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FOREWORD

This issue of the *Bulletin on Asia-Pacific Perspectives* provides an assessment of the most recent developments in the global economy and their impact and implications for various economies or groups of economies within the ESCAP region. A more detailed review is undertaken in the annual *Economic and Social Survey of Asia and the Pacific*, published in April. The assessment benefited greatly from the collective wisdom of eminent persons from 14 member countries of ESCAP.

The mid-term review comes in the wake of several adverse developments in 2003, including the war in Iraq, the outbreak of SARS and geopolitical tensions in North-East and West Asia. Nevertheless, aided by an environment of exceptionally low interest rates and the dynamics of lower costs for finance, among other positive ripple effects, the global and regional economies have shown unexpected strength in 2003. Barring new negative shocks, growth in production and income in 2004 could be a percentage point higher than the rate expected for 2003 as a whole.

Issues in global and regional interdependence and in the promotion of sustainable development remain the focus of the shorter articles in the *Bulletin*. These articles provide a perspective on some of the major policy challenges facing countries in managing stable and equitable economic growth and social development against the backdrop of the Millennium Development Goals as set forth by world leaders in 2000 as well as unexpected, adverse external shocks. This issue of the *Bulletin* therefore embodies the ongoing and concerted efforts that are being made to enhance the role and relevance of the secretariat in the ESCAP region.

Finally, I wish to put on record my deep appreciation to the eminent persons who so generously gave of their time in support of our work in the secretariat and to the high-level experts for their written thoughts and perspectives on major issues of concern to us all.

Kim Hak-Su
Executive Secretary

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CONTENTS

ABBREVIATIONS

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
BTA	bilateral trade agreement
CD-ROM	compact disk read-only memory
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement/area
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
HIPC	heavily indebted poor countries
HIV/AIDS	human immunodeficiency virus/acquired immunodeficiency syndrome
ICT	information and communication technology
IMF	International Monetary Fund
MEA	multilateral environmental agreement
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
PTA	preferential trade agreement
R and D	research and development
SAARC	South Asian Association for Regional Cooperation
SAPTA	SAARC Preferential Trading Arrangement
SARS	severe acute respiratory syndrome
SMEs	small and medium-sized enterprises
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
WHO	World Health Organization
WTO	World Trade Organization

I GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION[1]

The global setting

The global economy showed unexpected strength in 2003

The global economy, including the ESCAP region, showed unexpected strength in 2003 despite the war in Iraq, the SARS outbreak in Asia and geopolitical tensions in West and East Asia. Indeed, preliminary indications are that global GDP growth in 2003 will either match, or modestly exceed, the performance in 2002. Inflationary pressures have risen only slightly, despite volatility in the energy markets; as a result, monetary authorities virtually across the world have been able to maintain an environment of low interest rates. Growth in world trade was unchanged in 2003 compared with 2002. Assuming that there are no new negative shocks, the prospects for the global economy in 2004 are broadly positive, with the possibility of acceleration in the growth rate in the second half of 2004. In that event, GDP growth for the year as a whole could be around 1 percentage point more than in 2003. Selected indicators of global economic conditions and forecasts for 2004 are given in table 1.

However, at the same time as growth picks up steam, new policy issues will inevitably arise in the months ahead. In addition, as explained in the concluding section of this chapter, short-term policy issues have to be placed within a longer-term continuum. Most countries in the ESCAP region have to confront major development challenges that go beyond short-term economic management and embody structural change, such as progress in poverty eradication, in accordance with internationally agreed goals and commitments, notably the Millennium Development Goals. However, these longer-term objectives may not be reached if there is too much preoccupation with the short term and in the absence of more explicit policy interventions involving the application of additional financial and non-financial resources.

Within the ESCAP region, despite the rise in intraregional trade and the impact of domestic growth-enhancing measures, reliance on the United States economy continues; the United States still directly accounts for over 20 per cent of the exports of developing countries of the ESCAP region. Such reliance is a matter of concern for the region in that it intimately links the region to cyclical developments in the United States economy with growing current account and fiscal deficits. Concurrently, in many

[1] Prepared by Shahid Ahmed, Economic Affairs Officer, Poverty and Development Division, ESCAP.

Table 1. Selected indicators of global economic conditions, 2000-2004

		2000	*2001*	*2002*[a]	*2003*[b]	*2004*[b]
Economic growth (percentage change in GDP)						
World						
At market exchange rates		3.9	1.4	1.9	2.0	2.9
At PPP exchange rates		4.8	2.4	3.0	3.2	4.1
Developed economies		3.9	1.0	1.8	1.8	2.9
Japan		2.8	0.4	0.2	2.7	1.4
United States of America		3.8	0.3	2.4	2.6	3.4
European Union		3.6	1.7	1.1	0.8	2.0
Developing economies		5.7	4.1	4.6	5.0	5.6
Developing countries in the ESCAP region		7.3	3.5	5.6	5.4	5.8
Growth in volume of trade (percentage)[c]						
World		12.6	0.1	3.2	2.9	5.5
Developed economies	Exports	12.0	-0.8	2.2	1.6	5.2
	Imports	11.9	-1.0	2.2	2.8	4.8
Developing economies	Exports	14.4	2.7	6.5	4.3	6.9
	Imports	16.1	1.6	6.0	5.1	7.8
Inflation rate (percentage)[d]						
CPI in the developed economies		2.2	2.2	1.5	1.8	1.3
CPI in the developing economies		5.8	5.8	5.3	5.9	4.9

Sources: United Nations, Project LINK Research Centre, "Current Quarter Model Forecast for the Japanese Economy" (September 2003); IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, International Monetary Fund, 2003).

[a] Estimate.
[b] Forecast.
[c] Exports and imports (goods and services).
[d] Developed and developing economies ratios weighted at purchasing power parity.

developing economies of the region while overall external positions remain favourable, domestic public debt is rising. This rising incidence of macroeconomic imbalances could presage significantly increased instability in global financial markets in the near future.

Grounds for cautious optimism for 2004

In the near term, Governments of ESCAP member countries are also faced with the policy challenges of sustaining the momentum of growth by preserving business and consumer confidence, maintaining their commitment to the agenda of trade liberalization in the face of setbacks and difficulties in negotiations, such as those at the Fifth WTO Ministerial Meeting, held at Cancún, Mexico, in September 2003, and coping with the rapid increase in bilateral trade agreements. While there are grounds for cautious optimism with respect to the near-term growth prospects, it would be imprudent to assume that all countries will be able to negotiate the next 12-18 months smoothly. As stressed by the ESCAP secretariat in previous issues of the *Bulletin* and the *Economic and Social Survey of Asia and the Pacific,* individual Governments need to remain committed to macroeconomic prudence, good governance and flexibility in day-to-day economic management. Simultaneously, Governments must facilitate structural change to enable their economies to maintain competitiveness in a globalizing world economy. For the long term, the greatest challenges for the developing countries in particular emanate from meeting the Millennium Development Goals and agreements on sustainable development reached at the World Summit on Sustainable Development.

In the following pages, the differing roles of the developed and developing economies in terms of their participation in global trade and financial markets are analysed and the likely impact of prevailing global trends on the economies of the ESCAP region, and prospects for the various subregions and economic groupings among ESCAP member countries, assessed. Finally, the near-term policy issues and long-term development challenges facing the ESCAP region are discussed.

Developed countries

Despite a combination of low interest rates and higher government spending, output growth in the developed economies remained sluggish up to the middle of 2003. There were tentative signs of a pickup in the pace of growth in the second quarter in both the United States and Japan, but output growth in the European Union remained lacklustre in the first half of 2003. However, leading indicators in Germany, the largest EU economy, suggest that growth could gain momentum later in the year or early in 2004. Taking the triad of the United States, Japan and the EU together, there is now a degree of optimism that the next 12 months should see a steady improvement in GDP performance compared with the first half of 2003. While this assessment is the most probable scenario on the basis of currently available information, it is nevertheless subject to a number of risks.

Uncertain prospects for more robust growth in the United States in 2004

First, in the United States, household spending has been the principal driver of growth since the ending of the IT bubble in 2000. Corporate investment expenditure, despite improved balance sheets, has failed to pick up significantly, until recently at any rate. The signs are that this phase could be coming to an end. Profitability is improving and this, combined with low borrowing costs, is expected to translate into higher investment expenditure in the months ahead. New capital equipment is also likely to be needed after two years of declining investment and on account of the rapid obsolescence of most ICT-related high-tech capital equipment.[2] Nevertheless, corporations remain saddled with enormous debts, a legacy of the post-bubble economy, and any broad-based investment upturn in the near term is likely to be weak.

Second, while there are encouraging signs with regard to corporate capital investment, question marks hang over both the sustainability of household spending in the face of weak employment data and the wider repercussions of the twin deficits, external and fiscal, on growth in the

[2] The Semiconductor Industry Association is predicting growth of semiconductor sales by 10.1 per cent in 2003 and 16.8 per cent in 2004 (*Bangkok Post,* 6 August 2003).

United States economy over the next 12 months. Consumer and business confidence revived strongly following the formal ending of military action in Iraq but subsequent events in that country have served to undermine both to some extent. As a result, there are signs that spending on durable goods is tending to weaken. In particular, remortgages, a major factor in sustaining consumer spending over the last two or three years, appear to be tailing off as a result of uncertainty on the jobs front. Growth in the United States economy in both 2002 and 2003 has not been accompanied by higher employment. On the contrary, unemployment rose from 5.7 in September 2002 to 6.1 per cent in September 2003 and job losses continue to occur in the manufacturing sector.

The current account and fiscal deficits in the United States are a worry

Third, with regard to the simultaneous emergence of the twin deficits, the situation has significant worrisome elements. The United States current account deficit of –5.2 per cent of GDP is the worst in the country's history and there is the likelihood of a further deterioration in 2004. Here the principal concern is that the appetite of foreigners to invest in United States assets could be flagging. In the last two years the composition of capital flows has changed significantly. FDI in the United States has become negative and private portfolio flows financed only about a quarter of the deficit early in 2003, the remainder being funded by short-term speculative capital flows and official purchases of bonds by foreign central banks. This lack of enthusiasm for United States assets has already revealed itself in the decline of the dollar trade-weighted exchange rate by more than 15 per cent between September 2002 and September 2003. A weakening dollar will further dampen capital inflows into the United States unless compensated by higher returns.[3]

On the fiscal side, the deficit has risen above 4.5 per cent of GDP and, until growth revives in a more robust fashion, is unlikely to come down significantly. All things considered, the fiscal deficit is unlikely to boost long-term growth.[4] Recent empirical evidence from the United States, and indeed elsewhere, lends support to the view that budget deficits, over time, push up interest rates. In the United States, there has already been a steepening of the yield curve for bonds in recent months with a rise in long-term interest rates. Furthermore, there is a view, based upon macroeconomic simulations for a variety of differing scenarios, that deficits induced by tax cuts do boost activity in the short term. However, the rise in long-term rates eventually negates the boost owing to the slower capital accumulation caused by higher interest rates. It should also be noted here that, given the increased integration of capital markets, trends in United States interest rates could have a direct bearing on interest rates in other countries, possibly leading to higher global interest rates with negative spillovers on global growth.

Nevertheless, taking together the growing evidence of an upturn with the overall balance of forces operating in the United States economy,

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[3] The United States Federal Reserve, however, stated in October 2003 that interest rates would remain low "for a long time" (*Financial Times*, 28 October 2003).

[4] IMF, *United States: 2003 Article IV Consultation* (Washington, International Monetary Fund, 2003).

the consensus is that, while there is significant uncertainty in making an accurate assessment of prospects for 2004, the risks to growth at this stage are not immediate. It is possible, however, that with a resumption in capital spending, output growth could be at, or very close to, the long-term trend rate of growth of the United States economy of around 3.5 per cent a year in the second half of 2004.

Japanese growth: how sustainable?

Japan has been mired in a low-growth syndrome for the better part of a decade (1.2 per cent a year over the last eight years). However, its economy has been showing signs of revival in recent months. By the third quarter of 2003, Japan had enjoyed seven consecutive quarters of growth. This unexpected change in the fortunes of the Japanese economy is best exemplified by the resurgence of profits of Japanese companies, the rise in the stock market of nearly 30 per cent in dollar terms since the end of 2002 and improved business confidence. In fact, there is patchy evidence that consumer demand is also reviving, after several years of decline or flat growth. By July 2003, wages and earnings had registered year-on-year growth of 2.3 per cent and unemployment had fallen marginally from 5.4 to 5.3 per cent. Observers hold the view that many Japanese consumers now feel that the worst is over and that unemployment has stabilized. As a result, they could become less reluctant consumers in the months ahead.

While the recent performance of the Japanese economy gives grounds for optimism in the near term, a number of important caveats need to be stressed. First and foremost, despite the improvement in consumer confidence, the recent revival of growth has been driven primarily by exports. In this process the yen exchange rate appears to have played a major part. On a trade-weighted basis, the rate has appreciated by less than 1.5 per cent over the last 12 months, unlike, say, the euro, and the current account surplus has begun to increase. The Bank of Japan has intervened on a massive scale in order to prevent the yen from appreciating but in doing so has added to its already huge foreign exchange reserves, paradoxically adding to the upward pressure on the yen exchange rate.

Companies have begun to invest but these expenditures are viewed as being primarily in anticipation of higher export demand. Given this background, there are obvious doubts as to whether the contribution of net exports based upon a weak yen can be sustained for long. Second, the problem of deflation also continues essentially unabated. Indeed, should current forecasts be borne out, Japan will, in 2004, complete six years of falling price levels. The apparent revival of consumer confidence should be viewed in that context. Third, problems in the banking and corporate sectors, notwithstanding recent progress, remain daunting. The improved profitability of Japanese companies has not been reflected in any meaningful reduction in the non-performing loan problem, although the present Government has committed itself to a target of halving bad loans by March 2005. Provisioning against bad debts in the banking system is still low, the banking system is still minimally capitalized and most banks' capital is subject to a large measure of vulnerability emanating from fluctuating sentiment in the equity markets.

For these reasons, the overall judgement is that Japan will not be able to sustain growth at its present pace into 2004. Further, given the poor performance of the Japanese economy over a number of years, its potential growth rate may now be significantly below the 4 per cent a year that Japan achieved in the 1980s. In other words, an upturn in Japanese GDP growth will only be an improvement on its recent performance and not a return to the robust growth of the 1980s.[5]

EU economic performance remains weak

In late 2002, there were signs that growth in the EU would become stronger in 2003. In the event, the most probable outcome is likely to be a slight deceleration, with growth in France, Germany, Italy and Netherlands slowing perceptibly in mid-2003, registering negative growth in the second quarter of 2003. Only the United Kingdom of Great Britain and Northern Ireland is an exception to this trend but there too growth is turning out to be somewhat weaker than first forecast. Unemployment remains high in all the main EU economies, again with the exception of the United Kingdom.

The below-trend performance of the EU is turning out to be deeper and more prolonged than anticipated, especially following the introduction of the euro.[6] More disquieting, it is displaying some of the negative traits of the Japanese economy of the last decade. For example, there is general agreement that long-term structural factors, rather than cyclical forces or short-term geopolitical shocks and uncertainties, are hampering the revival of growth in the EU. This is most evident in Germany, the largest EU economy, where the high cost of the welfare State (severely compounded by the costs of reunification) has recently been exacerbated by the problems of an overvalued exchange rate. In 2003, the counterpart of a weakening dollar has been a stronger euro that has seen its trade-weighted exchange rate appreciate by more than 10 per cent in the 12 months from September 2002 to mid-September 2003 and by much more against the dollar on a bilateral basis. Germany's problem is now likely to be experienced by the EU as a whole as a stronger euro reduces the potential for export growth outside the euro zone.

In virtually all EU economies, with the exception of the United Kingdom, considerable product and labour market rigidities also remain. These are reflected in low rates of corporate investment and of productivity growth, especially over the previous five years. These rigidities came into sharp relief following the ending of the asset price bubble of the late 1990s, when unemployment climbed upwards and has remained high. More determined reform efforts in France and Germany have not yet garnered the required political support for implementation, while room for fiscal manoeuvre to stimulate growth is limited given the already high deficits in the EU. There is some scope for monetary easing given the undershooting of inflation targets, but the European Central Bank has not shown a willingness to cut interest rates pre-emptively in anticipation of the reduced price pressures

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[5] BIS, *73rd Annual Report* (Basel, Bank for International Settlements, 2003).

[6] IMF, *World Economic Outlook, September 2003* (Washington, International Monetary Fund, 2003).

that should follow the appreciation of the euro. This has almost certainly weakened the momentum of growth in the euro zone. As a result, the short-term outlook is weaker than assessed 12 months ago, despite the more optimistic forward-looking business surveys in a number of EU economies.

Developing countries

Divergent growth in developing countries

The moderate but uneven recovery in the global economy in 2002, interrupted by the pre-war uncertainties of the Iraq crisis, was reflected in an even sharper divergence of growth rates in the developing countries. While there was relatively strong growth in the Asian economies, led by China, in 2002, other regions fared less well. In 2002, Latin American economies collectively experienced a contraction in output and growth slowed, or was flat, in other developing countries, including the oil-exporting countries, with the exception of Central and South Asia. In 2003, the rapid ending of military hostilities in Iraq in the first quarter was followed by the SARS crisis in the second quarter. However, the two events are reckoned to have had only a small impact on the developing countries, even within the Asian and Pacific region. Growth rates dipped in the second quarter of 2003 but the available indications are that in the second half of the year growth will more than offset the effects of the Iraq war and SARS-related slowdown earlier in the year. Indeed, according to World Bank estimates,[7] developing countries as a whole should exceed 2002 growth by more than 1 percentage point in 2003. Once again, the Asian economies will be the best-performing group, with other developing countries also improving upon their performance in 2002. Growth in the region is in part cyclical following the 2001 downturn and in part driven by rapidly shifting production patterns in East and South-East Asia.

