisis, also provide the public with a variety of information and analyses. Thus, the availability of relevant information and relevant data to market participants is undoubtedly improving steadily. The problem from an international systemic viewpoint is the multiplicity of criteria and standards that are being added and an accompanying lack of clarity as to what individual countries are expected to do. As an operating principle, developing countries need to be provided with incentives to adopt better financial policies and to pursue higher standards of corporate and financial sector governance more vigorously. The incentives could even be non-financial to begin with and could merely consist of a "rating" awarded by IMF.

Capital controls

However, it is clear that better information alone is not enough. Once a financial crisis is in the making, more drastic short-term remedies are needed, among which are temporary capital controls on outflows or standstills.[7] The need for a standstill on short-term capital repatriation, or its implications, has not been discussed thus far in any official forum. Without a provision of some form of standstill arrangement whereby a country (or countries) can organize a breathing space, contagion can become unstoppable. Indeed, once an exchange parity has been put under significant market pressure it is rare for the country concerned to succeed in defending it for any length of time. In that situation the crisis becomes self-fulfilling, with the new parity validating the market's expectations and in a perverse way justifying speculative pressure itself.

The experience of Malaysia is instructive in this regard. In September 1998, non-residents in Malaysia were prohibited from repatriating investments in ringgit-denominated assets for a 12-month period. In February 1999, many of the quantitative controls were replaced with graduated exit taxes. A key feature of the Malaysian controls was the desire to close the offshore ringgit market that was offering higher interest rates for ringgit deposits than those prevailing in Malaysia; it could have countered the attractiveness of the offshore market by raising domestic interest rates, but this would have been at the cost of significant corporate and financial sector distress and could have deepened the recession further. During the initial few months of controls, Malaysia's risk premium in the international bond markets widened considerably but narrowed once the authorities shifted to exit taxes. In other words, the price that Malaysia had to pay for instituting capital controls was a temporary limitation of access to private capital, primarily in the debt market. In this context, the experience of chile in discouraging short-term flows and encouraging long-term flows is also worthy of note.[8]

The experience of Malaysia suggests that capital controls can help stabilize an otherwise difficult situation. Controls or standstills can work best for temporary periods during which the authorities

---

[7] See *Survey 1998*, chap. III, "Managing the external sector".

[8] For a discussion of the experience of Chile with short-term flows and other issues, see Azizul Islam, "An overview of the crisis in East and South-East Asia and selected policy implications", ESCAP, *Development Papers No. 20* (United Nations publication, Sales No. E.99.II.F. 71).

seek to introduce the needed corrective measures and help avoid major harm to the economy of the country in the interim. It is true that the option of capital controls is ultimately a national prerogative. In fact, for those countries in which some form of control on foreign transactions still exists and which are moving towards liberalization, the question of the proper sequencing of the liberalization measures becomes particularly germane. There is a large body of literature to guide them in this regard.

What is needed from the perspective of international systemic reform is a more explicit recognition that the option can be exercised in an emergency, similar to the kind of standstill clauses in many national legal systems for corporate bodies facing a major crisis of illiquidity. At present, a degree of stigma is attached to the use of capital controls by countries. Institutions like IMF can and should explain the case for temporary capital controls and make them an acceptable option when countries are confronted with major episodes of financial market instability that can harm development seriously. At a more general level and from a long-term perspective, the proposal of the Tobin Tax on all international transactions should be given more serious consideration.[9]

Provision of liquidity

Lender of last resort

When the 1997 crisis broke in Asia and international systemic weaknesses were identified, the absence of an international lender of last resort to meet liquidity needs was accepted as a major gap. Liquidity is needed both to pre-empt a looming crisis in a particular country or group of countries, and to contain it once it begins. Without a lender of last resort, a liquidity crisis can quickly degenerate into an insolvency crisis in a particular country and can impose negative externality on others through contagion. There would appear to be a clear a priori need for such a lender to exist. One view is that IMF, in partnership with other international and regional financial institutions, is, mutatis mutandis, such a lender. Another view is that there cannot be a credible lender of last resort given the massive resources that such a body would need if it was to have any relevance at the international level, and that it would be preferable, in any event, to react to crises on a case-by-case basis as each crisis is sui generis. Moreover, there is some concern that the ready, if not automatic, provision of liquidity would increase moral hazard and thus make the next crisis more, not less, probable.

Following the Asian crisis, the proposal of an Asian regional fund to provide liquidity in a crisis was aired as one modality for the rapid deployment and disbursement of liquidity in an emergency.[10] After considerable vicissitudes, the proposal has been implemented in the modified form of a swap facility between the members of ASEAN and China, Japan and the Republic of Korea. What resources each country is prepared to commit under this facility has been left open, at least for the time being, but follow-up work is under way. In addition, IMF had created its own contingent credit facility in 1999. Commitments under the contingent credit line are not subject to the general access limits of IMF but are likely to be in the range of 300-500 per cent of the member's quota. Generally speaking, the terms on which these contingent facilities are to be available are far more onerous than under the normal lending programmes of IMF, thus reducing their usefulness for countries facing a potential crisis. Argentina had to organize a large financing package with IMF, the Inter-American Development Bank and international banks in November 2000 to stave off a major default. Whether this included contingent credit lines from IMF is not known at this stage, but the announcement appears to have calmed the markets perceptibly, at least for now.

Thus, various forms of liquidity support have emerged following the 1997 crisis that can, in theory, be marshalled before a looming default by a country with a liquidity shortage. The problem, however, is that the resources available to public-sector institutions are limited, subject to significant delay in their application, as each package of support has to be individually negotiated, and cannot generate the needed credibility in the market once a crisis has begun.

---

[9] For information on the Tobin Tax, see Tobin Tax Initiative <http://www.ceedweb.org/iirp/>.

[10] ADB, Economics and Development Resource Center, *Strengthening the International Financial Architecture*, EDRC Briefing Notes, No. 12.