Rapid growth of trade in developing countries

The recent performance of the developing countries owes much to the strength of world trade (see table 2) and to stronger commodity prices (see table 3). In 2002, world trade volumes grew by around 3 per cent, following a small decline in 2001, and non-oil commodity prices recovered after more than a decade of decline. Weakness in manufactured goods prices was also reversed, although prices firmed only marginally. The most striking feature of global trading trends in 2002 was that while import demand by the developed countries grew by 1.3 per cent, that by developing countries grew by 5.6 per cent (for a graphic presentation, see figure I). On the basis of currently available information, these trends are likely to have strengthened significantly in 2003. World trade growth is expected to reach 6.7 per cent, with developed country import demand growing at 5.3 per cent and developing country import demand growing at almost double that rate, namely, over 10 per cent. The more rapid growth of international trade by the developing countries is particularly evident in the Asian region, where the developing economies are again expected to outperform other developing countries in 2003. Broadly speaking, these trends are expected to continue into 2004.

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[7] World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).

Table 2. World trade and prices,[a] 1991-2003

	Annual percentage changes					
	1991-2000	*1999*	*2000*	*2001*	*2002*	*2003[b]*
Trade volumes	7.3	5.8	13.3	-0.6	3.3	2.9
Trade prices (in US dollars)						
Manufactures	-0.9	-1.8	-4.7	-2.4	2.6	12.8
Oil	2.1	37.5	57.0	-14.0	2.8	14.2
Other commodities	-0.9	-6.7	4.5	-4.0	0.6	5.0
Terms of trade						
Developed economies[c]	0.2	0.1	-2.9	0.4	0.8	1.1
Developing economies	0.0	5.8	7.2	-3.9	1.8	-0.4

Sources: IMF, *World Economic Outlook*, cited in BIS, *72nd Annual Report* (Basel, Bank for International Settlements, 2002); and IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, International Monetary Fund, 2003).

[a] Goods only.

[b] IMF forecast.

[c] Advanced industrial economies plus newly industrializing Asian economies (Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China).

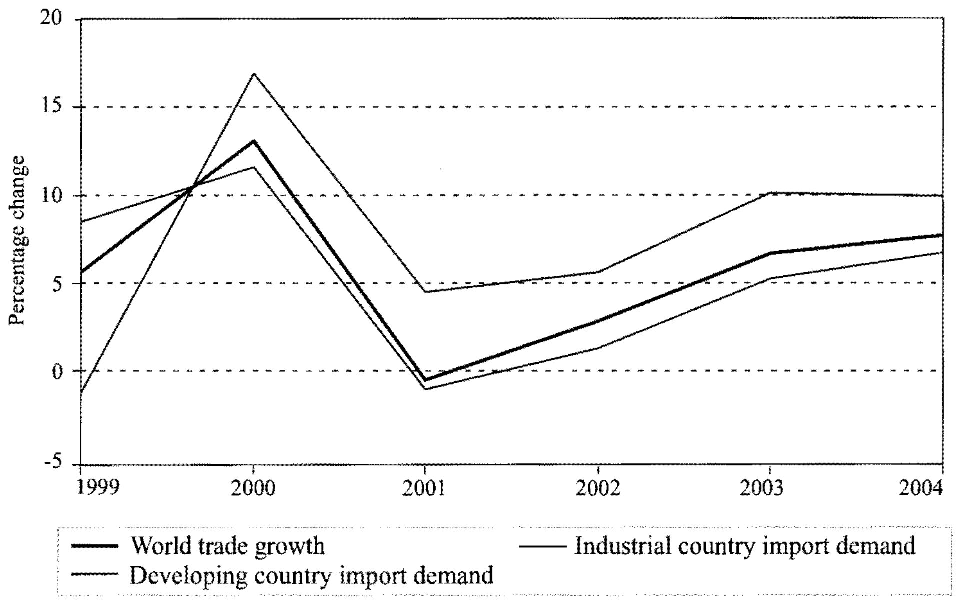
Table 3. Indices of major commodity prices, 1996-2003

(1995=100)

	1996	*1997*	*2000*	*2001*	*2002*	*2003 May*
Palm oil (Malaysia)	84.6	86.8	49.2	45.6	62.1	66.2
Rice (Thailand)	105.4	94.3	63.5	53.8	59.8	61.6
Rubber (Malaysia)	88.7	64.4	43.7	38.0	48.7	60.0
Sugar (US import price)	97.0	95.1	84.1	92.5	90.8	94.8
Tea (Sri Lanka)	126.5	134.5	119.9	117.1	113.4	..
Timber:						
Hardwood logs (Malaysia)	98.5	92.4	73.8	62.2	63.1	71.1
Hardwood sawnwood (Malaysia)	100.1	89.5	80.9	66.0	70.0	75.2
Softwood logs (United States)	105.3	95.6	93.3	81.4	75.3	80.7
Softwood sawnwood (United States)	103.1	97.8	94.7	94.1	90.9	91.9

Sources: IMF, *International Financial Statistics Yearbook 2002* (Washington, International Monetary Fund, 2002); and *International Financial Statistics* (Washington, International Monetary Fund, July 2003).

Figure I. External environment for developing countries, 1999-2004



Source: World Bank, *Global Economic Prospects and the developing countries 2003* (Washington, World Bank, 2003)

Recovery in global high-tech markets has played a pivotal role in world trade growth in 2002 and 2003. After the demand for semiconductors and related equipment collapsed in 2001, there was an expectation that recovery, when it came, would be sharp. ICT and its components are products with rapid obsolescence, a feature that leads to periods of very high growth followed by sharp slowdowns. Manufacturers are often reduced to being price takers as the amplitude of the production and demand cycles can, and has, led to overproduction. This is an area in which both East and South-East Asia have a strong competitive advantage. Furthermore, as noted in previous discussions on this subject, production of ICT is heavily "componentized", leading to strong intraregional trade in inputs with the final product often, but not always, exported outside the region. Table 4 shows the buoyancy of developing country exports, with export growth in general outpacing import growth in the main developed economies, reflecting the increase in trade between developing countries.

Developing economies of the ESCAP region to enjoy stronger growth in 2004

What impact will these developments have on developing countries in general and on the Asian economies in particular? As already observed, sharply varied growth patterns are likely to characterize economic activity across countries and regions in the short run. For instance, growth prospects in East and South-East Asia and, to a somewhat lesser degree, South Asia, are more buoyant than in other developing countries. These countries are both major centres of manufacturing and important commodity producers. Aided by a low interest rate environment and the inventory dynamics of low working capital costs, production of ICT is on a rising trend. As costs and prices have declined, the demand for new consumer products, such as

Table 4. Rate of growth of exports and imports, selected ESCAP economies

	2000		2001		2002		2003[a]	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
Bangladesh	23.7	7.8	2.6	0.1	-5.1	-13.2	19.9	6.3
China	27.8	35.8	7.0	8.2	22.1	21.3	34.0	39.9
Hong Kong, China	16.2	18.7	-6.0	-5.6	-29.6	-0.1	4.1	13.8
India	18.7	5.1	7.1	12.3	9.7	12.3	18.4	14.7
Indonesia	27.6	39.6	-9.3	-7.6	1.5	1.1	25.6	30.6
Iran (Islamic Republic of)	34.5	29.7	-8.3	11.6	-4.6	14.0	35.6	20.3
Malaysia	16.1	25.5	-10.1	-10.1	9.7	11.0	19.7	13.2
Pakistan	8.5	7.3	0.6	-7.7	7.4	10.1	28.0	31.1
Philippines	7.3	2.1	-15.6	-5.8	23.6	44.5	11.3	14.2
Republic of Korea	19.6	34.0	-12.8	-12.1	7.8	7.8	18.1	21.6
Russian Federation	42.2	11.8	-19.9	9.0	29.9	23.4	25.7	24.4
Singapore	20.2	21.2	-11.8	-13.8	2.8	0.4	16.7	15.3
Taiwan Province of China	22.0	26.5	-17.1	-23.4	6.3	5.0	6.8	9.4
Thailand	17.9	23.0	-5.6	0.2	5.7	4.3	20.8	18.8
Turkey	4.5	34.0	12.8	-24.1	11.9	22.8	27.0	37.8
Viet Nam	25.5	33.2	-6.9	6.1	14.5	15.5	46.9	19.7
Memo:								
United States	11.8	18.1	-5.3	-4.7	-5.2	1.9	4.3	14.3
Japan	14.1	22.1	-15.6	-8.0	3.3	-3.4	13.5	17.9
European Union	2.9	6.0	0.5	-1.7	5.4	3.3	11.3	17.8

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), September 2003; and national sources.

[a] Data relate to the first quarter of 2003, except for Taiwan Province of China, in which case the data refer to the second quarter.

mobile telephones, personal computers and household electronics, has risen rapidly. In addition, buoyancy in the manufacturing sector has spilled over into services. The resultant strong GDP growth has translated into rising incomes; these in turn have boosted the demand for, and the production of, a broader range of goods, particularly cars, and this has resulted in remarkable vibrancy in intraregional trade in East and South-East Asia.

This positive overview should not, however, be construed to imply that, from a forward-looking perspective, risks for developing countries of the region are now non-existent or negligible. The recent trading dynamism of China, for example, has been built upon a rapid increase in the global market share for a wide range of products. Although China's market share still constitutes only 5 per cent of global exports, it has already generated a degree of resentment in several countries. Retaliatory action in the form of trade barriers thus cannot be ruled out. The dynamics of high-tech markets, with their history of boom and bust, is another potential hazard. Intraregional trade itself owes some of its recent strength to the growth of household incomes, reflected in buoyant consumer demand, in the developing countries of Asia. This demand has been stimulated in part by looser fiscal and monetary policies. It is self-evident that there are limits beyond which the easing of fiscal and monetary policies is neither possible nor desirable. Hence, all developing countries in the Asian and Pacific region are faced with major policy trade-offs in maintaining the momentum of growth in 2004. The likely impact of the global economic environment and the policy issues it raises for the various subregions of ESCAP are discussed more fully elsewhere.

Financial market and related developments

The international financial system ...

Side by side with trade, financial markets play an important role in the global economy. Apart from the provision of finance, financial markets are a medium for the transmission of the collective judgements of investors and, as such, they act as monitors and bellwethers, not merely in matters of corporate performance but also in the performance of national Governments. With the rapid spread of globalization since the early 1990s, financial markets, despite bringing in a wider pool of investors and savers within their ambit, have been seen to be prone to excessive swings in sentiment.[8] In consequence, their ability to provide appropriate pricing information to investors has been adversely affected. Over the years, markets have also developed a tendency to overshoot or undershoot equilibrium values, be it equity or bond prices or exchange rates. The functioning of financial markets in themselves thus creates significant policy issues. Regardless of their deficiencies, however, financial markets are the primary interface between the real economy and the preferences of savers and investors all over the world. As much as the real economy drives financial markets, the latter equally have an impact on the real economy.

... shows resilience ...

The bursting of the equity bubble, unfavourable geopolitical developments and corporate governance scandals have severely tested global financial markets in recent years. By and large, however, the markets have shown considerable resilience in coping with these events. In fact, by late September 2003, stock markets virtually across the world had risen by a fifth or more, reflecting increased confidence in the future. Bond markets had also risen, but by less, as investors were beginning to discount the likelihood of further decreases in interest rates. Indeed, yields on long-dated bonds had begun to rise in the second quarter of 2003 as investors realized that the large United States fiscal deficit would inevitably mean higher interest rates at the longer end of the time spectrum in due course. Major exchange rate realignments had also taken place, primarily the depreciation of the United States dollar and appreciation of the euro, but these had not plunged the markets as a whole into turmoil.[9]

A part of the mood of optimism that began in 2002 has been based upon real improvements in corporate balance sheets and performance, a process

[8] IMF, *Global Financial Stability Report: Market Developments and Issues* (Washington, International Monetary Fund, September 2003).

[9] BIS, *BIS Quarterly Review, June 2003: International Banking and Financial Market Developments* (Basel, Bank for International Settlements, 2003).

aided by the low interest rate environment. Another part, however, is based upon the way investors have been reacting to the prospect of a prolonged period of low interest rates; they are being pushed, willy-nilly, into seeking higher yields for their savings and risk aversion is becoming less strong, though in an uneven fashion. In the process, however, there is the danger that both equity and bond prices may be bid up, once more, to values above those that could be justified by underlying corporate earnings or by a realistic perception of the balance of risks involved in such judgements, especially the lack of evidence so far of a solid recovery in the global economy. In other words, the equity and bond markets may be becoming excessively inflated, a phenomenon that is evident in both developed and developing economies.

... although private capital flows to developing economies are likely to decline in 2004

As a result of the upsurge in the equity and bond markets in 2002 and 2003, private capital flows to developing countries, as well as those in Asia, rose significantly, with portfolio flows and FDI proving particularly buoyant (see table 5). The former are usually of a short-term nature and can be easily reversed. Moreover, they are instrumental in inflating asset price bubbles. FDI flows, by contrast, are long-term, usually with an ongoing contribution to both production and exports. FDI in Asia has been buoyant for some time, with China leading the way. Manufacturing continues to shift to the region to take advantage of good infrastructure, large domestic markets and productive, low-cost labour. However, prospects for 2004 indicate that some decline is on the cards in view of the apparent overcapacity in many manufacturing activities. Investor nervousness relating to the developing countries could rise as perceptions regarding the fiscal situation in many of those countries become less sanguine. At the same time, the emergence of large imbalances in the global economy, such as the United States current account and fiscal deficits and how the two are likely to be financed, may presage a period of heightened exchange rate instability with investors seeking safe-haven-type outlets for their savings, such as precious metals. In such a scenario, investors would tend to eschew cross-border transactions or demand extra returns.

Exchange rates of Asian currencies are tending to appreciate

Up to the end of September 2003, realignments in exchange rates had been borne primarily by the euro, aided by a number of smaller developed and developing country currencies. Any further depreciation of the United States dollar in the months ahead would, of necessity, involve a wider range of economies and currencies. In those circumstances, Asian economies would be directly affected, given the size of the external trade in their economies and the persistence of large current account surpluses, which have resulted in the build-up of massive foreign exchange reserves in some economies of the Asian and Pacific region. The export sectors in most Asian economies play a much bigger role than in the developing countries as a group and any significant realignment of exchange rates, especially those in which a degree of overshooting is involved, could imply significant short-term changes in competitiveness and, perhaps, in trade flows. For most developing countries, this process, already in evidence to some extent, could then involve changes in the output mix and redeployment of productive resources compressed into a short period of time.

Table 5. Net capital flows[a] of developing economies and developing Asia, 1996-2004

(Billions of US dollars)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Total[b]									
Net private capital flows[c]	226.5	132.6	77.8	86.7	47.1	42.7	80.3	113.1	93.8
Net private direct investment	116.2	143.9	156.0	175.4	165.7	180.9	142.9	143.9	145.2
Net private portfolio investment	83.2	63.3	11.0	19.5	-3.8	-51.2	-52.9	-22.9	-16.8
Net other private capital flows	27.1	-74.6	-89.2	-108.2	-114.9	-87.1	-9.7	-8.0	-34.6
Net official flows	-1.8	42.6	57.6	7.6	-12.8	21.1	7.1	10.1	-16.0
Changes in reserves[d]	-104.6	-71.1	-49.7	-88.4	-117.2	-122.4	-211.6	-255.1	-148.5
Developing Asia[e]									
Net private capital flows[c]	124.6	10.8	-42.1	4.6	-3.3	25.2	57.0	62.4	13.7
Net private direct investment	55.0	59.8	60.9	60.6	58.4	50.9	57.8	66.5	59.6
Net private portfolio investment	30.0	7.3	-17.2	11.5	4.3	-13.5	-21.1	-10.9	-16.5
Net other private capital flows	39.6	-56.3	-85.8	-67.5	-66.0	-12.2	20.2	6.8	-29.4
Net official flows	-13.0	17.1	26.1	3.9	1.9	-9.7	-9.9	-7.1	-7.6
Changes in reserves[d]	-46.9	-15.1	-67.8	-78.9	-49.0	-84.9	-167.1	-159.9	-93.7
Memorandum:									
Hong Kong, China									
Net private capital flows[c]	-7.1	10.8	-8.5	1.1	4.2	-6.6	-24.9	-27.7	-25.6

Source: IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, International Monetary Fund, 2003).

[a] Net capital flows comprise net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private borrowing.

[b] Excluding Hong Kong, China.

[c] Because of data limitations, may include some official flows.

[d] A minus sign indicates an increase.

[e] Including Republic of Korea, Singapore and Taiwan Province of China.

One of the puzzles in the current situation relates to the behaviour of real estate, particularly housing prices. Housing and real estate prices have risen in virtually all countries of the world and their future course has important policy implications. Equity holdings and housing are the largest components of household wealth in developed countries, and increasingly so also in developing countries, and their values tend to move together over long periods. The same relationship holds true in the developing countries of the ESCAP region, where, if anything, the scarcity premium on urban real estate is even higher. However, three years after the equity markets began to decline real estate prices have continued to rise in most countries. Despite some cooling-off in recent months, the prices remain at historical highs in relation to disposable earnings. Indeed, there appears to be no immediate prospect of a price correction in most countries.

Low interest rates fuelling the real estate boom

A key factor in the housing boom has been the low interest rate environment in the region. The low rates have allowed borrowers to take on more loans relative to income, given the lower cost of servicing their debts. In the process, they have added to the market demand for housing and for real estate in general. Low interest rates have also forced savers to switch investments from financial assets to bricks and mortar. Some observers fear the creation of a bubble in housing with its attendant downside risks, as an increasing proportion of banking assets are, once again as in 1995-1997, invested in real estate. The majority of housing loans are tied to long-term interest rates and these have risen by approximately 40 basis points in the United States relative to 12 months ago.[10] As already mentioned, in an integrated global financial system the changing structure of interest rates in the United States will not remain confined to that country and will inevitably spill over into other markets. A firming trend in long-term interest rates will have an impact not only on the housing market but also on household consumption, especially debt-financed consumption. In other words, sustaining global growth in the months ahead could become problematic and require a policy approach which would involve the continuation of the low interest rate environment and simultaneously grappling with the possible emergence of asset bubbles in a number of economies.

Prospects for the ESCAP region

Investment pickup to strengthen growth momentum in the ESCAP region

Taking 2003 as a whole, despite the war in Iraq and the SARS crisis, the developing countries of the ESCAP region are likely to experience collective GDP growth very close to the rate achieved in 2002, when they were the fastest-growing economies in the world. Furthermore, on current trends, growth is expected to pick up additional momentum in 2004 should the global economy build up steam as posited earlier, via higher corporate investment expenditures, in the remaining months of 2003 and into 2004. Estimates for 2003 and forecasts for the ESCAP region for 2004 are given in table 6.

Comparable with the pattern in 2002, growth in 2003 has once again been driven by a combination of higher net exports, especially exports within the region, and buoyant domestic consumer demand. The short-term outlook for higher net exports, however, has to be seen in the light of a still rather fitful global recovery that could take time to become more firmly established, and a weaker dollar that has put upward pressure on a number of currencies in the region. There is thus the possibility of a loss of export momentum for some economies in the months ahead. Domestic policy measures, given their current constraints, may not be able to fully offset or mitigate changes in the external environment, at least in the short run.

[10] *The Economist*, 18 October 2003.

Table 6. Rates of economic growth of selected developing economies and North and Central Asian economies of the ESCAP region, 2001-2004

(Percentage)

	Real GDP			
	2001	2002	2003[a]	2004[b]
South and South-West Asia[c]	2.2	5.4	5.6	5.9
Bangladesh	5.3	4.4	5.3	5.7
India	5.6	4.4	6.0	6.3
Iran (Islamic Republic of)	4.8	6.5	6.7	6.8
Pakistan	2.7	4.4	5.1	5.3
Turkey	-7.5	7.8	4.6	5.0
South-East Asia	1.9	4.2	4.1	5.1
Indonesia	3.4	3.7	3.6	4.3
Malaysia	0.4	4.2	4.5	4.5
Philippines	3.4	4.4	4.5	5.0
Singapore	-2.4	2.2	1.0	4.9
Thailand	1.9	5.3	6.0	6.5
Viet Nam	6.9	7.0	6.9	7.2
East and North-East Asia	4.2	6.4	5.4	6.5
China	7.3	8.0	8.0	7.9
Hong Kong, China	0.6	2.3	2.0	4.8
Republic of Korea	3.1	6.3	3.1	5.0
Taiwan Province of China	-2.2	3.5	3.2	5.4
North and Central Asia	5.9	5.0	6.4	4.5
Russian Federation	5.0	4.3	6.0	4.0

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LVI, No. 9 (Washington, International Monetary Fund, September 2003); ADB, *Key Indicators of Developing Asian and Pacific Countries 2003,* vol. 34 (Manila, Asian Development Bank, 2003) and *Asian Development Outlook 2003 Update* (Manila, Asian Development Bank, 2003); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2003), various issues; web site of the Inter-State Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>; and national sources.

[a] Estimate.
[b] Forecast/target.
[c] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2003/04 = 2003 for India and the Islamic Republic of Iran, and fiscal year 2002/03 = 2003 for Bangladesh and Pakistan.

Need for developing economies of the ESCAP region to stabilize public debt and restrain credit growth

Domestic demand has been stimulated by explicit growth-enhancing domestic policies in the shape of higher fiscal spending and lower interest rates. After nearly three years of fiscal and monetary easing, additional scope in both areas of policy is limited. Public debt as a proportion of GDP has risen significantly in a number of countries and is perhaps already close to its upper limit (table 7). Although inflation remains low and most countries run balance-of-payments surpluses, additional fiscal or monetary stimulus is nonetheless conditioned by external market perceptions. Market participants, rightly or wrongly, take a negative view of rising domestic debt; this could impinge upon the ongoing debt restructuring of corporations and banks in the region. Thus, new public debt has to form part of a longer-term strategy of

Table 7. Debt indicators for selected Asian economies

	Public debt/GDP			*External debt/exports*		
	1996	*2000*	*2002*	*1996*	*2000*	*2002*
Bangladesh	44[a]	48	53	327	236	209[b]
China	7	15	16	85	60	54
India	57	67	73	283	236	216
Indonesia	24	82	92	259	217	231
Malaysia	35	37	46	51	43	49
Pakistan	79[c]	92	96	287	338	322
Philippines	53	66	74	197	134	158
Republic of Korea	8	17	22	126	78	82
Thailand	15	57	54	194	115	95
Turkey	38	51	100[b]	175	227	228[b]

Sources: BIS, *73rd Annual Report* (Basel, Bank for International Settlements, 2003); World Bank, *World Development Indicators* (Washington, World Bank), various issues; IMF, *International Financial Statistics*, vol. LVI, No. 9 (Washington, International Monetary Fund, September 2003).

[a] 1997/98.

[b] 2001.

[c] 1993.

keeping the debt-to-GDP ratio stable. The same constraints apply to the continuation of low interest rates. These have been accompanied in some countries by unsustainably rapid credit growth that will require corrective policy action before too long. However, by and large, the balance of risks vis-à-vis the near-term outlook remains neutral, with some likelihood of growth picking up in the second half of 2004. In the following paragraphs, the prospects for each subregion are briefly discussed. The discussion is perforce restricted to the economies for which the requisite data for 2003 and forecasts for 2004 are available.

Growth to pickup in South Asia

In South Asia, GDP growth picked up in 2003 compared with 2002. India, the largest economy in this subregion, is likely to see a rise in its GDP growth rate in 2003 relative to 2002. A good monsoon has boosted agricultural production and raised the GDP growth rate. A further pickup in momentum is expected in 2004. The Indian economy appears to have boosted its GDP growth significantly over the last few years, notwithstanding slow progress in fiscal and structural reform. The question remains whether this higher pace of growth is sustainable over the medium term. In Bangladesh and Pakistan, too, the GDP growth rate has picked up in 2003 and this higher pace is likely to be sustained in 2004. In South Asia as a whole, the contribution of net exports to GDP growth has risen substantially over the last two to three years. This has added to the growing strength of domestic consumption and investment demand, particularly in infrastructure. Improved inflows of remittances and foreign capital have improved the foreign exchange reserve position significantly in nearly all countries in South Asia. Exchange rates have appreciated relative to the dollar as a result. In the case of India and Pakistan, higher inflows of foreign resources have led to balance-of-payments current account surpluses. Although prospects for 2004 are for a pickup in GDP growth rates, especially in India and Pakistan, uncertainties remain. These are primarily external and could affect the contribution from net exports adversely if growth in the global economy remains tentative. Periodic increases in tension between India and Pakistan and the lack of stability in Afghanistan add to the overall climate of uncertainty in the subregion.

South-East Asia demonstrates its resilience

In South-East Asia, 2003 growth was particularly strong in Thailand, driven, for the most part, by buoyant consumption aided by a sharp upturn in exports. Firmer commodity and manufactured goods prices strengthened export earnings. These factors also applied to Viet Nam, where GDP growth remained buoyant in 2003. Growth was less strong in Indonesia and the Philippines, where the security situation tended to dampen business confidence. Singapore was the worst-affected economy in the subregion, having lost ground in consumer confidence sharply during the SARS crisis. However, the terrorist attacks overall and SARS appear to have had only a temporary economic impact in the subregion as a whole. SARS has adversely affected tourism and related activities, such as air travel, but was confined to the second quarter of 2003.[11] Tourism accounts for 4-6 per cent of GDP in South-East Asia generally and any temporary setback can be overcome either in the other components of GDP or later in the year by a revival in tourism itself. The outlook for 2004 is thus positive, barring any unforeseeable negative shocks such as terrorism. Rising exports to China in 2003 should continue to grow in 2004. Domestically, strong consumption growth, facilitated by easier macroeconomic policies, is likely to be sustained but could come up against rising personal debt levels and the need to begin fiscal consolidation in the near future. Subject to these qualifications, the subregion should enjoy stronger growth in 2004.

Strong growth in China

East Asia performed strongly in 2003, led by robust growth in China. In contrast, the Republic of Korea saw its GDP growth rate decline significantly In China, growth was particularly robust in the first half of the year. Both domestic demand and exports have supported growth in China. Domestic demand is mainly investment-driven in China, but rapidly rising middle-class incomes are boosting personal consumption expenditure as well, leading to the production of a wide array of consumer goods and a surge in FDI and imports. The slowdown in the Republic of Korea was led by a sharp decline in domestic demand, caused by a fall in credit growth as the authorities sought to head off a crisis of personal indebtedness. Perhaps not

[11] According to the World Tourism Organization, tourism overall grew in 2002 but growth was uneven. A similar pattern of uneven growth is expected in 2003.

unrelated to this action, there was also an easing of the housing boom. Accompanying the slowdown in domestic demand, export growth also slowed owing to price softness in ICT. In 2003, growth was less strong in Taiwan Province of China, and Hong Kong, China, barely skirted recession. The hitherto vibrant manufacturing sector in Taiwan Province of China remains tied to the dynamics of boom and bust in the global high-tech industry. Similar to the situation in Japan in the 1980s and 1990s, a "hollowing out" of manufacturing activity is under way, with many factories relocating from Taiwan Province of China to China. Unemployment and falling property prices in Hong Kong, China, have shaken consumer confidence and, as in Japan, the economy has become mired in deflation, prices having fallen for five straight years. Very low inflation also affects China to some extent, and Taiwan Province of China has seen no rise in prices for three years. Deflation, and even very low rates of inflation, tend to make the real cost of borrowing higher with unchanged interest rates. In both Taiwan Province of China and Hong Kong, China, interest rates are currently around 1 per cent and cannot be reduced much further. Notwithstanding these policy conundrums, prospects for the subregion in 2004 are that existing GDP growth rates will be broadly maintained, with some acceleration likely in the Republic of Korea and Hong Kong, China, as the global economy gains strength.

Growth improves in the least developed countries and Pacific island economies

On the basis of tentative information, GDP growth picked up in 2003 in the least developed countries. This was primarily the result of improved export growth as commodity prices rose. Least developed country exports are, however, still concentrated in a relatively narrow range of items, although newer exports such as garments are making a major contribution to exports and GDP growth. Tourism was adversely affected as concerns about security kept tourists away from several of the least developed countries, and especially from countries such as Nepal, where the security situation continues to give concern. On the positive side, inflationary pressures remained muted in 2003. For the future, taking the least developed countries as a whole, much depends upon the recovery of global growth in 2004 and more particularly upon growth in the ESCAP region itself, with which those countries are becoming increasingly integrated.

As in the case of the least developed countries, the Pacific island economies matched the rest of the ESCAP region in showing an improvement in GDP growth in 2003. The most visible turnaround appears to have occurred in Solomon Islands. Despite the fact that the Pacific island countries are away from the areas of tension, tourism displays a mixed trend. In 2003, the SARS-related downturn in international travel in the region also affected the Pacific island economies. For 2004, overall prospects are for GDP growth to match or exceed the performance in 2003, depending upon the strength of GDP growth in Australia and New Zealand.

Australia and New Zealand, with buoyant domestic demand, continued to show strong growth in 2003. The consensus view is that strong domestic demand should preserve the current momentum of growth in both countries, although the sharp appreciation of both the Australian and New Zealand dollars in 2003 could dampen export growth.

Growth to slow in Central Asia and the Russian Federation

In Central Asia and the Russian Federation, growth has been led by buoyant private consumption and investment in the energy sector in which large inflows of FDI are currently taking place. In the Russian Federation, some deceleration from the over 7 per cent GDP growth recorded up to the second quarter of 2003 on a year-on-year basis is likely in the later part of 2003. In addition, with energy prices now entering a period of stability, 2004 should also witness easing in the overall GDP growth rate to a more sustainable 5 per cent.

Near-term policy issues

The relatively quick end to the war in Iraq, with minimal disruption of the energy markets and limited impact of the SARS crisis, suggests, on the face of it, that the main uncertainties facing the ESCAP region have been resolved. Both consumer demand and fixed investment should benefit, particularly in countries where such spending has been weak in recent months. In addition, the need to rebuild inventories from the current low levels should also contribute to output growth. Nevertheless, there is currently no unambiguous mood of optimism regarding the future even though the relevant signs and forecasts indicate an improvement in the global economy in 2004. The failure of the Fifth WTO Ministerial Meeting to push forward the Doha Development Agenda might suggest systemic weaknesses in the WTO-driven model of trade negotiations (see box). A further failure at WTO could undermine cross-border investment flows to a significant extent.

The global economy faces a number of uncertainties

Some of this circumspection also relates to the aftermath of the twin bubbles, the Japanese bubble of the 1980s and the United States dot com bubble of the late 1990s, and their residues of high corporate debt levels, excess production capacity, especially in manufacturing, and low equity valuations. Both the Japanese and United States experiences indicate that the ending of asset bubbles tends to feed back into the real economy and the ensuing indebtedness and systemic problems in the financial sector can take a very long time to resolve. Another underlying fear could perhaps be of a new terrorist outrage, an event that makes investors and consumers nervous by its very unpredictability.

The unwinding of external and fiscal imbalances in the United States, EU and Japan will have implications for the Asian and Pacific region, where a number of emerging economies have built up large balance-of-payments surpluses. These imbalances, reflecting the persistent and sustained external deficit of the United States, virtually the world's single engine of growth, have already contributed to the volatility of exchange rates, in particular the depreciation of the dollar. Further abrupt exchange rate adjustments cannot rebalance global external gaps on their own. Neither can Japan, China and other Asian countries or the EU, at this stage, compensate for slower growth in the United States, nor can fiscal and external deficits in that country be adjusted quickly. This implies the need for a more coordinated and smooth adjustment process from which no country can be immune in the face of increased global integration. The global situation will place a high premium on greater international and regional cooperation through both formal and informal channels.

Post-Cancún[a]

The Fifth WTO Ministerial Conference at Cancún, Mexico, can no doubt be described as unparalleled in the multilateral trading environment: the largest number of members (148 with over 30 observers), over 4000 trade negotiators, the most ambitious agenda and, therefore, a lost opportunity. Not surprisingly, ever since that Sunday afternoon on 14 September, various commentators have been engaged in finger-pointing, seeking to identify a country or a group of countries as being most at fault for the Cancún collapse. This is, of course, the wrong approach if the talks are to be revived. The collapse is the collective responsibility of all as the benefits of multilateral trade liberalization are enjoyed by all. While trade liberalization benefits are not equally shared by all the liberalizing members, it is true that all countries benefit.

The Doha-mandated negotiating agenda is focused on development and on helping the poor, in particular. Successful completion of the Doha Round therefore has great potential to benefit both developing and developed nations alike: by World Bank estimates, it could bring 144 million people out of poverty by 2015, the year that world leaders set as a target for halving world poverty. It is further estimated that global income increases would be between US$ 290 billion and US$ 520 billion a year.

Liberalization of agriculture is one of the most important drivers of these benefits. Not surprisingly, it was first on the negotiating list. About three quarters of the world's poor live and work in rural areas and depend on agriculture for their survival. The Uruguay Round left much to be done on liberalizing agricultural trade and making the trading environment fairer. While some reforms took place, OECD subsidy payments to farmers are about six times the amount spent on ODA. Furthermore, developing countries continue to face high tariff and non-tariff barriers as well as increased pressure to open up their own domestic markets to heavily subsidized developed country products. At the same time, it is also true that the average levels of bound tariffs in the developing countries, in agriculture and in other sectors, are far higher than the levels prevailing in the developed countries. This goes against the fundamental economic justification for liberalizing trade: free trade first and foremost serves the interests of a country pursuing such a free trade policy.

Another two crucial sectors for fulfilling development and poverty reduction goals are the labour-intensive manufacturing sector and services. With respect to labour-intensive manufacturing, particularly textiles and clothing, for various reasons both developed and developing countries still maintain high trade barriers. Increasingly these barriers consist of safeguards, countervailing duties and anti-dumping measures which raise the cost of trade, especially for developing countries with limited resources to have recourse to dispute settlement processes.

Negotiation of further liberalization in services has also not moved forward as much as it could have as development depends heavily on access to high-quality, low-cost services. So far the liberalization of services reflects to a large extent the export interests of the developed countries, leaving aside subsectors of special interest for developing countries such as outsourcing and the movement of natural persons.

There was another big topic on the agenda - the so-called Singapore issues. Increasingly, at least some of these issues (competition, investment, government procurement and trade facilitation) appear to be moving away from the negotiating table. In the end, it was these issues that pushed the talks to an early closure without agreement. It turned out that the issues with the less direct economic impact for most of the countries prevented them from seriously addressing those such as agriculture and market access which would have brought much more substantive benefits to all.

In short, the talks failed for many reasons, including missed deadlines, misunderstandings about the stakes and the changed balance and dynamics of a much larger WTO. This should not prevent members from maintaining commitment to liberalizing trade, enhancing growth prospects and reducing poverty. Ways must be found to revive the process of meeting the Doha development goals. This means realizing that multilateral trade liberalization should not be taken for granted and that it does not happen on its own. It is based on reciprocity, non-discrimination and consensus. It is also slow and cumbersome. Perhaps the single most important result from Cancún is the realization that pragmatism and sincerity in negotiations are required to move a consensual process forward. And here developing countries too must be prepared to liberalize more boldly, to achieve their development goals. While developing countries rightly expect developed countries to open up their markets further, it is also true that some of the highest barriers to trade are among developing countries themselves.

Trade is an irreplaceable source of wealth creation and growth in the world, and we have yet to come up with anything better than the multilateral trading system to sustain development and contribute to peaceful relations among countries in the world. However, remembering Bhagwati's analogy of the bicycle, concerted pedalling will be needed, the sooner the better, to keep the multilateral trading system from teetering and falling over.

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[a] Prepared by Mia Mikic, Economic Affairs Officer and Tiziana Bonapace, Officer-in-Charge, Trade Policy Section, Trade and Investment Division, ESCAP.

The hard tasks of external and internal adjustment on a global scale need to be viewed against the background of the forces of globalization. Globalization has accelerated, with startling speed, the shift of a whole host of manufacturing activities away from their traditional centres, that is, the developed countries, to some developing countries. The process implies that traditional producers now have to move into other areas of manufacturing, such as new products, new applications of technology, products higher up the value chain, or into services, much faster than before. In fact, the move is not likely to be limited to the developed countries. All countries, developed and developing, must adapt to the growing importance of China in the global economy. Unless the process of shifting simultaneously generates new jobs, or wage rates become more flexible in all economies, there could be a significant increase in unemployment in several economies. Broadly speaking, therefore, the need to be able to respond with speed and flexibility to the rapidly changing global economic environment has never been greater. The alternative could be the rebirth of protectionist tendencies, concerns about which have been heightened by the failure at Cancún.