Given the above situation, it is very important for the private sector to be associated in these arrangements ab initio in a substantive manner. However, no such mechanism exists at present. The involvement of the private sector is needed both for the rolling over of maturing debt and the provision of some new financing to forestall panic. IMF, for its part, has set up the Capital Markets Consultative Group to create a dialogue between market participants and IMF management. These informal arrangements are a useful beginning, but crisis prevention would require more predictable and formalized solutions.

How international liquidity might be provided with the involvement of the private sector to countries facing or experiencing payment difficulties has been widely discussed over the last two or three years, with little concrete progress. There are two major difficulties: with what inducements are private sector creditors going to be persuaded to participate in such schemes and who, if anyone, would be able to offer and guarantee such inducements and what would be the right balance between the official and private creditors to minimize moral hazard?

One view is that the proportion of official funds in any liquidity package should be relatively small; another is that the terms and conditions of official support should be known in advance and should, in principle, be fairly onerous in order to discourage countries from taking too relaxed an approach prior to a crisis. A counter argument to both views is that, each crisis being unique, there can and should be no automaticity in the access to new liquidity and each emergency financing package should be negotiated with its own conditions.

Whatever the right approach, it is disturbing that no consensus has either emerged, or is likely to emerge soon, on this critical issue. The international financial system is not significantly better equipped to deal with a major crisis now than it was in 1997. For most developing countries that are relatively new participants in international financial markets, the involvement of official international and regional financial institutions, as both participants in and guarantors of emergency financial packages, remains crucial. Indeed, without their involvement it is unlikely that any private finance would be available to such countries.

Financial sector reform

Liberalized international capital flows have their counterpart in domestic financial systems that have to manage the pool of international resources so as to minimize, if not avoid altogether, the risks emanating from the currency and maturity mismatch that devastated the financial systems of the crisis economies of the region in 1997. Judgements have to be made regarding the robustness of the financial systems of individual countries, that is, their ability to absorb and effectively manage highly risk-averse international resources, the extent to which they have credible mechanisms for managing and containing risk and the financial strength, that is, adequate capital and reserves and profitable core activities, to cope with unexpected and/or adverse changes in the external economic environment. In recent years there has been significant progress with financial sector reform at the national level accompanied by international initiatives to raise institutional standards where cross-border business transactions are involved, better risk management and improved cooperation among financial sector supervisors and regulators.

Bank for International Settlements

BIS is the principal international body dealing with issues of international financial sector reform in so far as banking and related activities are concerned.[11] It now has three committees covering issues relevant to the above: the Basel Committee on Banking Supervision, the Committee on the Global Financial System and the Committee on Payment and Settlement Systems. All three committees in turn participate in the Financial Stability Forum, established by the G7 countries in 1999 to promote international financial stability and cooperation, while the Committees on Banking Supervision and Payment and Settlement Systems have been part of the consultative process for the drafting of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies. The Committee on Banking Supervision plays a central role in developing global standards for prudential regulation and supervision of the financial sector of countries, especially with regard to the measurement of risk-weighted capital

[11] Bank for International Settlements, *69th Annual Report*, June 1999, "Activities of the Bank", pp. 151-166.

adequacy ratios, the treatment of off-balance sheet activities and principles for the consolidation of balance sheets. Its latest recommendations are contained in the revised Basel Capital Accord.[12]

A large number of countries have declared their intention to implement these standards, the Core Principles for Effective Banking Supervision, which are also used by IMF and the World Bank as a basis for judging the effectiveness of supervision in individual countries. BIS has also established the Financial Stability Institute with a mandate to help improve financial systems worldwide and to provide training to senior government functionaries and to central bank supervisors in risk management, fraud, supervision of consolidated bank accounts, capital adequacy, the establishment of deposit insurance schemes and corporate governance.

The remit of BIS is undoubtedly wide-ranging and highly relevant to the problems of the financial sector exposed by the crisis in 1997. However, until recently, BIS had very little operational involvement with the developing countries and many of those countries felt that they were being obliged to adopt the prudential standards and norms for banking developed by BIS without any say in how they were established in the first place. On the other side, the problem for BIS has been, and continues to be, that making recommendations and setting standards is the easy part; the actual implementation is far more difficult. BIS has no direct power to have any of its recommendations carried out. Only through the sanction of being unable to deal with counterparties in BIS standards-observing countries are non-observing countries obliged to accept the need for compliance. A connected problem in the corpus of prudential norms is the absence of any kind of regulation at the international level whereby banks can continue to lend to over-borrowed entities and governments and build up risk in the process.

In this context, two issues deserve attention: the first is the danger that the pressure for reform may be losing its momentum and urgency in the face of intractable problems in several countries; the most important of these problems are the sheer size of non-performing loans and the huge costs of recapitalizing insolvent banks. The second is the realization that considerable time is needed to develop the appropriate human resources skills for more effective financial sector supervision and regulation in order to ensure compliance with the norms and ratios being developed at BIS. Furthermore, the political will for reform may have become less strong than it was in 1998.

Non-performing loans

The true estimation of non-performing loans is proving to be a particularly difficult problem. While some convergence is taking place towards a standardized definition of non-performing loans so that individual banking accounts and reporting systems can become broadly comparable across national boundaries, the whole issue of non-performing loans remains fundamentally difficult to reduce to a single formula. In the matter of making adequate provisions for bad debts, national central banking and tax authorities still lack a unified approach in the classification of non-performing loans.

It is true that banks on their own are becoming more transparent and prudent in categorizing impaired assets as non-performing and are less reluctant than before to make adequate provision against earnings and/or capital as required. They would prefer, however, to have a less mechanical approach to the subject. There are several obstacles that stand in the way of maintaining the required tempo of reform, three obvious problem areas being administrative inertia, political opposition and a continuing lack of relevant laws and definitions. Furthermore, there is the problem of under-trained and underpaid public officials who have to oversee and regulate the financial sector. There are also problems arising from corporate practices which make it difficult to evaluate balance sheets in the absence of benchmarks (for example, relating to debt-equity ratios) that can be uniformly applied.

These are clearly rather complex problems for any country to tackle within the span of two or three years. With incentives for reform seemingly losing their raison d'être of only two years ago, partly on account of the huge costs of financial-sector rehabilitation, governments are finding it expedient, at least for now, not to press ahead with the required speed. This being the state of play at the national level, the reform effort for the financial sector at the international level has also inevitably lost a degree of

[12] Bank for International Settlements, *70th Annual Report*, June 2000, "Activities of the Bank", pp. 155-172.

momentum. It is not surprising, therefore, that the various working groups formed under the aegis of BIS in 1998 have not made any major progress in policy recommendations thus far.

Bank recapitalization

Within the above context, an important issue from a national perspective, but one with international systemic implications, is the use of public-sector guarantees in rescuing insolvent private banks. To some extent this has been a necessary consequence of the crisis in Asia. It has been discovered, however, that such guarantees have become open-ended, involving the taxpayers in long-term financial sector bailouts with huge opportunity costs. The question of moral hazard thus needs to be faced one way or another. Will these bailouts make the banking system more or less risk-averse in the future? There is no obvious answer. However, new international norms and modalities for dealing with the problem are now needed.

At the basic oversight level, the risks inherent in financial sector operations should, of course, be more realistically assessed and better managed. But they could also be internalized as much as possible. Technically insolvent banks have a franchise value as "going concerns" which closure destroys. Such banks could recover, given access to minimal new capital and some additional liquidity. Blanket guarantees, on the other hand, increase moral hazard and involve massive commitments for taxpayers. A regional or subregional fund imbued with some central banking functions to provide emergency lifelines to illiquid banks needs critical examination.[13] Such a fund could initially function on the same basis as the asset management companies set up in several countries after the crisis. As a multilateral fund might reduce the equity stake of owners in return for liquidity support, it could, over time, encourage more prudential management practices at the national level through reduced political leverage. This may result in heightened risk aversion on the part of existing bank owners and managers, perhaps, and slower growth in the real economy, but may reduce significantly the likelihood of periodic crises in the financial sector.

[13] For a discussion of the division of responsibilities between the European Central Bank and national central banks, see "The European Central Bank", *The Economist*, 6 January 2001.

Debt workouts

Orderly debt workouts based on relatively clear-cut criteria have been another element in the international reform agenda. Here, too, there has been little progress. On the face of it, providing a mechanism in advance for the orderly workout of debts could actually reduce the build-up of financial panic and assist in the subsequent restructuring negotiations. In fact, it is possible to argue that together with IMF or IMF-led financial package "lending into arrears", orderly debt workouts could promote greater stability and contribute to a better sharing of the costs of a crisis between lenders, and borrowers. In this area, however, there is reluctance on the part of both borrowers and lenders, and hence lack of progress.

Individual lenders, understandably, would like to be the first to be repaid. Moreover, they would not wish to abandon voluntarily the notion of "full value maintenance", a notion that has bedevilled negotiations between lenders and borrowers over the years. Borrowers, too, might prefer to have some freedom to discriminate between various lenders, for a variety of reasons.

Orderly debt workouts, hence, remain in the realm of academic discussion for the time being. Nevertheless, some initiatives are needed for laying down the broad principles for such workouts, especially in the area of greater coordination between official and private creditors. Underpinned by greater transparency in the information needed by creditors, what is being done piecemeal with creditors and debtors negotiating individual agreements could be embodied in broad formulae and relatively predictable outcomes so that such agreements could be reached more quickly.

Limiting access to foreign borrowing

As the problem of financial instability has been seen to begin with "over-borrowing", a part of the solution would appear to lie in restricting access to both banks and the bond market on the part of borrowers. In this regard, one of the solutions suggested to pre-empt a crisis is to monitor more closely the activities of highly leveraged institutions, such as hedge funds. Although the problem relates primarily to bank loans, high-interest bonds can also

aggravate indebtedness. On the face of it, a limitation on borrowing would appear to be in the interests of both borrowers and lenders. For borrowers, the dangers of over-leveraging would be reduced, while for lenders the risks of being caught in a major default could be eliminated or reduced.

There are, however, major practical problems in implementing such a solution. It could easily apply to sovereign borrowers where reasonably good information exists about levels of aggregate indebtedness, including any contingent liabilities. But the corresponding information about corporate entities is not readily available in many instances. There are also concerns that the dissemination of such information on an unrestricted basis would transgress conventions of commercial privilege and confidentiality. There is a contention too that gathering and using such information is the function of international credit-rating agencies and hence there is no need for any new initiative in this regard. Nevertheless, the need for what would in essence amount to a quasi credit-referencing system on behalf of corporations in countries where credit-rating agencies are in their infancy cannot be denied.

Moreover, many sovereign borrowers are unhappy with the operations and modus operandi of the existing international credit-rating agencies in recent years. They are also concerned at their failure to spot the enormous debts accumulated by the *chaebol* in the Republic of Korea prior to the crisis of 1997. In such a situation some form of subregional cooperation between central banks/regulators would be clearly beneficial as an additional element in the vetting services available to lenders. Such cooperation could also help alert participating central banks to looming credit risks being taken by major borrowers in different legal jurisdictions and would enable central banks and regulators to take preventive action and thereby avert a crisis triggered by an unexpected default.

However, there are substantial difficulties in achieving such cooperation and it would be wrong to underestimate them. For one thing, a creditworthy borrower could not be denied access to finance without good reason. For another, restrictions on lenders would constitute undue interference in their freedom to exercise their commercial judgement. There are thus serious problems in this area. Nevertheless, some systemic response is needed. A coordinated response could, for example, lay down broad principles to assess the level of debt that a country or corporate entity might incur against benchmarks such as foreign earnings or gross revenues. Since these principles can vary from time to time, from country to country and from industry to industry, they would have to be used with considerable flexibility and finesse in particular applications. The existing subregional mechanisms for cooperation in the financial area do not have the administrative capacity to establish the kind of norms or standards required in the credit-referencing system outlined above.