Reduced vulnerability of the global financial system to external shocks

One welcome aspect of recent developments has been that the global financial system has coped reasonably well with the strains put on it over the last two or three years.[12] Large-scale bankruptcies in ICT companies and weaknesses in the equity markets have not created major systemic problems in the financial sector. That sector, for its part, has not engaged in any marked retrenchment of credit, the credit crunch problem of recent years being both a supply- and demand-driven phenomenon. In fact, the financial sector in the region has speedily redeployed its resources to finance housing and personal consumption and has thus successfully stimulated higher levels of activity in several economies of the region.

Nevertheless, it would be prudent for policy makers to monitor the health of the financial system more closely. Banks in the ESCAP region, especially those in the economies affected by the 1997 crisis, have for the most part not yet fully tackled the problems of impaired asset quality built up over the years. New bad loans would make them acutely vulnerable to insolvency, with serious spillovers into the real economy in the event of a slowdown. Asia's financial markets still face unresolved problems of

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[12] Alan Greenspan, Chairman, United States Federal Reserve, quoted in the *Bangkok Post*, 1 September 2003.

fragmentation and a lack of depth centring around an overdependence on bank finance.

Low inflation and low interest rates have not eliminated cyclical fluctuations in economic activity

The last few years have seen policies to lower inflation being remarkably successful, with some minor exceptions. Nevertheless, low inflation by itself has not minimized fluctuations in levels of output and activity. In theory, low inflation should have laid the basis for more stable growth and less variation in exchange rates. Together, these should have lowered risk premiums on investments. This rosy scenario has not, however, materialized. Low inflation has undoubtedly delivered benefits such as low interest rates, which have certainly boosted consumption expenditures. However, when invoking the test of promoting or impeding overall economic stability, the answer is more equivocal. Low inflation and low interest rates have proved to be necessary but not sufficient conditions for moderating the amplitude of fluctuations in key economic aggregates. Paradoxically, the low cost of borrowing probably leads to the creation of asset bubbles in real estate and in the equity markets. Regardless of whether problems of instability are considered to be permanent or temporary, how to minimize fluctuations in the economy remains an important policy question. More particularly, the question of how and when to intervene in the deflation of asset bubbles to prevent large-scale unwinding of balance sheets at a subsequent stage still has no satisfactory answer. Monetary authorities primarily focusing on low inflation thus face difficult policy dilemmas during the build-up of an asset price boom, whether in the stock markets or in real estate.

Structural changes in the real economy are always difficult to push through, even if the direction of change is reasonably well known. This is unfortunate, as experience shows that flexible economies grow faster, have lower unemployment and can adjust to shocks more quickly. From an Asian perspective, the need for continued structural reform is paramount. A concentration on export-led growth has delivered handsomely in terms of rapid output growth and efficiency, though perhaps not to the least developed countries, which continue to suffer from market access problems. It is perhaps time now to alter the focus to more sustainable, more domestically driven growth which, in the case of the least developed countries, will require significant external support in the form of ODA.

Against this background, domestic policy priorities will vary widely across the ESCAP region. In some economies, the recent appreciation in exchange rates, and their implied policy tightening, suggests that there is additional room for monetary easing. But simultaneously, it is vital that Governments do not discount the need to have in place credible programmes of fiscal consolidation. As explained in previous issues of the *Bulletin*, most economies in the region need to approach the issue of long-term public debt within an ongoing programme of fiscal reform, to reduce the burden of indirect taxation, improve incentives for production and re-examine their patterns of expenditure. In this context, it is worth noting that most economies in the ESCAP region have relatively low levels of public investment, especially in infrastructure. Such investments will have to be built up over the years. Other areas requiring State investment are education and health. Governments in the region will have to find new and durable financing mechanisms for the public sector in the years ahead. The Asian Bond Fund is a good beginning. Other developing economies of the region should seek to replicate or acquire access to it.

Problem of appreciating exchange rates and rising foreign reserves

The most urgent policy issue in the region is almost certainly the question of appreciating exchange rates. At the international level, much of the burden of dollar depreciation has been borne by the euro, with the yen giving some ground in recent weeks. In the event of further downward pressure on the dollar in the coming months, it would be both appropriate and desirable from a regional perspective that the burden be shared more widely. In these circumstances, it may be useful for the authorities in countries where reserves and current account positions have strengthened to consider the policy option of greater exchange rate flexibility, as is being urged in different forums. Such a policy option would reduce the need for sterilizing financial inflows and would automatically have the effect of tightening policy without having to raise interest rates when the need arises. It is worth pointing out that exchange rates exercise some influence on competitiveness, but not a decisive one. Long-term competitiveness is more a matter of product differentiation, quality control and timely delivery to customers rather than price competitiveness per se. It would be appropriate, too, for exchange rate policies to be coordinated within the region so that they are not used as proxies for improved competitiveness.

In the ESCAP region there has been a rapid accumulation of reserves in the last few years. Very large reserves, while clearly providing effective insurance against a foreign debt crisis, also have costs, mainly opportunity costs. It is true that the absorptive capacity of most economies of the ESCAP region in terms of deploying substantial additional financial resources in the public sector in a cost-effective manner, is limited. Nevertheless, the accumulation of reserves beyond what might be warranted by the need to meet trading and debt service needs is questionable. In fact, beyond a certain point large foreign reserves will make the exchange rate inflexible in practice with the burden of macroeconomic adjustment falling on the price level, as has happened in Hong Kong, China, and Taiwan Province of China, and perhaps even in China itself. By and large, excessive reserve accumulation may also reflect some degree of undervaluation of the exchange rate. More flexible exchange rates are thus a policy option worth considering in the current situation. Exchange rate stability is an important policy objective. With stable or falling price levels, some flexibility in exchange rates would expand the range of policy options in macroeconomic management.

The Doha Development Agenda: option for developing economies of the ESCAP region

A major policy issue facing all developing countries is the question of trade liberalization under the Doha Development Agenda. While the onus of success in this regard lies primarily with the developed countries, especially in the need to remove barriers to trade in agricultural commodities, developing countries for their part should do everything possible to remove impediments to trade in agriculture between them. The remarkable growth of intraregional trade and the rapid expansion of subregional trading agreements, such as those between ASEAN, China, Japan and the Republic of Korea and now between ASEAN and India, is testimony to the scope for enhancing trade not merely in manufactured goods but also in a wider range of agricultural commodities and services. Developing countries should not become hostage to the pace of liberalization at WTO but take initiatives themselves to lower barriers and promote trade in different areas. The objective of an ASEAN economic community is a goal that should be examined, and replicated as appropriate, in the region as a whole.

Long-term development challenges

Sustaining development so as to meet the Millennium Development Goals and the objectives of the World Summit on Sustainable Development

The objectives of development are relatively invariant over time. These can be summarized as promoting economic growth, delivering improvements in the quality of life of the people and promoting fairness and equity in the distribution of the rewards generated by growth so as to make the growth process sustainable. Environmental considerations are a recent addition. The relative emphasis placed upon these objectives can and has varied over time and in different countries depending upon their stage of development and the prevailing socio-political ethos of the country concerned. The new challenge that all developing countries face is that these objectives have to be pursued in a world economic environment defined by intensified globalization and competition between countries. The trade liberalization agenda at WTO sets the parameters within which developing countries have to function in the spheres of trade in goods, services and FDI. International agreements or compacts such as the Millennium Development Goals and the objectives of the World Summit on Sustainable Development provide benchmarks against which the performance of all countries will be measured in relation to the eight Goals and the key outcomes of the World Summit. Indeed, the international community has also identified, through the Monterrey Consensus reached at the International Conference on Financing for Development, the appropriate means and policies to achieve the Goals and the objectives of the World Summit over a defined time-span.

In the real world, the pursuit of development is rarely a smooth or effortless exercise. Quite apart from the impact of unpredictable natural events, such as drought, disease, floods and acts of terrorism, policy makers in Governments are often constrained by the power of vested interests, hamstrung by weak institutions and a lack of information that induces policy errors and misjudgements and leads to poor policy implementation. In fact, democratic politics itself creates a bias in favour of shorter time horizons for decision-making, as the typical life of an elected Government is no more than five years before it must renew its mandate with its electors. Long-term objectives are often pushed into the background as a result. Policies whose impact creates winners and losers are difficult to implement if the losers cannot be compensated in some way. There is the perennial problem of balancing centralized control over resources against their decentralized distribution. Above all else, poor governance in which weak leadership is combined with a lack of motivation among public sector functionaries can negate the gains of development, even in societies apparently run by democratically elected Governments.

Against such a complex background, it is a major challenge for any Government to look at the short term as an integral stage in the pursuit of long-term goals and thus to pursue a development agenda primarily determined by long-term objectives. Yet, for development to succeed in a demonstrable way, Governments need to combine short-term economic management with a long-term strategy in which realistic goals are laid out and society as a whole can see, and identify with, the direction and pace of long-term change and development.

Development necessitates structural change

All development is ultimately structural change. Some of the driving forces of structural change are external, consisting of the changing patterns of international trade and investment; others are driven by changes in technology whereby technological change and innovation make particular production techniques and goods obsolete. Governments should therefore facilitate structural change and not resist it, although it is essential that there be arrangements to protect workers who lose their jobs in the process; robust institutions and adequate resources will also be needed to retrain such workers. In a globalizing world, structural change, in turn, will be based upon countries being able to maintain and, indeed, enhance their international competitiveness as the ratio of trade to GDP rises. Productivity and efficiency are vital prerequisites for competitiveness and growth; these involve investment in public and merit goods that enhance skills and education, provide for public health and foster the relevant arrangements and institutions for their long-term development. In other words, the role of the public sector, taken in its widest significance, is critical in this process. The public sector has not only to provide leadership in terms of setting objectives but also to simultaneously provide crucial inputs for meeting them, in the form of rules, regulations and oversight. In all developing countries the constraint on financial resources is a fact of life that cannot be wished away. The public sector has therefore to facilitate the involvement of private sector skills and resources in meeting long-term objectives, such as through public-private partnerships.

In this context it is worth stressing that because resources are scarce Governments should target their expenditures more carefully. By and large, they should avoid activities that the private sector is able and willing to carry out. Such expenditures tend to have high opportunity costs and any gains accruing to the national balance sheet are purely technical, as the private sector would have carried out such investments anyway. Governments should invest more in such areas as infrastructure and public education, which then attract or "crowd in" additional private investment. Empirical research for East Asian economies indicates that there have been substantial gains in terms of investment and growth from the positive externalities generated by the public sector.[13]

[13] World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).

There are currently a number of fundamental long-term objectives that all developing countries have agreed to pursue, those constituting the Millennium Development Goals and those contained in the Plan of Implementation agreed at the World Summit on Sustainable Development. Without going into detail, the two together oblige Governments to have a long-term development strategy that enables them, intra alia, to halve poverty between 1990 and 2015 and to pursue sustainable development, broadly defined to include poverty reduction, protection of the natural resource base and ensuring the health of the people; all this is to be achieved in a rapidly globalizing world economy.

The goals of poverty reduction ...

What are the policy challenges that Governments will have to contend with in pursuit of these objectives? There are no precise answers and individual Governments will have to look at their specific circumstances to decide how to meet the challenges. For instance, costing the Millennium Development Goals raises complex issues of unreliable data, the clear need for substantial extra financial and non-financial resources and changes required in the priorities of government expenditures. Recent research suggests that there are difficulties in determining the exact relationship between a given level of financial resources and the corresponding reduction in the level of income poverty. In the light of this uncertainty, within the limits of given financial resources, which interventions aimed at poverty reduction should then be assigned priority? Moreover, on equity grounds it would seem self-evident that policy interventions in poverty reduction should benefit all the poor equally. What would be the policy implications of ensuring such an outcome? It is clear that greater financial resources alone are not going to guarantee the achievement of the Goals. The effective and efficient utilization of these resources, as well as well-targeted policies and programmes and investment in human capital, will also be needed. Governments of the region thus need to critically reassess their policy approaches in this area and discuss them, both formally and informally, in regional forums, to develop the most effective means of achieving the Goals. A long-term route to poverty reduction is cross-border migration within the region. If organized in a sensible way it could be implemented without the feared political upheavals or difficulties, as has been done by the EU.

... and sustainable development

The objective of sustainable development similarly creates major policy dilemmas. Thus, for instance, while the linkage between economic growth and poverty reduction is obvious, the relationship between economic growth and the environment is less clear and might even work in the opposite direction. In fact, judging by the experience of the ESCAP region, rapid economic growth has been often accompanied by a range of adverse environmental impacts. Moreover, the poor tend to be disproportionately affected by environmental deterioration. There is thus a strong need to establish robust mechanisms and institutions to coordinate national economic policy-making in different areas. These fall into two broad genres, the first the so-called command and control measures that utilize the authority of the Government in forcing economic agents to adhere to sustainable environmental practices, and the second market-based instruments, consisting of interventions in relative prices with taxes and subsidies to bring private and social costs more into line. Both approaches are equally valid and useful according to the circumstances and the prevailing institutional capacity of individual countries. The policy dilemma consists in their impact on levels of poverty. Here, too, the problem essentially lies in substantial gaps in the analytical knowledge of the impact of various policies. These arise from gaps in data that properly capture environment-poverty interlinkages. The relatively intangible nature of environmental costs and the negative externalities that they generate are difficult, if not impossible, to subsume within a practical matrix of impact assessment exercises. Formulating effective policies would be more difficult still. Nevertheless, Governments must take action within these limitations and the most practical approach would be to learn from the successes of countries in the region. Regional cooperation in this sphere would thus be very useful.

Finding the resources for development: the Monterrey Consensus

Finally, how do the Millennium Development Goals and the objectives of the World Summit link up with the issues raised at the International Conference on Financing for Development and embodied in the Monterrey Consensus? The Consensus recognizes that each country has the primary responsibility for its own social and economic development. Primary responsibility refers here to policy approaches: it does not refer to a sufficiency of resources. Few, if any, developing countries, especially least developed countries, have the resources to successfully meet the Goals and the objectives laid out at the World Summit. But extra resources, especially raised in the form of debt obligations, will create their own problems. The Asian economic crisis of 1997 and the current situation in South Asia are testimony to the vulnerabilities inherent in this area of policy. In the crisis countries, vulnerability, primarily via excessive external debt, plunged the countries into a crisis that sharply increased poverty; in South Asia, the combined effect of internal and external indebtedness has been to raise the cost of capital. Overall GDP growth has suffered as a result. Moreover, countries with high domestic debt are now facing a new resource crunch, in the form of a rising burden of debt-servicing. In the past, these countries have not invested enough in education, health and infrastructure, with the result that there is no secure foundation for long-term growth. The Monterrey Consensus spells out the need for countries to enhance the funding of education, health and infrastructure, if necessary by widening the tax base. Millennium Development Goal 8 refers to developing a global partnership for development, that is, raising ODA and expanding market access, particularly at a time when textile and garment quotas come to an end at the beginning of 2005. To what degree, and how, these daunting challenges of development can be met should become the subject of debate and discussion in the region so that Governments can devise realistic approaches for long-term development.

II SUSTAINABLE DEVELOPMENT - AN ASIAN PERSPECTIVE

by Bibek Debroy[1]

Sustainable development is a multidimensional concept

If one is writing a paper on sustainable development, one should begin by trying to understand what the expression "sustainable development" means. Unfortunately, this is an expression that is impossible to pin down. The Brundtland report[2] tells us that there are more than 60 possible definitions of sustainable development. Of these, the preferred one defines it as "satisfying present needs without compromising the ability of future generations to meet their own needs". This is not a very satisfactory definition. Present needs can reasonably be defined and quantified but future needs are impossible to anticipate. Anticipation of the ability of future generations to meet these needs is even more difficult.

History is replete with examples of "bad predictions". There is even a book on the subject.[3] The list include the prediction of Thomas Watson, Chairman of IBM in 1943 that there would be a world market "for about five computers", noted surgeon Alfred Velpeau's 1839 dismissal of anesthesia with the words, "Knife and pain are two words in surgery that must forever be associated", and the *New York Times* argument in 1939 that "The problem with television is that the people must sit and keep their eyes glued to a screen: the average American family hasn't time for it." According to such predictions, in the year 2000, mail would be delivered by pneumatic tube and there would be disposable clothing and robot armies. Among the most bizarre of the predictions was that in the *Ladies Home Journal,* which proclaimed that by 2000, the letters "C", "X" and "Q" would disappear from the alphabet.

Technological advances can ease resource constraints in several ways ...

None of this has happened. While the above is in the realm of bad predictions in general, predictions have been just as bad in the unsustainable development category. The classic example, of course, is the bleak Malthusian prediction of population growing geometrically and food production increasing arithmetically. In a superficial sense, a population graph tends to fit the Malthusian prognosis. However, there are caveats. First, population growth resulted from drops in infant mortality and increases in life expectancy, both associated with improvements in the quality of life

[1] Director, Rajiv Gandhi Institute for Contemporary Studies, Rajiv Gandhi Foundation, New Delhi.

[2] World Commission on Environment and Development, *Our Common Future* (Oxford, Oxford University Press, 1987).

[3] Laura Lee, *Bad Predictions* (Rochester, MI, Elsewhere Press, 2000).

rather than misery and death.[4] Second, the long-term decline in fertility and its inverse correlation with income increases was also unanticipated. For instance, the average annual rate of world population growth is expected to slow from 1.6 per cent during the period 1975-1999 to 1.2 per cent in 1999-2015[5] and, while the world's population is increasing, it will probably stabilize at around 11 billion beyond 2010. Perhaps more important, having failed to anticipate advancements in technology, especially agricultural technology, Malthus was wrong about the increase in food production being unable to keep pace. Agricultural productivity has increased, not only in developed countries but also in developing ones. Between 1979-1981 and 1996-1998, the food production index went up by 74 per cent in low-income countries and by 100 per cent in middle-income countries.[6] Across different geographical regions, the increase was the lowest in Latin America and the Caribbean and in sub-Saharan Africa. But even there, the increase in the index was over 50 per cent.