CONCLUSIONS

The international financial system has had a critical bearing on development in the past two decades. During this period the system has undergone radical change. As far as developing countries are concerned, ODA has been eclipsed by private capital, which itself has many different and constantly changing components. This has made national financial-sector supervision a complex affair requiring constant improvement. The international institutional structure, on the other hand, has undergone much less change. IMF (and the World Bank) operates alongside a number of regional financial institutions. There is, however, no body or agency that has been given responsibility to oversee, monitor and supervise the huge volumes of private capital flows that dominate the world economy. There is a perception that the international financial system as it exists at present is unable to provide systemic stability which should be considered to be a global public good. A world financial organization[14] to establish guidelines, benchmarks and rules for private capital flows, rather like WTO, was suggested in the wake of the 1997 crisis, but there has been little discussion as to its merits. Several relevant considerations need to be examined, particularly the need for any international oversight body to be free from political control and, indeed, from the domination of economic dogma of any kind.

[14] The Committee for Development Planning, an independent body of reputed experts constituted by the Secretary-General of the United Nations, had concluded in 1998 that the proposal for a world financial organization (WFO) merited serious consideration.

The question remains whether "monitoring" and "oversight" of private capital flows are enough or whether some form of regulation is also needed at the international level. There is no agreement on regulation: indeed, the very word "regulation", which is accepted without demur in the case of a national financial system, is regarded as anathema in the case of the international financial system. If there is to be no world financial organization, then who should play a comparable role in the international financial system? For now it is IMF that has, willy-nilly, filled this gap at the international level and sought to address significant weaknesses in the system.

One direction for systemic reform could be to view the IMF of the future not as a single, global institution, but rather as the apex of a network of regional and subregional bodies with strengthened participation in its decision-making by the developing countries. The existing regional or subregional bodies are primarily trade-related, but financial oversight functions could easily be added. Those functions could include the provision of macro-economic consultation and surveillance for the prevention and containment of crises, as well as coordination and surveillance of national systems of financial-sector regulation and supervision for establishing operating norms at the regional and/or subregional levels. The example of the EU and arrangements leading up to the creation of the European Central Bank and the euro are a possible model in this context. It is also important to emphasize that in such a scheme, apart from other functions, regional development banks could play a significant role as a mechanism to pool the risks of groups of developing countries, thus allowing them to make more effective use of the opportunities provided by private capital markets.

An institutional framework such as that suggested here would have two positive features. First of all, it should help bring more stability to the regional economy by providing essential public good services that existing institutions find difficult to provide. Second, from the point of view of the balance of interregional cooperation, it would be more practical than a system based on a few world or regional organizations all jealously guarding their individual mandates. This might also increase the commitment of less powerful countries to abide by conditionalities that contribute to regional or sub-regional financial stability and, by inference, to world financial stability.

What also has to be accepted is that while policy makers can aim for stability, the incidence of individual crises cannot be realistically eliminated entirely. Given this, an immediate objective requirement should be to have arrangements in place that can speedily deal with a new crisis when it occurs. Such arrangements should manifestly involve some form of public and private sector cooperation. As mentioned earlier, a consideration of the "rules of engagement", or a set of principles, for the two needs to be thought through. Such discussions could begin in the subregional bodies that already exist within the ESCAP region. Of course, their capacity to serve as effective forums for such discussions would require considerable strengthening.

IX CONCLUSIONS AND RECOMMENDATIONS

Chapters V-VIII have provided an analysis of the situation in the ESCAP region with regard to the mobilization of financial resources for development. These chapters contain a large number of suggestions for further action by governments and the international community as well as by the private sector. The key ideas behind these recommendations relating to the major areas of concern are summarized briefly below. It is, of course, obvious that, as the countries in the region vary enormously in terms of size, level of development and degree of liberalization and integration with the global economy, certain recommendations are more relevant to some than to others.

DOMESTIC RESOURCE MOBILIZATION

Macroeconomic policy

It may be restating the obvious, but a fundamental condition for a country to be able to finance its development from both internal and external sources is that its government devise and implement a consistent set of appropriate macroeconomic policies. Fiscal, monetary, exchange rate, financial sector as well as trade policies need to complement each other in a way that promotes the growth and development of the real sectors of the economy (agriculture, industry and services). Likewise, there is a need to avoid sudden or frequent changes in macroeconomic policies as they provide a framework within which private initiatives can function.

In a globalizing world, countries wishing to be active partners in world financial markets have little choice but to move all the regulation of their financial and corporate sectors towards international norms and standards. Such efforts will minimize the risk of exclusion from sources of finance, reduce the likelihood of financial or corporate sector collapse and increase the confidence of investors, both domestic and foreign, considerably. The important norms or standards include not only those under BIS (capital adequacy as well as the BIS Core Principles for Effective Banking Supervision) but also those for stock markets under IOSCO, those for accounting and auditing under the International Accounting Standards Committee and those on public sector transparency under IMF (Code of Good Practices on Fiscal Transparency and Code of Good Practices on Transparency in Monetary and Financial Policies).[1]

In line with the above two points, it is now generally accepted that there has to be careful sequencing of the liberalization of the capital account of a country in line with the development of the necessary institutions and regulations. This is needed not only to develop sufficient legal authority and expertise in supervisory and regulatory agencies but also to improve the performance of national credit-rating agencies so that they can provide credit assessments of national corporations that are viewed as credible and reliable by investors, domestically and internationally. Options in this regard include fostering partnerships with international credit-rating firms or developing credit-rating standards at the subregional or regional level for implementation at the national level.

As part of the macroeconomic framework, a government also has an obligation to manage the domestic and external public debt in a prudential manner so as to minimize adverse effects on inflation, the exchange rate, interest rates and growth and to monitor a range of macroeconomic indicators of the economy closely in order to be alert for signs of potential crises. This, in turn, requires investment in an appropriate reporting and surveillance system.

---

[1] For more details on these various standards, see ESCAP, *Survey 2000*, part two, "Economic and financial monitoring and surveillance", chap. V, annex V.2, "International codes and standards for financial markets", pp. 206-214.