... while resource scarcity is often a relative matter

Perhaps the most articulate exposition of the modern-day Malthusian idea was made in the early 1970s by Paul Ehrlich and associates.[7] The Club of Rome document followed.[8] There was the spectre of famines with hundreds of millions of people starving to death and mankind breeding itself into oblivion. Nothing of the sort has happened and the dramatic negation of the Malthusian nightmare was in the famous bet between Ehrlich and Simon.[9] In less dramatic terms, the economic counter-arguments can also be found in Julian Simon.[10] First, natural resources, even supposedly non-renewable ones, are not a constraint because a supply shortage leads to higher prices and substitution by alternative sources. Second, innovation and new technology continuously lead to the discovery of new reserves. Third, technology leads to cost reductions in exploiting resources and efficiency in use. Fourth, diminishing returns do not set in because land, labour, capital and technology encounter supply-side shifts. Fifth, population is itself an asset and an increase in population spurs invention and a search for new technologies.

It is curious how expectations about environmental degradation are often exaggerated. Some 50,000 horses were used in London's transport

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[4] See Mark Skousen, *The Making of Modern Economics: The Lives and Ideas of the Great Thinkers* (Armonk, NY, M.E. Sharpe, 2001).

[5] UNDP, *Human Development Report 2001* (New York, Oxford University Press, 2001).

[6] World Bank, *World Development Report 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001).

[7] Paul R. Ehrlich, *The Population Bomb* (New York, Sierra Club, 1968).

[8] Dennis and Donella Meadows, eds., *The Limits to Growth: A Report for the Club of Rome's Project on the Predicament of Mankind* (New York, Universe Books, 1972).

[9] There was a US$ 1,000 bet that prices of five key commodities would be lower in 10 years. Julian Simon won his bet, but had no takers for his subsequent bet on the prices of any other resources.

[10] Julian Simon, ed., *The State of Humanity* (Cambridge, Mass., Blackwell Publishers, 1995) and Julian Simon, *The Ultimate Resource 2* (Princeton, NJ, Princeton University Press, 1996).

system in 1900 and 1,000 tons of dung were produced every day. The most important issue then was what could possibly be done with this mammoth quantity of dung and whether London would be buried under heaps of it.[11] The eventual replacement of horses was completely unanticipated.

Economic growth and environmental preservation are not necessarily mutually exclusive

Stated differently, the doomsday argument can be separated into four interrelated strands.[12] First, natural resources are becoming exhausted. Second, population is increasing, which will eventually lead to a food shortage. Third, species (flora and fauna) are becoming extinct. Fourth, air and water are becoming polluted. Having commented on the first two, one need only add that fears about the third and fourth arguments are greatly exaggerated.[13] More significantly, economic growth does not cause environmental degradation. Instead, growth frees resources that can be used to further the cause of environmental protection. Not that Lomborg has not been criticized: the Union of Concerned Scientists offers the following critique by experts: These separately written expert reviews unequivocally demonstrate that on closer inspection, Lomborg's book is seriously flawed and fails to meet basic standards of credible scientific analysis. The authors note how Lomborg consistently misuses, misrepresents or misinterprets data to greatly underestimate rates of species extinction, ignore evidence that billions of people lack access to clean water and sanitation, and minimize the extent and impacts of global warming due to the burning of fossil fuels and other human-caused emissions of heat-trapping gases.[14] Fair enough. Clean water and sanitation are important. The Millennium Development Goals adopted by the General Assembly in 2000, which follow, are important.[15]

An exploration of the Millennium Development Goals

Under Goal 1, the first target is to halve, between 1990 and 2015, the proportion of people whose income is less than US$ 1 a day. This is a measurable and tangible target and, other than the proportion of the population below the threshold of US$ 1 a day, the poverty gap ratio and the share of the poorest quintile in national consumption are other possible indicators. A further target is to halve, between 1990 and 2015, the proportion of people who suffer from hunger, measured as the prevalence of underweight children or the proportion of the population below minimum levels of dietary energy consumption.

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[11] Gavin Weightman and Steve Humphries, *The Making of Modern London 1815-1914* (London, Sidgwick and Jackson, 1984).

[12] See Bjorn Lomborg, "The truth about the environment", *The Economist*, 2 August 2001.

[13] The arguments are developed further in Bjorn Lomborg, *The Skeptical Environmentalist: Measuring the Real State of the World* (Cambridge, Cambridge University Press, 2001). This book also demolishes several popular environmental myths.

[14] <http://www.ucsusa.org/environment/lomborg.html>.

[15] See IMF, OECD, United Nations and World Bank, *A Better World for All: Progress towards the International Development Goals* (Washington, 2000).

Under Goal 2, the target is to ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling. Among the possible indicators are the net enrolment ratio in primary education, the proportion of pupils starting grade 1 who reach grade 5 and the literacy rate of 15- to 24-year-olds.

Under Goal 3, the target is to eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels of education no later than 2015. The indicators that can be used are the ratio of girls to boys in primary, secondary and tertiary education, and of literate females to males among 15- to 24-year-olds, the share of women in wage employment in the non-agricultural sector and the proportion of seats held by women in the national parliament.

Under Goal 4, the target is to reduce by two thirds, between 1990 and 2015, the under-5 mortality rate. Obvious indicators include the under-5 mortality rate, the infant mortality rate and the proportion of 1-year-old children immunized against measles.

Under Goal 5, the target is to reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio. Possible indicators are the maternal mortality ratio and the proportion of births attended by skilled health personnel.

The first target under Goal 6 is to have halted by 2015 and begun to reverse the spread of HIV/AIDS, measured by HIV prevalence among 15- to 24-year-old pregnant women, the contraceptive prevalence rate and the number of children orphaned by HIV/AIDS. The second target is to have halted by 2015 and begun to reverse the incidence of malaria and other major diseases, measured by prevalence and death rates associated with malaria, the proportion of the population in malaria-risk areas using effective malaria prevention and treatment measures, the prevalence and death rates associated with tuberculosis and the proportion of tuberculosis cases detected and cured.

Social achievements are predicated on sustained economic growth, which, in turn, depends on several other preconditions

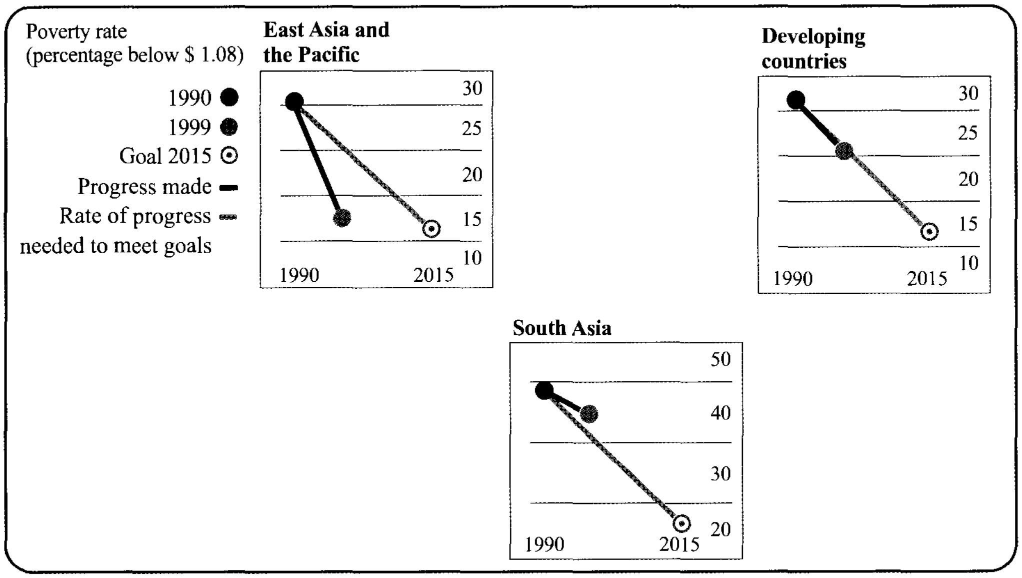
Asia's track record in human development indicators is spectacular, but this is more valid for East Asia than for South Asia. This is evident from the six figures that follow, one for each of the first six goals.[16]

What are the prerequisites for attaining, or moving towards attaining, these goals? An obvious requirement is growth. Without growth, no poverty reduction is possible.[17] In the presence of misgovernance, or gross

[16] Reproduced from <http://www.developmentgoals.org>.

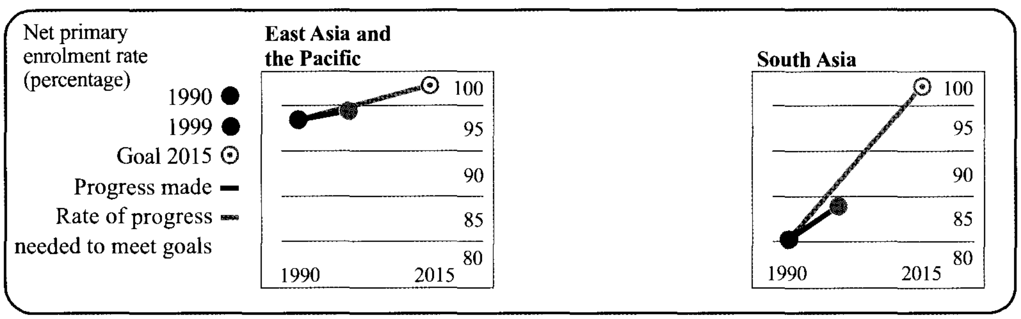
[17] The correlation between growth and poverty reduction has been documented for many countries, in a cross-country as well as time series sense. In the 1980s and 1990s, the most obvious examples are China, Viet Nam and India. Because income distribution typically tends to be log normal, income increases are often associated with sharp drops in poverty from around 30 per cent of the population to around 15 per cent. Thereafter, poverty reduction becomes more difficult.

Figure I. Poverty ratios



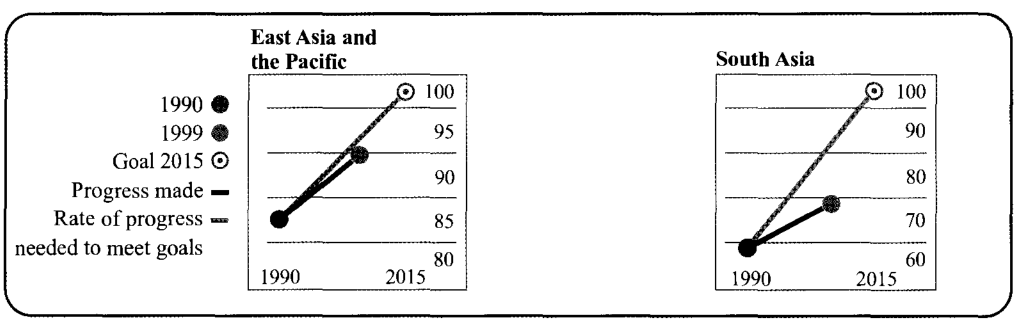
Source: < http://www.developmentgoals.org >.

Figure II. Indicators of education



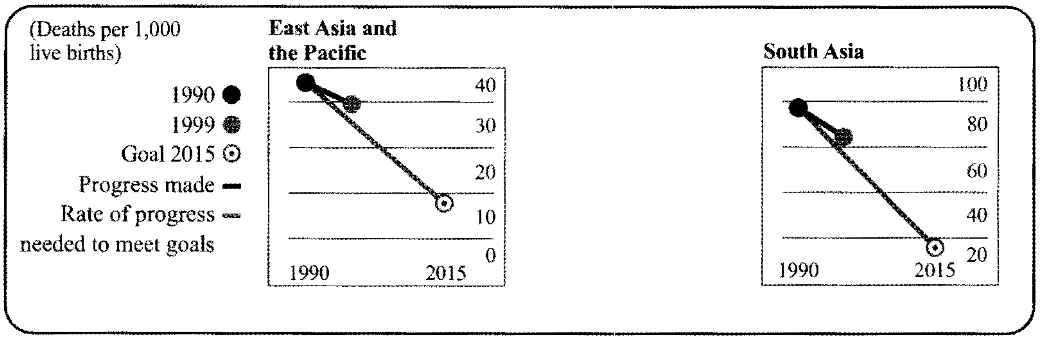
Source: < http://www.developmentgoals.org >.

Figure III. Ratio of girls to boys in primary and secondary school (percentage)



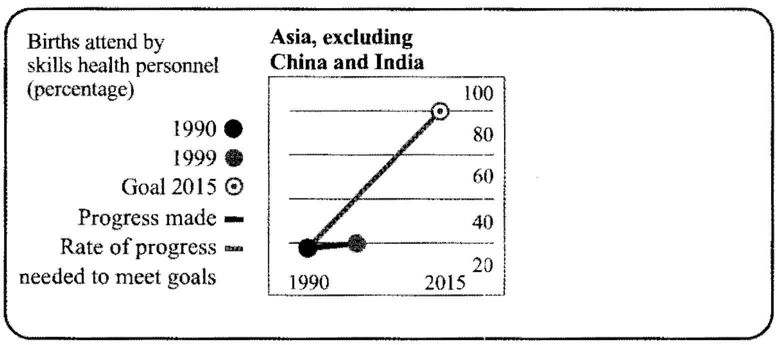
Source: < http://www.developmentgoals.org >.

Figure IV. Infant mortality rates



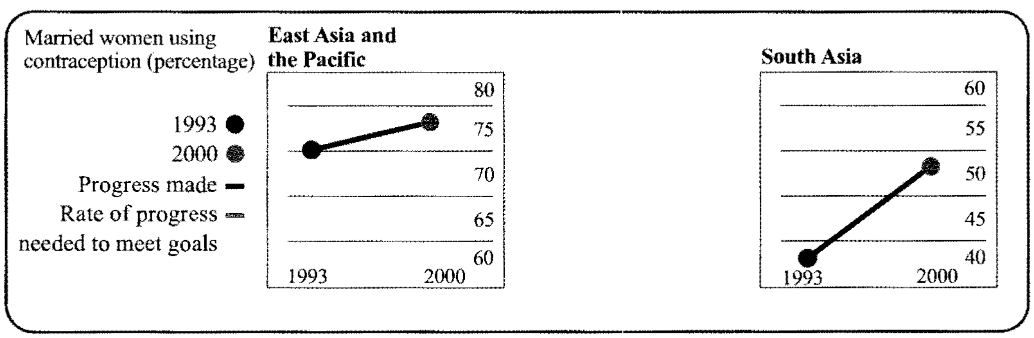
Source: < http://www.developmentgoals.org >.

Figure V. Maternal mortality indicators



Source: < http://www.developmentgoals.org >.

Figure VI. Indicators for HIV/AIDS



Source: < http://www.developmentgoals.org >.

inequalities in income distribution, growth alone may not be sufficient to improve health or educational outcomes or to help to reduce gender biases in such outcomes. Typically, social sector delivery has been through public sector monopolies.[18] Not only are such delivery systems not accountable to users, by virtue of being monopolies, but they also lead to inefficiency. In addition, success is measured through expenditure rather than through improvements in outcomes. Even when there is a need to retain State financing and subsidies for the poor, innovative mechanisms that delink State financing from State delivery, and thus introduce competition, are possible. Hence growth and internal reforms that improve governance are key. In addition to the endogenous factors, there is the exogenous environment, that is, growth also requires the continued existence of an open trading environment which is free not only in the movement of goods and services but also of factor inputs such as labour and capital.[19]

While the first six development goals are measurable, tangible and desirable, the last two are vague, and the seventh especially so.

The first target under Goal 7 is to integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources, measured as the proportion of land area covered by forest, the land area protected to maintain biological diversity, GDP per unit of energy use, and carbon dioxide emissions (per capita). The second target is to halve, by 2015, the proportion of people without sustainable access to safe drinking water, measured as the proportion of population with sustainable access to an improved water source. The final target is to have achieved, by 2020, a significant improvement in the lives of at least 100 million slum dwellers, measured as the proportion of people with access to improved sanitation and the proportion with access to secure tenure.

In addition to the possible dichotomy between sustainable development and social progress ...

Especially since the Earth Summit in 1992, the use of the term "sustainable development" has become fashionable and almost inevitable. But what has improvement in the lives of slum dwellers to do with sustainable development, whatever its definition? The availability of safe drinking water (and sanitation) is indeed important, but what does sustainable access to drinking water mean? If the provision of drinking water and sanitation is not sustainable, are we to argue that the poor should be deprived? In short, who decides what is sustainable and what is not? While land area covered by forest, land area protected to maintain biological diversity, GDP per unit of energy use and carbon dioxide emissions (per capita) are measurable variables, who decides on the priorities and the trade-offs?

[18] This is true of physical as well as social infrastructure.

[19] This is a function of the openness of economies and those in East Asia generally exhibit higher levels of trade intensity (exports or imports as shares of GDP) than economies in South Asia. Capital flow indicators behave in a similar way. Within South Asia, the larger economies are relatively more insular than the smaller ones. However, because of liberalization and reforms, all economies in the Asian region are becoming more open over time.

... there is the internationalization of sustainable development itself

Protecting the environment is often a matter of ensuring appropriate prices and property rights, as shown in the literature on the tragedy of the commons.[20] Through appropriate prices, it is often possible to internalize the costs of negative externalities. In the absence of such internalization, it is indeed true that marginal social benefits may deviate from marginal private benefits and marginal social costs may also deviate from marginal private costs; hence the argument that national income accounting does not always take into account the costs of environmental degradation. However, decisions about marginal social benefits or costs ought to be internal to the country concerned and are a function of its stage of development. The problem with the argument about sustainable development is that it makes this a cross-border issue, which is a point to be discussed later.

To complete the statement of the Goals, the following is the eighth one.

The first two targets under Goal 8 are to develop further an open, rule-based, predictable, non-discriminatory trading and financial system (includes a commitment to good governance, development and poverty reduction, both nationally and internationally) and to address the special needs of the least developed countries (includes tariff- and quota-free access for exports; an enhanced programme of debt relief for heavily indebted poor countries (HIPC) and cancellation of official bilateral debt; and more generous ODA for countries committed to poverty reduction).

There are quantifiable targets of net ODA as a percentage of donors' gross national income, the proportion of ODA meant for basic social services (basic education, primary health care, nutrition, safe water and sanitation), the proportion that is untied, the proportion earmarked for the environment in small island developing States and the proportion meant for the transport sector in landlocked countries. The third target under Goal 8 is to address the special needs of landlocked countries and small island developing States through such indicators as the proportion of exports (by value and excluding arms) admitted free of duties and quotas, average tariffs and quotas on agricultural products and textiles and clothing, domestic and export agricultural subsidies in OECD countries, and the proportion of ODA provided to help to build trade capacity. The fourth target is to deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term using indicators such as the proportion of official bilateral HIPC debt cancelled, debt service as a percentage of exports of goods and services, the proportion of ODA provided as debt relief and the number of countries reaching HIPC decision and completion points.

There are other targets envisaged as well: in cooperation with developing countries, to develop and implement strategies for decent and productive work for youth: in cooperation with pharmaceutical companies,

[20] See Garrett Hardin and John Baden, eds., *Managing the Commons* (San Francisco, W.H. Freeman, 1977).

to provide access to affordable, essential drugs in developing countries; in cooperation with the private sector, to make available the benefits of new technologies, especially in information and communications. The indicators are the unemployment rate of 15- to 24-year-olds, the proportion of the population with access to affordable essential drugs on a sustainable basis, telephone lines per 1,000 people and personal computers per 1,000 people.

Universal standards for players and actors of diverse capabilities and needs ...

The eighth goal is sometimes just as vague as the seventh and the text is also peppered with the adjective "sustainable". However, going back to sustainable development and the seventh goal, from the perspective of Asian developing economies three kinds of problems arise. First, there is an ethical-cum-moral kind of issue. In 1996, total carbon dioxide emissions by low-income countries amounted to 2,433.8 million metric tons, compared with 10,732.1 million by high-income countries.[21] Per capita, the comparison shows a wider disparity. Low-income countries contributed 1.1 metric tons of carbon dioxide emissions, while high-income countries contributed 12.3 metric tons. The imposition of similar standards on both sets of countries, as is sometimes attempted, is patently unfair, especially in the light of the historical backlog of emissions that industrialized countries contributed in their process of economic growth. Second, while environmental degradation may be damaging, the shadow price imposed should be a sovereign decision. If 38 per cent of the population in Bhutan do not have access to improved water sources,[22] should Bhutan worry about providing water or about air pollution that might conceivably contribute to cardiovascular diseases? If 47 per cent of Nepal's children (under the age of 5) are underweight,[23] should Nepal worry about feeding them properly or about carbon dioxide emissions? Should government expenditure focus on primary education, rural health care and rural infrastructure, or on improving the environment?

... which are also subject to change as a result of ongoing development and transformation

As was mentioned earlier, priorities and objective functions change as economies develop and the best option before developed countries to further the cause of the environment is through opening up markets in developed countries. Markets in developed countries are not open. Agriculture, and textiles and garments are two obvious instances, characterized by quotas, high tariffs, tariff escalation and specific duties that convert to high ad valorem equivalents. In addition, faced with disciplines on tariffs, policy substitution takes place by resorting to non-tariff barriers through anti-dumping and anti-subsidy investigations. Not only are markets not open, they are further closed by using the bogey of the environment and sustainable development. While the General Agreement on Tariffs and Trade (GATT) and WTO are about free trade, caveats exist to free trade principles to allow for justifiable cases of damage.

[21] World Bank, op. cit.

[22] UNDP, op. cit.

[23] Ibid.

Admittedly, partial exemptions and special and differential treatment are provided for in global systems such as GATT ...

Many caveats date back to the 1947 GATT articles. For example, Article XX, on general exceptions, states:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> (a) Necessary to protect public morals;
>
> (b) Necessary to protect human, animal or plant life or health;
>
> (c) Relating to the importation or exportation of gold or silver;
>
> (d) Necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trade marks and copyrights, and the prevention of deceptive practices;
>
> (e) Relating to the products of prison labour;
>
> (f) Imposed for the protection of national treasures of artistic, historic or archaeological value;
>
> (g) Relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;
>
> (h) Undertaken in pursuance of obligations under any intergovernmental commodity agreement which conforms to criteria submitted to the contracting parties and not disapproved by them or which is itself so submitted and not so disapproved;
>
> (i) Involving restrictions on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan; provided that such restrictions shall not operate to increase the exports of or the protection afforded to such domestic industry, and shall not depart from the provisions of this Agreement relating to non-discrimination;
>
> (j) Essential to the acquisition or distribution of products in general or local short supply; provided that any such measures shall be consistent with the principle that all contracting parties are entitled to an equitable share of the international supply of such products, and that any such measures, which are inconsistent with the other provisions of this Agreement shall be discontinued as soon as the conditions giving rise to them have ceased to exist.

The language of some of these clauses, such as (c), (i) or (j), reflects the year (1947) when the Agreement was signed. Yet these clauses remain, virtually unchanged. Also virtually unchanged is clause (g), which can be used for protectionist purposes as long as national treatment is not violated. Clause (b) does not even mention national treatment.

... and the World Trade Organization

The Uruguay Round negotiations provided further grist to the mill. For instance, article 3.3 of the Agreement on the Application of Sanitary and Phytosanitory Measures states:

> Members may introduce or maintain sanitary or phytosanitary measures which result in a higher level of sanitary or phytosanitary protection than would be achieved by measures based on the relevant international standards, guidelines or recommendations, if there is a scientific justification, or as a consequence of the level of sanitary or phytosanitary protection a Member determines to be appropriate in accordance with the relevant provisions of paragraphs 1 through 8 of article 5. Notwithstanding the above, all measures which result in a level of sanitary or phytosanitary protection different from that which would be achieved by measures based on international standards, guidelines or recommendations shall not be inconsistent with any other provision of this Agreement.

But complications can arise in the name of sustainable development relating to the environment ...

International standards are usually higher than standards prevalent in developing countries and those countries have little influence in establishing the standards. The above Agreement allows standards that are even higher than such international standards, as long as the somewhat subjective test of scientific justification is satisfied. The Agreement on Technical Barriers to Trade also permits deviation from international standards, with slightly different justification. Under article 2.4, "Where technical regulations are required and relevant international standards exist or their completion is imminent, Members shall use them, or the relevant parts of them, as a basis for their technical regulations except when such international standards or relevant parts would be an ineffective or inappropriate means for the fulfilment of the legitimate objectives pursued, for instance because of fundamental climatic or geographical factors or fundamental technological problems."

... or labour standards, among several other issues of contention ...

The "shrimp-turtle dispute"[24] complicated matters further, because the WTO Appellate Body ruled in 1998 that unilateral action in the interests of protecting the environment was permissible. At the time of the third WTO Ministerial Conference, held at Seattle in 1999, it was clear that both labour and the environment were being pushed as protectionist devices by developed countries. Environmental non-governmental organizations were described as water-melons: green on the outside and red on the inside. At the time of the Doha Ministerial Conference in 2001, the European Union effectively linked the liberalization of agriculture to environment-related negotiations. The Doha

[24] The dispute was brought by India, Malaysia, Pakistan and Thailand against the United States of America (WTO dispute No. 58).

Ministerial Declaration provides for limited negotiations on the environment through "the relationship between existing WTO rules and specific trade obligations set out in multilateral environmental agreements (MEAs). The negotiations shall be limited in scope to the applicability of such existing WTO rules among parties to the MEA in question. The negotiations shall not prejudice the WTO rights of any Member that is not a party to the MEA in question." However, broader negotiations on the environment are not precluded and will undoubtedly continue to be a controversial issue as demonstrated, at the time of the Fifth Ministerial Conference held at Cancún, Mexico, in September 2003. The European Union continues to link agricultural liberalization to the environment.

... making the danger of protectionism more palpable

There are several MEAs that can be listed, for example, the Montreal Protocol on Substances that Deplete the Ozone Layer, the Vienna Convention for the Protection of the Ozone Layer, the Convention on Biological Diversity, the Convention on International Trade in Endangered Species of Wild Fauna and Flora and the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal. This is by no means an exhaustive list. Nor is this the place to discuss the MEAs exhaustively. Suffice it to say that WTO agreements tangentially provide for protectionism through the sustainable development bogey. Many MEAs are much more direct. Given the incompatibility between many MEAs and present WTO provisions, when this incompatibility is examined and provisions from MEAs are used to override present WTO provisions the dangers of protectionism become even more palpable.

Care has to be taken to ensure that sustainable development for some does not entail sustainable deprivation for others

The average annual rates of growth in GDP have been high in East Asia for several decades. Those rates of growth were high in South Asia in the 1990s. This is making it possible to attain the first six development goals and improvements in the indicators are also evident. Unfortunately, the seventh development goal of sustainable development works at cross purposes and curbs growth. Sustainable development from the perspective of rich developed economies becomes sustainable deprivation from the perspective of poor Asian developing economies. And since poverty ought to be unsustainable, this deprivation is also unsustainable and unacceptable. Economies that have historically been characterized by underconsumption should not be asked to curb their consumption and economic growth. Let the development sustain itself and the environment will sustain itself when the time comes. That has been the case in Western Europe, North America and Japan. Why should Asia be treated differently?

III BEYOND "SUBSISTENCE AFFLUENCE": POVERTY IN PACIFIC ISLAND COUNTRIES[1]

Introduction

Economic growth was the main objective of development policies in the 1950s and 1960s but the recognition that growth by itself did not eliminate poverty led to the adoption of a series of poverty-reducing strategies, including the basic needs approach, in the 1970s. However, this new focus was short-lived as stabilization and adjustment issues came to dominate the policy debate in the 1980s and poverty was relegated to the back burner. The poor economic performance and sharp rise in poverty in many developing countries in that decade led to a renewed interest in poverty and related issues,[2] culminating in the adoption of the Millennium Development Goals by world leaders in 2000.

Poverty is not easy to define or to measure

The first Goal is the elimination of extreme poverty, although the next six are also directed at eliminating poverty in all its forms and are interlinked.[3] Poverty is not easy to define and, once defined, is not easy to measure (Greenwell, Lloyd and Harding, 2001). Different definitions of poverty require the use of different indicators for measurement and the adoption of different poverty eradication strategies (Ruggeri Laderchi, Saith and Stewart, 2003). In the past, an income level of US$ 1 per day was widely accepted as the basic measure of poverty but now there is universal agreement that the dimensions of poverty far transcend this traditional definition. Poverty is thus better measured in terms of access to basic education, health care, nutrition, clean water and sanitation, and the most broadly used standard for measuring poverty in practice is likely to continue to be the adequate consumption of food and other essentials.

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[1] Prepared by Marin Yari, Economic Affairs Officer, Poverty and Development Division, ESCAP. Helpful comments from Helen Tavola and Alistair Wilkinson are duly acknowledged but the author is solely responsible for the contents of the article.

[2] Several important publications (UNICEF, 1987; UNDP, 1990; and World Bank, 1990) enabled poverty reduction once more to become central to policy debates.

[3] The first seven Goals are as follows: Goal 1, Eradicate extreme hunger and poverty; Goal 2, Achieve universal primary education; Goal 3, Promote gender equality and empower women; Goal 4, Reduce child mortality; Goal 5, Improve maternal health; Goal 6, Combat HIV/AIDS, malaria and other diseases; and Goal 7, Ensure environmental sustainability. The last one, Goal 8, Develop a global partnership for development, seeks to strengthen the means to achieve the first seven.

Data on poverty in the Pacific are lacking

According to a recent study (ESCAP, 2003), countries in Asia and the Pacific are estimated to have reduced the overall incidence of poverty from 34 to 24 per cent in the 1990s, the most successful among them being countries in East and South-East Asia, many of which have already achieved their targets. Much of this progress can be attributed to their sustained economic growth, providing ample proof of its importance for poverty reduction.[4] The poverty situation in the Pacific is, however, difficult to gauge owing to the lack of reliable data, although work by ADB and UNDP, among others, shows that poverty is on the rise in some Pacific island countries. The following discussion focuses on the current poverty situation in the Pacific and highlights policy issues and options for consideration.

Poverty in the Pacific island context

Subsistence affluence is a term used to describe societies in the Pacific ...

The majority of people in the Pacific still rely on subsistence agriculture for their livelihood and the term "subsistence affluence" (Bayliss-Smith and Feacham, 1977; Lam, 1982) has been used to describe their societies, in which strong support for the extended family or community is said to have contributed to alleviating extreme poverty. However, Pacific island countries are not as equitable as they are sometimes portrayed and, in some ways, inequalities within those countries are deepening. The spread of the cash-based economy, together with new forms of employment and urbanization, has restructured national and household economies and accentuated economic differences in the process (UNDP, 1999: 5). There are communities, families and individuals throughout the Pacific living in deep poverty despite traditional social support systems (Lightfoot and Ryan, 2001). Poverty is often not as visible or as extreme as it is in some of the poorest parts in the world, but there are people in the subregion who are truly disadvantaged and deprived (UNDP, 1999: 17).

... but people in the subregion are disadvantaged by limited opportunities

The term "poverty of opportunity"[5] aptly describes the more encompassing image of poverty in the Pacific (UNDP, 1999: 5). It is attributable to the limited opportunities to earn cash income; the risks associated with change; the shortages of financial, technical and social services; and the nature and quality of governance (Lightfoot and Ryan, 2001). Weak economic growth for prolonged periods of time, coupled with annual population growth rates in excess of 2 per cent in many island economies, particularly Kiribati, Papua New Guinea, Solomon Islands and Vanuatu, has caused per capita incomes to stagnate or decline, leading, in turn, to high urban unemployment, crime and violence. Several Pacific island countries have also experienced political instability and serious civil disorder in recent years, which has strongly discouraged private investment and reduced employment opportunities and, in some cases, resulted in outright poverty.

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[4] The overall rate of economic growth appears to be much more important than its sectoral composition in reducing the incidence of absolute poverty in some East and South-East Asian countries (Warr, 2000).

[5] The idea underlying this concept is that many more people are denied basic human opportunities than are denied a minimum income (UNDP, 1997b).

Emigration is an answer for some and a problem for others

High emigration to countries like Australia and New Zealand has relieved some of the pressure in countries like Cook Islands, Niue, Samoa and Tonga. Fiji has witnessed a brain drain of people leaving in search of better opportunities as a result of the political instability and lack of business confidence engendered by several coups. In smaller countries in the southern and northern Pacific, however, emigration has become a real problem. While emigration means inward remittances, it can also be a cause of poverty, as in the case of children who are semi-abandoned by parents working overseas and left in the care of grandparents and other relatives unable to care for them adequately. Many emigrants from the Pacific are unskilled workers and may themselves be experiencing hardship and poverty.[6]

Vulnerability is high in the Pacific island countries

Because of their small size, remoteness and geographical fragmentation, many Pacific communities are highly vulnerable and suffer disproportionately from external shocks, such as adverse climatic events or market failures.[7] Natural disasters have caused extensive damage to lives and property, while the very existence of several atoll economies is threatened by higher sea levels. With the exception of Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu, agricultural land is very limited and can do little more than support the local population. Traditional ownership patterns govern land use in the Pacific and the atoll economies are increasingly constrained by the shortage of usable land. A few Pacific island countries have developed the tourism industry but lack of infrastructure, especially regular transport services and accommodation, prevent it from reaching its potential. Fisheries, especially tuna, are an important resource in several of these countries but fish processing is limited as it is too capital-intensive. Timber is another natural resource available to some countries but exploitation is unsustainable, reflecting both the inability of the large number of traditional owners of this resource to protect their interests adequately in commercial negotiations, and weak governance.

Aid has not been the answer

Pacific island countries have been recipients of large aid flows. For example, aid from Australia since 1970 has amounted to about US$ 50 billion. However, in a recent study (Hughes, 2003) it is argued that aid has failed the Pacific and that the suspension of all aid would provide a catalyst for change. This policy recommendation seemed inappropriate for Pacific island countries and, if adopted, could even contribute to worsening the poverty situation in these countries.[8] A more realistic option, however,

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[6] There are many Pacific island emigrants living in Australia and New Zealand in relative poverty, impoverishing themselves to send money back home. Unfortunately, this money often goes into the building of grand churches.

[7] For example, Vanuatu, Tonga and Fiji have been ranked first, third and eighth respectively out of 111 developing countries on the vulnerability index (Advisory Board to the Joint Commonwealth Secretariat/World Bank Task Force on Small States, "Small States: a composite vulnerability index" available at <http://wbln0018.worldbank.org/external/lac/lac.nsf/0/629bfda942b112e2852567fc00530409?OpenDocument>).

[8] Another recent study suggests that policy makers should be less sanguine about concluding that aid boosts growth in countries with good policies (Easterly, Levine and Roodman, 2003). In their paper, the authors expand on an earlier paper which concluded that aid had had a positive impact on growth in developing countries with good fiscal, monetary and trade policies but little impact in the presence of poor policies (Burnside and Dollar, 2000).

might be for donors and recipients to agree on the principle of mutual obligation in aid to the Pacific so that aid would only be spent on mutually agreed development projects designed and monitored by teams nominated by the sovereign recipients and donors. Recent approaches to aid in the Pacific have moved in this direction but institutional and capacity-building issues need to be addressed if aid is to make a substantive contribution to the economic and social development of these countries.

The quality of governance is key to economic growth in Pacific island countries

Recent debate has centred on the need to improve good governance and to increase accountability in Pacific island countries as important factors in economic growth. Pacific societies have a strong tradition of patronage, which favours those with influence and connections, particularly in the exploitation of natural resources, and penalizes those without. Nauru is an example of a country with such a bad governance record that it has gone from being one of the richest countries in the world, based on revenues from phosphate mining, to one of the poorest.

Bad governance also means that inequalities between urban and rural areas, between socio-economic groups and sometimes between ethic groups, are becoming increasingly entrenched. Rural development in terms of transport and social infrastructure is often accorded low priority, leading to a reduction in the opportunities available to those living in rural areas, where the construction of roads would contribute to poverty reduction by providing access to markets, health, education and other services. There is a growing gap between a few well-to-do persons, mostly based in urban areas, and the majority of the population in the Pacific island countries, who are less educated and live in rural areas. Furthermore, the difficult physical environment, with high mountainous terrain in some countries and vastly spread-out, remote atolls in others, makes the provision of services such as education and health very difficult and costly, so that small, remote communities are marginalized, with reduced opportunities and increased poverty incidence.

Empowering women would go far in fighting poverty

Women continue to be prominent in traditional agriculture in the Pacific island countries, which has ensured that there is no absolute poverty and associated hunger in the subregion, unlike in many other parts of the world. However, most women in the Pacific are disadvantaged by their underrepresentation at all levels of society, especially in the decision-making process. The same could be said of other vulnerable groups, such as the disabled. Empowering women could, for example, contribute significantly to changing traditional attitudes to family size, leading to slower population growth and improved human development indicators. In addition, policies with regard to several emerging social issues, such as HIV/AIDS, sexual abuse of children and prostitution that have major implications for fighting poverty in some Pacific island countries, would benefit from the empowerment of women.