Stimulation of private sector (household and corporate) savings

The need to strengthen and diversify the financial sector to provide a wider range of savings instruments with varied risk, yield and maturity characteristics is well recognized in the countries of the region. Since the banking sector currently provides and is likely to continue to provide the core of the financial sector, its reform and modernization have to be the main focus of efforts to strengthen this sector. While banking reform has many aspects, including the application of norms and standards promoted by BIS, three central ones are the improvement of the credit risk assessment methods used by banks (moving away from client-based to data-based methods); enhanced transparency and disclosure practices; and a solution to the problem of non-performing loan. The third one is required in order that the other two problems can be tackled without compromising the financial viability of the entire domestic banking system. The government can assist the first two by instituting a strict and comprehensive reporting mechanism for banks on their financial transactions and status. The banks will then, in turn, be obliged to put pressure on their corporate clients for transparent accounting. The solution to the problem of non-performing loans will vary from country to country but will inevitably involve some significant use of public funds to write off bad loans. Such use of government revenue is usually subject to public criticism and therefore some sort of quid pro quo should be exacted from banks in terms of the conduct of their future operations.

To reduce over-dependence on the banking system, the use of new instruments for household savings should be encouraged: these can include privately sponsored mechanisms such as mutual funds, pension funds, life insurance schemes and venture capital funds. Government-sponsored mechanisms include unit trusts, postal savings and provident funds. The savings under unit trusts are usually invested in capital market instruments such as stocks and bonds as well as in bank deposits under the professional supervision of fund managers; these often provide additional investment finance for the government for certain earmarked activities. The spread of microfinance institutions for mobilizing savings and investment for the poor, who are usually outside the regular financial system, should be promoted with the intention of graduating both the users and the institutions into the formal, regulated financial system over time.

Financial sector diversification into stock markets seems most appropriate for the larger economies of the region. These markets need to be robust (both deep and broad) if stocks are to be viewed by investors as a viable savings instrument, and this is not possible when a market serves a small economy. In any event, for existing markets, legal and technical regulations, including those relating to transparency and disclosure to tackle information asymmetries between corporations and investors, need to be improved. There are also possibilities for enhancing cooperation with markets outside the region and among exchanges in the region (cross-listings, mergers, Internet trading etc), in order to profit from modernization trends, increase the product range offered and enhance the robustness of markets. In fact, it would appear more plausible for small economies to allow their investors to trade on the more robust markets of other countries, or work towards some common market for several countries together, than to have their own small market.

With the increasing awareness of the need for longer-term domestic investment instruments in the aftermath of the recent financial crisis, considerable effort has been put into promoting the development of national bond markets, including developing benchmark curves, especially longer-term ones, based on government securities; fostering the setting up of institutional investor groups independent of banks; encouraging the use of small-scale retail bonds; and increasing, when appropriate, securitization techniques, particularly for mortgages and infrastructure. In addition, there is an urgent need to enhance the education of savers and investors through campaigns to explain the various options for saving, their risks and benefits, and ways in which savings portfolios can be diversified easily and safely.

In the longer run, it is in the common interest of countries to engage in subregional or regional discussions of initiatives designed to work towards regional (subregional) capital markets. First steps could include developing regional disclosure and accounting/auditing standards for financial institutions

and corporations; regional standards for credit-rating agencies or a regional credit-rating agency; and regional regulatory standards for capital markets and for the use of Internet trading throughout the region. Eventually, a common trading platform for capital markets could be developed, with all the financial markets of the region thus becoming stronger and more viable mechanisms for mobilizing savings.

The mobilization of funds for government

The traditional prescription for governments to increase tax revenues remains particularly valid in the ESCAP region, where taxes as a percentage of GDP appear low by global standards. Again, the frequently discussed modalities of simplifying rules and administration, broadening the tax base (introducing or improving VAT and taxing some modern services) and improving collection, remain valid. Governments also have room to increase their non-tax revenues by increasing fees for the services they provide, within the limit of equity considerations, and making some of the newer services, such as regulation of the financial sector, self-financing. However, there is the view that most individuals and corporations lack the motivation to pay taxes because of the perception that tax revenues are not efficiently used to achieve development objectives. Most governments in the region need to enhance the transparency of their government budget processes on both the revenue and expenditure sides and bring off-budget transactions into the budget; these moves would help to convince the public that their government is a responsible agent for development and hence lead to better compliance with their tax obligations.

To finance their deficits or their capital development projects, governments sometimes resort to borrowing from the local capital markets. This should be undertaken with care to avoid distorting the market or crowding out the private sector (this is more of a problem in economies with small markets). In more developed financial markets, government security issues can be used to develop benchmark curves for the pricing of bonds on the local bond market. This is clearly a valid reason for encouraging government borrowing from local markets even when there is no fiscal deficit.

INTERNATIONAL CAPITAL FLOWS

Foreign direct investment

The measures for enhancing FDI flows to developing countries have been on the national and international agenda for several years and technical assistance has been provided by international institutions to help countries implement them. These measures include improving the transparency of approval procedures and efficiency of government offices; reducing lists of restricted areas; upgrading physical infrastructure facilities, including electricity, water and transport supplies; providing ICT and developing modern financial sector infrastructure. It is also clear that tax and other financial incentives can be minimized as they have little to do with investment decisions and may contribute to non-productive competition among countries. However, this requires inter-country cooperation. It should also be emphasized that having these measures in place is no guarantee that FDI will necessarily follow, as transnational corporations have a multitude of criteria. Providing a conducive environment is thus a necessary, but not a sufficient, condition.

Regional or subregional cooperation measures to supplement national ones to enhance the prospects of FDI include accelerating subregional trade liberalization arrangements, promoting growth triangle and growth zone arrangements, and facilitating information flows on investment and trade possibilities.

Short-term capital inflows

One of the lessons drawn from the contribution of surges in short-term capital flows in and out of the economies of the region prior to the 1997 crisis relates to the need to sequence carefully the liberalization of the capital account of a country to match its development of financial sector institutions and regulations; opening the account prematurely can be a recipe for disaster. However, this does not imply that capital accounts should never be opened. Rather, as short-term flows can contribute positively to the robustness of domestic savings markets, there should be pre-planned strategies to make proper use of this form of capital inflows and efforts need to be put into the related institutional development and

human resources expertise. Another lesson to be drawn is that it is preferable to open domestic capital markets to foreign investors within progressive limits so that both sides can gain comfort and knowledge over time. This should help them avoid unnecessary volatility.