National poverty reduction strategies in the Pacific

Poverty alleviation is now central to the agenda of many Governments in the subregion

Pacific island countries have now recognized that poverty exists and are undertaking initiatives at the national level to address this issue. Many of them have targeted anti-poverty measures, such as the allocation of funds in national budgets for activities specifically aimed at disadvantaged groups. Fiji, for example, recently approved plans to establish a Department of Poverty Eradication in its efforts to reduce poverty by 5 per cent annually. The Department will be responsible for ensuring that the Government's poverty alleviation policies, projects and programmes are well coordinated and implemented in an integrated manner. At the same time, Pacific island countries have also recognized the importance of creating an environment conducive to growth as being necessary to fighting poverty. With the assistance of organizations such as ADB and the World Bank, most of them have undertaken economic reform initiatives in recent years, albeit with mixed results. While the primary responsibility for tackling poverty rests with the countries themselves, it is imperative for them to work closely with each other as well as with international organizations, given their lack of financial and human resources. It is encouraging that the recent Forum Economic Ministers Meeting, held at Majuro, Marshall Islands, in June 2003, accorded poverty reduction priority status in the agenda for the region.

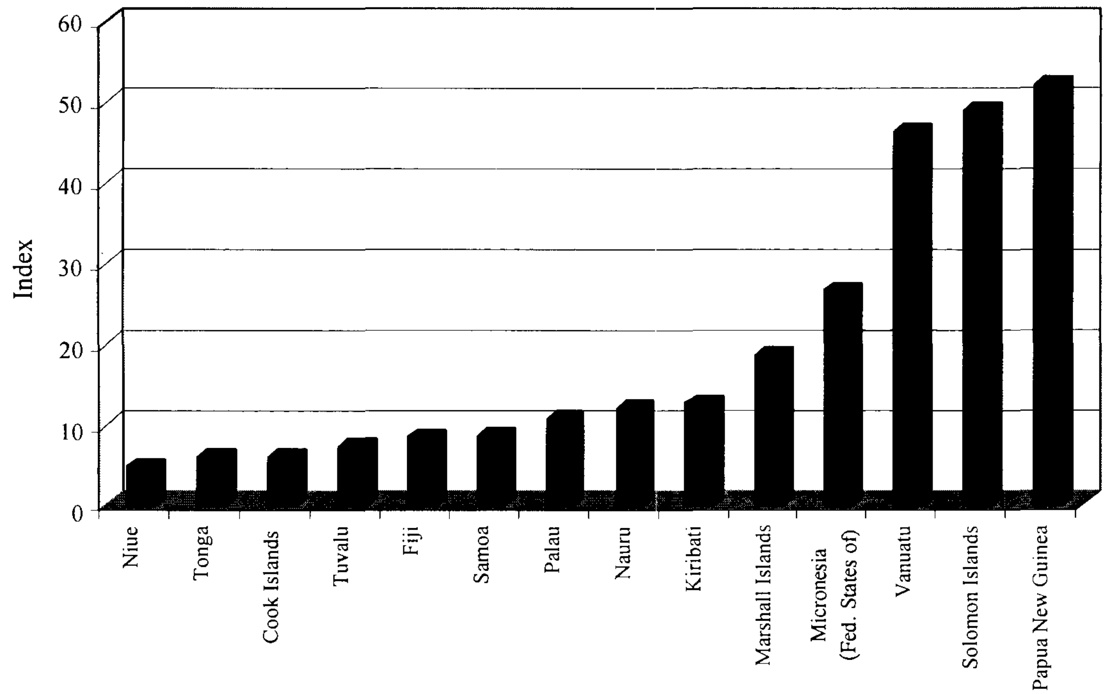
Partnerships with international and civil society bodies and the private sector will be crucial in alleviating poverty

Partnerships with international organizations, non-government organizations and the private sector will also be crucial if Pacific island countries are to grapple successfully with poverty and related issues. Several countries, such as Cook Islands, Fiji, Papua New Guinea, Samoa, Solomon Islands and Tuvalu, have signed partnership agreements with ADB to work on the development of national poverty reduction strategies. Such assistance has enabled those countries to analyse poverty and conduct participatory poverty assessments. The calculation or recalculation of poverty lines has helped the general public and their leaders to appreciate the extent of poverty in their countries and contributed to the development of a broad understanding of the nature of poverty and to a greater focus on priority programmes. For example, such assistance to Papua New Guinea contributed to the incorporation of poverty issues into the new medium-term development strategy of the Government. ADB has taken the lead in considering the establishment of a multi-donor Pacific poverty fund to pool external funds for a more effective and efficient analysis of poverty in the region. Apart from ADB, other organizations assisting Pacific island countries in addressing poverty include the World Bank and United Nations agencies.

The human poverty index shows a mixed picture in the Pacific

The human poverty index, which captures deprivation in three basic dimensions of human development, namely, longevity, knowledge and standard of living, shows a mixed picture for Pacific island countries, with some countries, especially the smaller ones, doing much better than the larger ones, such as Papua New Guinea, Solomon Islands and Vanuatu (figure I). Another study on the Millennium Development Goals in the Pacific (ADB, 2003) also gives a mixed picture, with some countries making significant progress in some areas and others struggling to promote human development.

Figure I. Human poverty index in selected Pacific island economies



Source: UNDP, *Pacific Human Development Report 1999: Creating Opportunities* (Suva, Quality Press, 1999).

Notes: The human poverty index is a composite index measuring deprivations in the three basic dimensions captured in the human development index: longevity, knowledge and standard of living. The higher the index number, the greater the composite poverty.

The ADB study notes that several countries have already achieved some targets, such as universal primary education or the elimination of gender disparities in education. However, many are finding it difficult to provide efficient and equitable access to basic social services and an environment conducive to private sector development. The report also notes signs of emerging pockets of poverty in some of the countries (figure II).[9]

The incidence of poverty is increasing in Fiji but social indicators have been improving

The *Fiji Poverty Report* notes that in 1991, 25 per cent of households were below the poverty line while another 15 per cent were vulnerable to poverty (UNDP, 1997a). Fiji's Poverty Task Force has estimated that poverty incidence increased to between 33 and 50 per cent in 2002 and new pockets of poverty, such as urban squatter settlements, are emerging. The non-renewal of sugar-cane leases held by Indo-Fijians has resulted in the eviction of several farmers. At the same time, the stagnant labour market has not provided any alternative to the displaced families and several new

[9] The report covers 12 Pacific island countries. Although recent work by ADB and others has contributed to a better understanding of the poverty levels in Pacific island countries, the lack of data continues to be a big constraint in determining the extent of poverty in most of these countries. Work done by ADB shows that there are significant disparities in income, as well as in access to services such as education and health, particularly between rural and urban areas and there are even significant inter-island variations in most of these countries.

Figure II. Review of poverty of opportunity indicators in selected Pacific island countries

Millennium Development Goals	*Fiji*	*Papua New Guinea*	*Samoa*	*Solomon Islands*	*Tonga*	*Vanuatu*
Goal 1	Poverty has increased to possibly 33-50 per cent	Poverty has worsened in the last five years	No extreme poverty or hunger but pockets of hardship exist	Poverty situation expected to worsen	No poverty line established and no inequality measures available	Hardship worsened in the last five years and high household income inequalities exist between urban and rural areas
Goal 2	Achieved primary school enrolment but low retention in secondary schools	Low enrolement rates in primary schools	Universal primary education achieved	Low enrolment rates for primary schools	High enrolment rates for primary schools	Improvement in primary school enrolment
Goal 3	Gender equality almost achieved in primary and secondary education	Slight improvement in female primary and secondary school enrolment rates	Gender equality achieved in enrolment ratio for primary and secondary schools	Gender gap has narrowed in school enrolment	Gender equity in education and literacy rates achieved	Improving gender disparity in education
Goal 4	Child mortality rates have decreased	Slight improvement in infant mortality rate from 83 per 1,000 live births in 1990 to 58 in 2001	Child mortality rates have declined	Decrease in under-five mortality rates and infant mortality decreased from 29 to 22 in 2001	Decreasing child mortality rates	Improvement in under-five and infant mortality rates
Goal 5	Maternal mortality rates almost doubled between 1995 and 1998	Maternal mortality rates more than doubled between 1995 and 1998	Maternal mortality rates increased between 1995 and 2002	Maternal mortality rates doubled between 1995 and 1999	Maternal mortality rate remains high in rural areas	Maternal mortality rates increased from 32 in 1995 to 68 in 1995
Goal 6	Non-communicable diseases are major causes of morbidity and mortality	Threat of an HIV/AIDS epidemic but contraceptive prevalence has improved significantly	Contraceptive prevalence rate higher but increasing lifestyle diseases	Communicable diseases remain the main cause of morbidity and also increase in lifestyle diseases	Low level of contraceptive use and rising levels of non-communicable diseases	Non-communicable diseases have become main causes of morbidity and mortality
Goal 7	Less than 50 per cent of population have access to safe water and sanitation	Low access to safe drinking water but increase in access to sanitation in urban areas	Improvement in access to safe water and sanitation	Slight increase in access to safe drinking water and sanitation	High level of access to safe drinking water and improved access to sanitation	Fifty per cent of population have access to safe drinking water and sanitation

Source: Adapted from ADB, *Millennium Development Goals in the Pacific: Relevance and Progress* (Manila, Asian Development Bank, 2003).

squatter settlements have appeared around the sugar-cane districts as a consequence. In recognition of the seriousness of the poverty problem, the Government of Fiji allocated F$ 101 million and F$ 157 million for poverty alleviation in the 2001 and 2002 budgets respectively. In addition, the income tax-free threshold was increased from F$ 6,500 to F$ 7,500. In the provision and extension of education and health services to the community at large, including the poor, Fiji has continued to perform well. Literacy rates are now at 93 per cent on average and 100 per cent among young adults. Gender equity is improving, with increasing participation of women in tertiary education and in the skilled workforce. Life expectancy continues to improve and is now 69 years. Infant mortality rates have declined to just 18 deaths per 1,000 live births, compared with 25 a decade ago. Half the population has access to safe water supplies while access to sanitation is reported at 75 per cent in urban areas.

Poverty is on the rise in Papua New Guinea, where the standard of social services has been falling

Papua New Guinea is experiencing a rapid increase in the incidence of poverty, which seems to have worsened in the last five years. There have been relatively sharp falls in GDP per capita since the mid-1990s but government expenditure as a share of GDP has been steady against the backdrop of relatively poor economic performance. This implies a lower level of public spending per head of population. There has been some deterioration in the standard of government services, especially in those extended to rural areas, and in infrastructure and the maintenance of law and order. The last two factors are essential for farmers to gain access to markets and such access has been a matter of significant concern to highland coffee growers; some half a million people, or 10 per cent of the total population, in Papua New Guinea depend on coffee for their incomes. A compounding difficulty for them was the recent slump in the world coffee market, leaving many farmers with little choice but to revert to a subsistence lifestyle.

Without access to sufficient cash incomes, rural farmers in Papua New Guinea will be constrained in their access to health care and education services. However, the decline in government resources committed to health and education in per capita terms has, to some extent, been offset by services provided by non-governmental organizations, churches and other civil society organizations. Nevertheless, the falling standard of living in rural areas in Papua New Guinea, especially in the coffee-growing regions, will be likely to increase the rate of rural-to-urban migration, thus fuelling urban unemployment and other social and infrastructure problems. Indeed, Papua New Guinea's quality of life indicators are comparatively low and have not improved noticeably over the last decade. The infant mortality rate of 79 per 1,000 live births has not changed in a decade and is the highest among the Pacific island countries, while life expectancy, at just 59 years, has improved but is still the lowest in the region. One third of the adult population is illiterate; this situation is improving only gradually, with one quarter of those aged 15-24 still not literate. There is a high degree of gender inequality in education and the female-to-male enrolment ratio in primary schools stands at just 0.86. Prostitution and the rapid increase in HIV/AIDS are becoming serious health problems in the country and urgent measures are needed to address them.

Civil unrest appears to have exacerbated the poverty situation in Solomon Islands

Solomon Islands appears to be lagging behind in meeting the Millennium Development Goals by 2015 (ADB, 2003). There are indicators that the poverty situation has been exacerbated by the civil unrest in the country. With a population growth rate of just over 3 per cent a year, Solomon Islands will see a doubling of its population in a little over two decades. The rapid population growth has put severe strains on cultivable land and forestry resources and has partly contributed to the eruption of violence and civil unrest experienced by the country in 1999. Government services have diminished with the provision of very basic services often being confined to the immediate periphery of the urban centres. The budgetary position of the State is such that meeting the salary costs of public servants is becoming increasingly difficult and this has had obvious consequences for both access to, and provision of, social services such as health care and education.

Solomon Islands made considerable progress in health services in the 1990s but the recent civil unrest is likely to have had an adverse impact on the maintenance of improved health standards. Evidence of this and of the decline in education services will, however, appear with a lag in terms of the relevant indicators. The infant mortality rate had fallen to just 21 per 1,000 live births by 2000 and life expectancy had reached 69 years, which is impressive in view of Solomon Islands' level of economic development. There was much less success in education, with a completion rate for primary school education of only about 80 per cent; many of those who failed to enrol in school were female. Although the enrolment rate at the primary level was quite good, many children do not go beyond this level. Over two thirds of the population had access to safe drinking water but only a third to sanitation facilities. The adult literacy rate stood at 77 per cent in 2002.

Income disparities are on the rise in Vanuatu

Vanuatu has considerable potential for sustaining poverty reduction efforts if the structural adjustment being put in place with the financial support of ADB begins to deliver economic returns soon. Vanuatu's progress towards achieving the Millennium Development Goals has been slow or stagnant (ADB, 2003). Income disparities are rising and this is of concern to the Government, as aggregate income contracted in the last two years and the population expanded at 3 per cent a year. Across all households, the income of the highest quartile was 4.6 times that of the lowest. The difference was even greater in urban areas, and in Port Vila the income of the top quartile was almost 52 times that of the bottom quartile. Large-scale rural-urban migration has meant that the population of Port Vila and Luganville, the two major urban centres, is growing in excess of 4 per cent a year. The rising number of unemployed youth in urban areas is posing a threat to peace, social stability and the crime-free image of the country. If conditions worsen, this could have adverse effects on the tourism industry, on which Vanuatu's future economic growth is heavily dependent.

Life expectancy in Vanuatu, at 68 years, reflects the success of past programmes to improve health standards, but much work remains to be done in extending health services to poor and remote communities and in improving immunization and post-natal care. At 35 per 1,000 live births, the infant mortality rate was high compared with other Pacific countries but significant progress has been made in reducing it. In 1990, for example, the rate was 52 per 1,000 live births. The level of education in the country is improving, with close to universal enrolment in primary school. Considerable achievements have also been made in ensuring equity in education, and gender representation in primary and secondary school is now nearly equal.

Reforms in Samoa appear to have paid off as extreme poverty and hunger are absent

Samoa is said to be free of extreme poverty and hunger. An effective reform programme, which resulted in positive economic growth in recent years, along with the strong culture of redistribution within the extended family system, contributed to this outcome. In particular, the country has been successful in extending services to the community at large and this is reflected across the spectrum of poverty indicators. The adult literacy rate of 80 per cent is second only to that of Fiji and there is gender equity in primary and secondary education. The infant mortality rate is now well below the average of developing countries, at 21 per 1,000 live births, less than half the rate a decade earlier. Life expectancy has reached 69 years, access to safe drinking water is almost universal and sanitation standards are high. However, a recent ADB study reveals that some Samoans are living in difficult conditions and others are facing real hardship, which appears to have increased in recent years in both rural and urban areas, creating pockets of poverty (ADB, 2002). Those most affected include the jobless, the disabled, single mothers, the homeless, the landless and the unskilled, while the most vulnerable are children, youth and women.

Tonga has made consistent efforts to provide universal access to basic services

A poverty line has not yet been established for Tonga and measures of inequality are not available. As in many other Pacific island countries, however, there is a strong culture of redistribution in the country that helps to prevent extreme poverty. The general standard of living is enhanced through inward remittances from the large number of Tongans working and living abroad. In fact, Tonga is one of the few Pacific island countries that has achieved or nearly achieved several of the targets specified in the Millennium Development Goals (ADB, 2003). Tonga has made consistent efforts to provide universal access to basic services, particularly in health and education. The infant mortality rate is among the lowest in the Pacific island subregion, at 17 per 1,000 live births. The incidence of malaria, tuberculosis and HIV/AIDS is also low. Life expectancy in Tonga has risen to 71 years and is the highest in the Pacific. There is close to universal education, with the high standards of education providing the basis for emigration and subsequent remittances from abroad. There is virtually universal access to safe drinking water. However, in common with many other Pacific island countries, Tonga is particularly vulnerable to natural disasters, ranking third among developing countries on the vulnerability index. There has been some concern in recent years over the rising inequality in Tonga, as rapid urbanization has led to the emergence of shantytowns and urban unemployment while affluence on the main island relative to the outer islands has increased.

Policy issues, implications and options

The subsistence economy is no longer sufficient if social goals are to be met in the Pacific

Pacific societies are justly proud of their culture and, in particular, the strong culture of redistribution that exists within the extended family system, with the result that many have trouble accepting that poverty exists in their midst. Nevertheless, recent studies have clearly shown that poverty exists and, in some cases, may be getting worse, although its incidence, depth and severity vary greatly between countries. Poverty is on the rise owing to two decades of weak economic performance and slow job creation in the face of fairly rapid population growth and urban drift, growing inequalities and declining public services. These in turn have had an impact on traditional support systems, which are under strain and are slowly breaking down. Furthermore, the subsistence sector, which has played an important role in sustaining livelihoods in the Pacific island economies in the past, is no longer sufficient to ensure adequate health and education or improved life expectancy in these countries in the long term. Pacific island countries are also facing new and emerging social issues, such as prostitution and the rapid spread of HIV/AIDS.