A third lesson is the need for each country to develop reporting and monitoring mechanisms for short-term inflows of both the government and the private sector, including their contingent liabilities. While such mechanisms are not necessarily able to predict a crisis, they can provide early warning signals. It is also desirable to develop and participate in subregional mechanisms to avoid or limit contagion. In addition, countries need to have the prerogative to implement emergency restrictions on capital outflows in case of a crisis, either quantitative restrictions or tax-based measures or both, and to publicize these so that foreign investors are aware of their existence and of the conditions for their imposition. Lastly, all governments have an obligation to increase the awareness of problems of currency and maturity mismatches in their domestic investor communities, to help make investors more knowledgeable and less prone to become victims of a sudden reversal of short-term capital.

Longer-term capital inflows

Given the limited experience with bond markets in the region, investor reluctance to hold bonds and yet the urgent need for some longer-term savings instruments for intermediating resources to longer-term projects, including infrastructural ones, it would seem desirable to promote this type of capital market. However, it is probably advisable to open domestic bond markets to foreigners slowly, and to encourage the issuing of bonds by domestic corporations on international markets and so obtain an international credit rating. Tackling the information asymmetry problem head-on is a crucial issue for the development of bond markets, as are the devising of retail style bonds accessible to the small investor and encouraging the setting up of groups of institutional investors independent of the banking sector.

In addition, in line with earlier recommendations on early warning and transparency, having a regular and complete reporting and monitoring mechanism for long-term inflows of both government and the private sector will be needed. For all countries, but particularly those where bond markets are not viable and access to international capital markets is difficult, there is a need to learn about and use new forms of raising finance, such as structured finance, selectively.

OFFICIAL FLOWS

It is clear that there is an ongoing need for ODA in a number of countries in the region, particularly the least developed and Pacific island developing countries as well as the economies in transition, for reasons connected with their small economic size, geographic state and the many and varied structural constraints to development that they face. The amount of aid provided to these countries is quite small. In fact, doubling it would add less than 5 billion dollars, or a miniscule proportion of the GNP of donor countries. In view of the fact that for many of these countries, the day when they could reasonably expect not to be dependent on aid flows for their critical developmental needs is a very long way off, there is an urgent need to reach an international understanding to increase the aid flows available to them and make them more secure. However, for such a proposal to have any reasonable chance of success, there is a need to combat the feelings of aid fatigue in donor countries. One approach to this could be to encourage governments of donor countries to educate their public on the quantitative smallness of their contribution and the mutuality of interests in providing aid.

On the other hand, it is imperative for the recipient countries to demonstrate judicious use of the aid they receive. This can be tackled by strengthening their efforts to maximize the benefits from aid through its assignment to sectors and activities with the highest social return and through its speedier allocation and use. Enhancement of the efficiency and effectiveness of the utilization of aid flows also requires that the ongoing process of untying aid should be pushed further and that modalities be found to cope with the provision of local or recurrent costs when justified.

Lastly, there is a need to reinforce ongoing efforts at aid coordination among recipient governments, donor governments and international

agencies. Such efforts should include capacity-building for recipient government officials, so that they become well-informed decision makers on programme development, choice and oversight of aid flows, and efforts to reduce cross-conditionalities among donors.

INTERNATIONAL SYSTEMIC ISSUES

International financial architecture as an international public good

As international financial instability generates unhealthy uncertainty at the national level and can undermine national development efforts, reform of the international financial system is an integral part of the recommendations designed to mobilize a larger and more stable flow of resources for development. This reform has several crucial elements premised on the need for the collective provision of systemic stability which can be considered to be a global public good. The elements include the dissemination of relevant information, international agreement on modalities for reducing and coping with systemic risks of various sorts and, in parallel, development of supporting institutions and regulations.

There is clearly a need to contain the contagion of financial instability. At the national level, the relevant action includes finding an appropriate exchange rate regime which avoids both the inherently enormous costs of maintaining a fixed rate and the excessive volatility of freely floating rates that can severely damage investment and trade flows. This also involves instituting monitoring and surveillance mechanisms at the national, subregional, regional and international levels to provide early warning signals of emerging problems. Explicit international recognition is required of the option of using capital controls as a temporary standstill measure to stabilize an economy hit by an unexpected episode of financial market volatility. One idea that requires more serious international discussion is the application of a Tobin-type tax[2] to reduce instability on a global basis. In addition, attention should be paid to the conditions for and the modalities of providing increased emergency liquidity through both public and private channels to avoid economic chaos. In particular, international financial institutions would need to be involved as participants and guarantors of emergency financial packages for developing countries that are relatively new participants in the international financial markets, at the minimum as a signal to the private sector.

In terms of institutions and related standards and norms for the financial sector, while considerable progress has been made at the international level through, inter alia, IMF and BIS, more input from developing countries is needed in defining these norms before they are required to implement them. The time and resources required for developing the requisite human skills to implement the standards in many developing countries tend to make this an extremely challenging task. Therefore, some sequencing of adoption is probably in order, along with periodic outside assessments of compliance, as could be embodied in the Financial Sector Stability Assessment of IMF. Otherwise there is likely to be little serious effort and reforms may flounder, leaving the countries vulnerable to another crisis.

Regional and subregional cooperation

Increased cooperation at the subregional and regional levels among ministry of finance personnel, central bankers and regulators seems a good way of increasing confidence, transparency and the sharing of good practices. The ASEAN Surveillance Process is a concrete and functioning example of such a move. The ASEAN+3[3] "Chiang Mai Initiative" to create a swap facility among the countries concerned for the rapid deployment of liquidity in case of a crisis needs some vigorous follow-up if it is to be realized. The ADB Regional Economic Monitoring Unit and the related Asia Recovery Information Centre are also valuable additions to regional exercises. However, further assistance to a wider range of countries in developing their own surveillance systems, and to contribute to regional and international reform agendas, is clearly warranted.

---

[2] See chapter VIII, footnote 9.

[3] ASEAN, China, Japan and the Republic of Korea.

One area in which there is growing cooperation among countries in the region is on the treatment of non-performing loans and the recapitalization of banks. Beyond discussions of definitional differences and the varying mechanisms to deal with these loans in the crisis countries, there seems to be room for a regional initiative on strengthening the solvency and stability of domestic banking systems, which are, after all, the core of the financial system in every country. A regional or subregional fund could be considered with some central banking functions to provide emergency lifelines to illiquid banks in return for instituting some more prudential management practices. This has a clear parallel in the European experience and would help to reduce the degree of political interference in the modernization and professionalization of banks.

The development of systemic responses

The need for some broad principles to guide the process of debt workouts and to increase coordination between official and private creditors should in principle be possible. This could lead to quicker outcomes and ones more acceptable to the financial markets. Similarly, it appears possible to develop some broad principles to assess the maximum level of debt which a country or a corporation should incur against benchmarks such as foreign exchange earnings or gross revenues. This could help avoid a problem of overborrowing that was clearly evident before the recent financial crisis.

As there is currently a plethora of institutions supervising or providing regulatory norms for parts of the international financial system, and yet there is no lender of last resort, it does not seem feasible or even desirable at this time to turn IMF into a world financial organization covering the functions of both surveillance and lender of last resort. There is, however, another seemingly more feasible option. IMF could be viewed as the apex institution for the world financial system with contributions from (a) other international bodies on standards and norms in their areas of expertise; (b) subregional and regional bodies in the areas of surveillance and early warning, the pooling of risks, coordination and policy advice, as well as the development and implementation of standards and norms at the regional level; (c) international private sector bodies on their perceptions of problematic issues and policy recommendations; and (d) national bodies, which would remain the responsible authorities at the domestic level. Such an arrangement could help provide the public good services mentioned earlier and yet avoid protracted negotiations among institutions and countries that guard their mandates closely.

In this regard, increased discussions, exchange of experience and technical assistance to countries of the ESCAP region on the international financial architecture and their role and interaction with it should be provided through the cooperative efforts of ESCAP, ADB, BIS, IMF and the World Bank. Systemic issues are too important to leave it only to the actors directly involved to provide a menu of options: independent opinions from organizations such as ESCAP and other regional and subregional organizations can also offer an assessment of options and point out the advantages and disadvantages to member states.

* * * * *

It is hoped that the above brief outline of conclusions and recommendations will be useful to governments in considering the issue of financing for development. However, it does not do justice to the large number of recommendations in the preceding chapters. What does emerge, however, is that there are many initiatives for the mobilization of domestic and external financial resources which countries can undertake themselves. There are also clearly areas in which subregional or regional cooperation can play a very positive role. Nevertheless, the international dimensions of financial markets are now so important that progress, or lack of it, in the reform of areas with systemic implications will have an important bearing on the development outcomes of developing countries for the foreseeable future.

Since the 1957 issue, the *Economic and Social Survey of Asia and the Pacific* has, in addition to a review of the current situation of the region, contained a study or studies of some major aspect or problem of the economies of the Asian and Pacific region, as specified below:

1957: Postwar problems of economic development
1958: Review of postwar industrialization
1959: Foreign trade of ECAFE primary exporting countries
1960: Public finance in the postwar period
1961: Economic growth of ECAFE countries
1962: Asia's trade with western Europe
1963: Imports substitution and export diversification
1964: Economic development and the role of the agricultural sector
1965: Economic development and human resources
1966: Aspects of the finance of development
1967: Policies and planning for export
1968: Economic problems of export-dependent countries. Implications of economic controls and liberalization
1969: Strategies for agricultural development. Intraregional trade as a growth strategy
1970: The role of foreign private investment in economic development and cooperation in the ECAFE region. Problems and prospects of the ECAFE region in the Second Development Decade
1971: Economic growth and social justice. Economic growth and employment. Economic growth and income distribution
1972: First biennial review of social and economic developments in ECAFE developing countries during the Second United Nations Development Decade
1973: Education and employment
1974: Mid-term review and appraisal of the International Development Strategy for the Second United Nations Development Decade in the ESCAP region, 1974
1975: Rural development, the small farmer and institutional reform
1976: Biennial review and appraisal of the International Development Strategy at the regional level for the Second United Nations Development Decade in the ESCAP region, 1976
1977: The international economic crises and developing Asia and the Pacific
1978: Biennial review and appraisal at the regional level of the International Development Strategy for the Second United Nations Development Decade
1979: Regional development strategy for the 1980s
1980: Short-term economic policy aspects of the energy situation in the ESCAP region
1981: Recent economic developments in major subregions of the ESCAP region
1982: Fiscal policy for development in the ESCAP region
1983: Implementing the International Development Strategy: major issues facing the developing ESCAP region
1984: Financing development
1985: Trade, trade policies and development
1986: Human resources development in Asia and the Pacific: problems, policies and perspectives
1987: International trade in primary commodities
1988: Recent economic and social developments
1989: Patterns of economic growth and structural transformation in the least developed and Pacific island countries of the ESCAP region: implications for development policy and planning for the 1990s
1990: Infrastructure development in the developing ESCAP region: needs, issues and policy options
1991: Challenges of macroeconomic management in the developing ESCAP region
1992: Expansion of investment and intraregional trade as a vehicle for enhancing regional economic cooperation and development in Asia and the Pacific
1993: Fiscal reform. Economic transformation and social development. Population dynamics: implications for development
1995: Reform and liberalization of the financial sector. Social security
1996: Enhancing the role of the private sector in development. The role of public expenditure in the provision of social services
1997: External financial and investment flows. Transport and communications
1998: Managing the external sector. Growth and equity
1999: Social impact of the economic crisis. Information technology, globalization, economic security and development
2000: Social security and safety nets. Economic and financial monitoring and surveillance

This publication may be obtained from bookstores and distributors throughout the world. Please consult your bookstore or write to any of the following:

Sales Section
Room DC2-0853
United Nations Secretariat
New York, N.Y. 10017
USA

Tel: (212) 963-8302
Fax: (212) 963-4116
Email: publications@un.org

Sales Section
United Nations Office at Geneva
Palais des Nations
CH-1211 Geneva 10
Switzerland

Tel: (41) (22) 917-1234
Fax (41) (22) 917-0123
Email: unpubli@unog.ch

Chief
Conference and General Services Section
Division of Administration
Economic and Social Commission for
Asia and the Pacific (ESCAP)
United Nations Building
Rajadamnern Avenue
Bangkok 10200, Thailand

Tel: (662) 288-1234
Fax: (662) 288-1000
Email: likitnukul.unescap@un.org

For further information on publications in this series, please address your enquiries to:

Director
Development Research and Policy Analysis Division
Economic and Social Commission for
Asia and the Pacific (ESCAP)
Rajadamnern Avenue
Bangkok 10200, Thailand

Tel: (662) 288-1610
Fax: (662) 288-1000, 288-3007
Cable: ESCAP BANGKOK

READERSHIP SURVEY

The Development Research and Policy Analysis Division of ESCAP is undertaking an evaluation of this publication: ***Economic and Social Survey of Asia and the Pacific 2001,*** with a view to making future issues more useful for our readers. We would appreciate it if you could complete this questionnaire and return it, at your earliest convenience, to

Director
Development Research and Policy Analysis Division
ESCAP, United Nations Building
Rajadamnern Avenue
Bangkok 10200, THAILAND

QUESTIONNAIRE

	Excellent	*Very good*	*Average*	*Poor*
1. Please indicate your assessment of the *quality* of the publication on:				
• presentation/format	4	3	2	1
• readability	4	3	2	1
• timeliness of information	4	3	2	1
• coverage of subject matter	4	3	2	1
• analytical rigour	4	3	2	1
• overall quality	4	3	2	1
2. How *useful* is the publication for your work?				
• provision of information	4	3	2	1
• clarification of issues	4	3	2	1
• its findings	4	3	2	1
• policy suggestions	4	3	2	1
• overall usefulness	4	3	2	1

3. Please give examples of how this publication has contributed to your work:

.....

.....

.....

.....

4. **Suggestions for improving the publication:**

.....

.....

.....

.....

5. **Your background information, please:**

Name: .....

Title/position: .....

Institution: .....

Office address: .....

.....

Please use additional sheets of paper, if required, to answer the questions.
Thank you for your kind cooperation in completing this questionnaire.



كيفية الحصول على منشورات الامم المتحدة

يمكن الحصول على منشورات الامم المتحدة من المكتبات ودور التوزيع في جميع انحاء العالم . استعلم عنها من المكتبة التي تتعامل معها أو اكتب الى : الامم المتحدة ،قسم البيع في نيويورك او في جنيف .

如何购取联合国出版物

联合国出版物在全世界各地的书店和经售处均有发售。请向书店询问或写信到纽约或日内瓦的联合国销售组。

HOW TO OBTAIN UNITED NATIONS PUBLICATIONS

United Nations publications may be obtained from bookstores and distributors throughout the world. Consult your bookstore or write to: United Nations, Sales Section, New York or Geneva.

COMMENT SE PROCURER LES PUBLICATIONS DES NATIONS UNIES

Les publications des Nations Unies sont en vente dans les librairies et les agences dépositaires du monde entier. Informez-vous auprès de votre libraire ou adressez-vous à : Nations Unies, Section des ventes, New York ou Genève.

КАК ПОЛУЧИТЬ ИЗДАНИЯ ОРГАНИЗАЦИИ ОБЪЕДИНЕННЫХ НАЦИЙ

Издания Организации Объединенных Наций можно купить в книжных магазинах и агентствах во всех районах мира. Наводите справки об изданиях в вашем книжном магазине или пишите по адресу: Организация Объединенных Наций, Секция по продаже изданий, Нью-Йорк или Женева.

COMO CONSEGUIR PUBLICACIONES DE LAS NACIONES UNIDAS

Las publicaciones de las Naciones Unidas están en venta en librerías y casas distribuidoras en todas partes del mundo. Consulte a su librero o diríjase a: Naciones Unidas, Sección de Ventas, Nueva York o Ginebra.

Printed in Bangkok
March 2001 – 2,860

United Nations publication
Sales No. E.01.II.F.18
Copyright © United Nations 2001
ISBN: 92-1-120031-8
ISSN: 0252-5704
ST/ESCAP/2104

- Following the impressive recovery in 1999, the economic performance of the ESCAP region strengthened further in 2000 in an environment of low inflation. The developing economies of the region increased GDP growth from 6.1 per cent in 1999 to 7.2 per cent in 2000, with the majority of them exceeding 1999 growth rates. Growth was generally driven by buoyant world trade, declining domestic interest rates and continuing fiscal stimuli.

- Prospects for 2001 are mixed. A sharp slowdown in the United States and a weaker than expected recovery in Japan could dampen export growth. High and volatile oil prices might be another inhibiting factor. However, continuing growth in the European Union and strong intraregional trade could partially offset such adverse effects. A moderate deceleration of growth of around 1 percentage point, accompanied by a slight pickup in inflation, is likely to occur in 2001.

- Financing investment for development poses a formidable challenge for many developing countries because of declining official development assistance, a high concentration and/or volatility of private external resources and difficulties in raising domestic savings.

- For countries to achieve greater success in raising finance for development, their governments must, inter alia, implement a consistent and prudent set of macroeconomic policies, enhance transparency of the budgetary process, develop wider and deeper financial markets, improve the management of domestic and foreign debt and apply international norms and standards in the governance of the corporate and financial sectors.

- Domestic policy initiatives must be complemented by supportive international action. The international financial architecture should be reformed to reduce periodic bouts of instability; measures should be adopted to widen access to foreign direct investment; and the flow of official development assistance on improved terms must increase, particularly for the least developed, landlocked and island developing countries and the economies in transition.