Several Asian countries have been successful in reducing their poverty levels in recent years and Pacific island countries can learn from their experience. One of the important factors responsible for poverty reduction in Asia has been sustained economic growth, an area where Pacific island countries have not been notably successful so far. In the Pacific island context, economic growth depends on overcoming socio-economic vulnerability, ensuring political stability and good governance, developing capacity and skills, controlling population growth and developing physical and financial infrastructure.

The centrality of good governance and accountability to economic and social development cannot be ignored

Good governance and accountability are important ingredients for sustained economic growth. This is all the more so in the Pacific, given the severe resource constraints faced by these countries, on the one hand, and the traditional system of patronage, on the other. Good governance will require rationalizing the roles of the private and public sectors, strengthening national leadership through representative and independent institutions, increasing and enhancing opportunities for government/civil society partnership and improving the delivery of social services. An important part of the process is to engage vulnerable groups, such as the poor, the disabled and women, in the decision-making process so that they can play a proper role in formulating the programmes and policies that are implemented for their benefit.

Translating national strategies into targeted anti-poverty measures is the challenge facing many Pacific island countries

Many Pacific island countries have been working closely with international and multilateral organizations in reforming their economies to address some of these issues, especially in trying to revive their economies, with countries like Samoa reaping benefits from such reforms with improved growth performance in recent years. However, efforts towards economic growth need to be balanced with measures to increase social capital formation. The work already done by international bodies such as ADB has raised awareness of increasing poverty levels in Pacific island countries, which has enabled some of these countries to incorporate national poverty reduction strategies into their national development strategies. The challenge for Pacific island countries is to translate these national strategies into concrete, targeted anti-poverty measures while at the same time maintaining macroeconomic stability, developing infrastructure and human resources and ensuring that credit is readily available to the private sector, including the poor.

Greater coordination of poverty reduction activities between donors and between donors and recipients is also necessary so that such assistance is not duplicated and implementation does not become a major burden for these small countries.

Collaborative efforts between Governments and donors are needed to improve poverty data

It is also clear that Pacific island countries must first understand poverty and related issues, as well as the changes that are taking place in their social fabric, before they can formulate appropriate policy responses. An important requirement for this is the availability of reliable data. Lack of reliable data on human development indicators continues to be a major constraint in determining the extent and true nature of poverty in the Pacific island countries. Collaborative efforts between the Governments and donors, directed at improving the design and collection of data, ought to build on the good work already done by the Governments of the Pacific island countries themselves, with the assistance of international organizations such as ADB.

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IV THE BANGKOK AGREEMENT: PROSPECTS FOR TRADE EXPANSION IN THE ASIA-PACIFIC REGION[1]

Introduction

The First Agreement on Trade Negotiations among Developing Member Countries of the Economic and Social Commission for Asia and the Pacific, known as the Bangkok Agreement, was established in 1975 as Asia's first multi-member preferential trade agreement (PTA) between developing countries (Mukherji, 1978; Kelegama, 2001). ESCAP has served as the interim secretariat to the Bangkok Agreement since its inception. The five countries that originally ratified the Agreement were Bangladesh, India, the Lao People's Democratic, the Republic of Korea and Sri Lanka. In an important recent development, China acceded to the Agreement in 2001.

Established in 1975, the Bangkok Agreement is the oldest preferential trade agreement between Asian developing countries

Trade between Bangkok Agreement member countries has remained low throughout the Agreement's history, and many PTAs in the region that were formed after the inception of the Agreement have overtaken it in terms of concessions offered, amount of intra-member trade generated and interest from prospective members and the world as a whole.[2] However, China's recent accession has provided the Agreement with new impetus that could contribute to transforming the Agreement into a more dynamic PTA in the region. Member countries of the Agreement have recognized the importance of China's accession and have launched a process to revitalize the Agreement.

With some of the major economies in the region participating in the Bangkok Agreement, it has the potential to become a major PTA in Asia and the Pacific. It is the only preferential trade agreement in force that

Membership in the Bangkok Agreement is open to all developing countries in the region

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[1] Prepared by Harish Iyer, Economic Affairs Officer, Trade Policy Section, Trade and Investment Division, ESCAP. This paper has benefited from helpful comments by Tiziana Bonapace, Officer-in-Charge, Trade Policy Section, Trade and Investment Division, ESCAP. The views expressed in the paper do not necessarily reflect those of the ESCAP secretariat.

[2] In this paper, the term PTA will be used to describe all agreements that liberalize trade on a selective basis, that is, between a subset of member nations only. The definition therefore includes free trade agreements/areas (FTAs), which are PTAs that allow for full trade liberalization between members. Bilateral trade agreements (BTAs) are also included. Where necessary, a distinction will be made; the Bangkok Agreement, for example, is not an FTA. A preferential trade agreement of course only makes sense as long as its members offer more to each other than they do to the rest of the world; for member countries of a PTA that are also members of the WTO, commitments under the PTA should in some way go beyond commitments that have been made at the multilateral level.

links East and South Asia, as well as the two most populous countries in the world, China and India. The Agreement's unique status as the only PTA with membership open to all developing countries in the region[3] further suggests that it can be a used as a mechanism to promote regional cooperation in trade, and perhaps also in related areas such as investment. The ongoing revitalization measures are crucial for the future of the Agreement, for it is through the implementation of those measures that its potential can begin to be realized. Full commitment by member countries will be required through the revitalization process and beyond, for in a region that is seeing several far-reaching trade liberalization initiatives, this may be the only way for the Agreement to maintain its relevance.

The objective of this paper is to present the Bangkok Agreement in the light of current revitalization efforts and to assess its future in the broader picture of trade in the region. The paper begins by providing an overview of the Agreement and its potential and goes on to summarize the measures being implemented as part of the revitalization process. A final section discusses what will need to be done in the future in order to build on the current momentum within the Agreement, and thus permit it to maintain its relevance in the region.

Some facts

So far, the Bangkok Agreement has served as a forum for the exchange of tariff concessions on goods. Trade negotiations under the Agreement have followed the positive list, product-by-product, approach. Two full rounds of negotiations have so far been completed, and some additional modifications have occasionally been made to concession lists. At the end of 2001, the number of items covered under the Agreement was 926, of which 94 were exclusively for least developed member countries.[4]

Since its inception, the Bangkok Agreement has been governed by a Standing Committee consisting of representatives of member countries. Standing Committee meetings have become less than frequent over the years, and member country representation has not been at a level to necessarily warrant the attention of top trade policy decision makers or the media. In addition, unlike other PTAs, the Agreement has never had its own secretariat; member countries have relied on ESCAP to serve as the interim secretariat. The unfortunate result of these arrangements is that the Bangkok Agreement has remained a low-key agreement, relatively unknown to the general public.

Trade between Bangkok Agreement member countries has remained low ...

Throughout its history the Bangkok Agreement has also shown a less than satisfactory trade performance. Table 1 shows the consistently low proportion of intra-member trade flows in the total trade of member

[3] More specifically, membership in the Bangkok Agreement is open to all developing member countries of ESCAP.

[4] Concessions offered under the Bangkok Agreement are based on the Harmonized Commodity Description and Coding System (HS). Thus an "item" as discussed here would be an HS product code, which typically is at the 6-digit level or higher under the Agreement.

countries. The few cases of important shares in trade cannot necessarily be attributed to the Bangkok Agreement. In particular, the relatively high proportions of products from member countries imported by Bangladesh and Sri Lanka come mainly from India (India accounted for about 13 per cent of Bangladesh's total world imports in 2001, and for over 10 per cent of those of Sri Lanka). However, there exist several trade agreements that link these South Asian countries, and a host of other factors that contribute to the formation and maintenance of trading relationships have no doubt played a role in determining the pattern of trade flows in the subregion. It is also worth noting from table 1 the very low shares of the Republic of Korea's trade with member countries of the Agreement, which is striking given that the Republic of Korea is one of the major trading economies in the region.

Table 1. Bangkok Agreement: intra-member trade (excluding China), as a percentage of the total

	1980		*1990*		*2001*	
	Exports	*Imports*	*Exports*	*Imports*	*Exports*	*Imports*
Bangladesh	2.9	3.5	1.9	9.1	1.3	17.8
India	3.2	1.5	3.2	1.5	5.9	3.3
Lao People's Democratic Republic	n.a.	n.a.	0.5	0.2	0.2	1.0
Republic of Korea	1.6	0.2	1.3	0.4	1.6	0.8
Sri Lanka	3.7	6.6	1.8	9.7	2.3	16.4
All Bangkok Agreement countries	2.2	1.2	1.7	1.2	2.5	2.6

Source: IMF, *Direction of Trade Statistics* (CD-ROM), various editions (Washington, International Monetary Fund, 2002-2003).

Note: n.a. = not available from this source.

... and the coverage of the Bangkok Agreement has been limited relative to other agreements in the region

It may be said with some certainty that the relatively limited concessions that have been available under the Bangkok Agreement have not had an impact on intra-member trade flows. As a point of comparison, after three rounds of negotiations resulting in concessions on 5,550 items under the SAARC Preferential Trading Arrangement (SAPTA), debate continues as to whether these concessions have had a positive effect on intra-SAPTA trade (Mohanty, 2003). Of course, it is not simply the number of concessions that will determine the ability of a PTA to generate trade flows. The depth of concessions will also be an important determinant, and in this regard the preferences under the Bangkok Agreement have not only remained relatively low but have also become smaller in some cases when general tariff rates have been reduced with no appropriate correction in the rate offered under the Agreement. A third important determinant is the extent of inclusion of items actually traded (or items with a potential to be traded) in concession lists, and in this regard Kelegama (2003) has pointed out that member countries of the Agreement have granted minimal concessions in major import areas. In all of these respects, it would seem that the ASEAN Free

Trade Area (AFTA) is substantially ahead of other established PTAs in the region.[5] AFTA concessions are based on the negative list approach to trade liberalization, under which all items except those specified in the so-called negative list are eligible for preferential treatment. Provided that the negative list is not overwhelmingly large, this approach to trade liberalization will generally lead to a more comprehensive reduction in trade barriers than what can be achieved through the positive list approach. In the case of AFTA, all items covered by liberalization commitments are placed within the framework of the Common Effective Preferential Tariff (CEPT) scheme, which has specified a tariff range of 0-5 per cent. Through a number of initiatives to bring forward the dates for CEPT to come into force for different categories of products, as well as the eventual inclusion of unprocessed agricultural products under the scheme, AFTA member countries have demonstrated a convincing commitment to trade liberalization. It should be noted particularly that the response of AFTA members to the East Asian economic crisis of 1997-1998 was to accelerate the tariff reduction programme and lower the target tariff rate to zero (Scollay, 2003).

China's accession is a major step forward for the Bangkok Agreement ...

China entered the Bangkok Agreement with an offer of 739 items for general concession and an additional 18 items for special concession to least developed member countries. With the addition of China's list of concessions, which came into force on 1 January 2002, a total of 1,670 items are now covered under the Bangkok Agreement, of which 112 are directed towards least developed countries.[6] Table 2 summarizes the current coverage of the Agreement, which is admittedly still limited compared with agreements such as AFTA, or even SAPTA. However, China's accession should nevertheless be seen as a major step forward for the Agreement. First, China is a major trader in the world economy, ranking sixth worldwide in 2001 in terms of both merchandise exports and imports (WTO, 2002a). Further, the combined populations of member countries of about 2.5 billion people make the Bangkok Agreement the largest PTA in the world in terms of population (Ratnayake, 2002). With the presence of several major economies in the Agreement, particularly China, India and the Republic of Korea, the market potential within the Agreement is huge. China's entry into the Agreement has therefore brought with it several interesting possibilities and could have profound implications for trade in the region.

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[5] The newer bilateral trade agreements that are being formed in the region are, however, also typically comprehensive in coverage. These will be briefly discussed below.

[6] China and India have taken some time to conclude their bilateral negotiations under the Bangkok Agreement, although recent press coverage indicates that agreement has been reached between these countries (see, for example, *International Herald Tribune*, 30 June 2003). The concession list of China summarized here does not include any agreement on product coverage that has been reached between China and India. The general concessions shown are offered to Bangladesh, the Republic of Korea and Sri Lanka, while special concessions to least developed countries are offered to Bangladesh. The Lao People's Democratic Republic has been an inactive member of the Agreement thus far (Ratnayake, 2002).

Table 2. Number of products offered concessions under the Bangkok Agreement

	General concessions	*Special concessions to least developed countries*	*Total*
Bangladesh	129	-	129
China	739	18	757
India	188	33	221
Republic of Korea	214	29	243
Sri Lanka	288	32	320
All Bangkok Agreement countries	1 558	112	1 670

Source: I.N. Mukherji, "The Bangkok Agreement: a negative list approach to trade liberalization in Asia and the Pacific", paper prepared for the nineteenth session of the Standing Committee of the Bangkok Agreement, Bangkok, 19-21 March 2003.

Note: The Lao People's Democratic Republic has up to the present not issued customs notification on tariff concessions granted under the Bangkok Agreement. Some members, however, extend their concessions to that country.

Potential trade

... and results in a significant increase in the proportion of trade flowing between members

A comparison of the 2001 intra-Bangkok Agreement trade figures in table 3, which include China as a member (China acceded to the Agreement in that year), with the figures in the last column of table 1 shows that China's entry substantially increases the proportion of trade of member countries flowing within the Bangkok Agreement. It may be seen that China's presence in the Agreement is of particular importance for the Republic of Korea, whose trade with China is substantially higher than with any other member.

Table 3. Bangkok Agreement: intra-member trade (including China), 2001, as a percentage of the total

	Exports	*Imports*
Bangladesh	1.4	26.4
China	5.9	10.3
India	9.2	6.7
Lao People's Democratic Republic	1.8	9.9
Republic of Korea	13.7	10.3
Sri Lanka	2.4	20.2
All Bangkok Agreement countries	8.7	10.4

Source: IMF, *Direction of Trade Statistics* (CD-ROM), various editions (Washington, International Monetary Fund, 2002-2003).

In addition, it is worth exploring how the exports of the original member countries to China changed from 2001 to 2002, the latter being the first year of implementation of China's concessions under the Agreement. As will be seen in table 4, all original members' exports to China increased between 2001 and 2002. Without access to data at the tariff-line level, it is not possible to ascertain the extent to which this increase in exports is due to the Bangkok Agreement.[7] It is also rather early to evaluate the full impact of China's accession. Nevertheless, the rise in trade should be seen as a positive development for the Agreement, and seems consistent with the optimistic estimations of Ratnayake (2002) on the possible impact of China's entry into the Bangkok Agreement.[8]

Table 4. Bangkok Agreement: percentage increase in exports to China, 2001-2002

	Increase in exports (percentage)
Bangladesh	120.0
India	29.4
Lao People's Democratic Republic	29.4
Republic of Korea	30.6
Sri Lanka	107.5
Five original members	30.5

Source: IMF, *Direction of Trade Statistics* (CD-ROM), various editions (Washington, International Monetary Fund, 2002-2003).

Trade potential within the Bangkok Agreement is high

While Ratnayake (2002) estimated specifically how China's concession list would affect intra-member trade flows, it is also useful to go beyond the current concessions to study in more general terms the potential for trade expansion between member countries of the Agreement. Given that the Agreement is the largest PTA in the world in terms of population, and therefore market possibilities, it would seem that vast trading opportunities exist, particularly after the accession of China. Mukherji (2003), using 1998-1999 data, undertook a detailed analysis of trade potential between the member countries, the results of which are summarized in table 5. The vast differences in all cases between actual trade and potential trade give a

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[7] Even tariff-line trade data might not, however, give a complete picture of the impact of a PTA on trade flows, since it is not necessarily true that all goods traded under a preferential tariff line actually benefit from the preferential treatment (see, for example, WTO, 2002b). Given that China's concessions were not offered to India in 2002, and that, as mentioned earlier, the Lao People's Democratic Republic is an inactive member of the Agreement, the increase in trade with these two countries occurred independently of the Agreement.

[8] Ratnayake (2002) looked at how exports of food items and manufactured products to China from original Bangkok Agreement members benefiting from China's concession list would increase following China's accession. Positive opportunities were found in both sectors and for the three countries investigated, Bangladesh, Republic of Korea and Sri Lanka, with the highest gains in terms of percentage of export increase going to Bangladesh.

striking picture of the possibilities that exist under the Agreement.[9] Ratnayake (2002) treated the issue of trade potential in the context of China's accession by calculating the complementarity in trade existing between China and the original member countries.[10] It was found that not only is total complementarity high in all cases, but for each country's trade with China there is additionally a significant difference in complementarity at the product level, suggesting that the major trading opportunities of each country with China lie in different sectors.

Table 5. Potential trade between Bangkok Agreement member countries, 1998-1999

(Millions of US dollars)

	Actual trade with member countries	*Potential trade with member countries*
Bangladesh	93	2 337
China	10 784	54 899
India	313	16 570
Lao People's Democratic Republic	11	487
Republic of Korea	19 132	70 952
Sri Lanka	115	3 554
All Bangkok Agreement countries	30 448	148 799

Source: I.N. Mukherji, "The Bangkok Agreement: a negative list approach to trade liberalization in Asia and the Pacific", paper prepared for the nineteenth session of the Standing Committee of the Bangkok Agreement, Bangkok, 19-21 March 2003.

Revitalization process

In 2001, a number of measures to revitalize the Bangkok Agreement were initiated in an effort to bring the Agreement closer to its potential

In 2001, Bangkok Agreement member countries, recognizing the potential of the Agreement, particularly in the wake of China's accession, agreed to launch a process to revitalize the Agreement. Three major measures have been agreed upon as part of the revitalization process. First, the text of the Agreement is being revised to reflect changes in the international trading system that have taken place since the Agreement was first established. Probably the most important development in the international trade arena since the birth of the Agreement has been the establishment of WTO in 1995, and the text of the Agreement now takes account of that institution and the trade agreements embedded therein. Second, a Ministerial Council has been established to provide overall supervision for the manage-

[9] Actual trade and potential trade in Mukherji's study are viewed from the supplier's point of view and are therefore calculated in terms of exports.

[10] Complementarity was calculated in the same way as was done by Drysdale (1988) and Anderson and Norheim (1993).

ment of the Agreement. It is envisaged that the Ministerial Council, which will meet at regular intervals, will help to transform the Agreement into a more effective mechanism and will also raise its profile. Finally, a third round of negotiations has been launched.

The revitalization measures can put the Bangkok Agreement on the right track, but in themselves will probably not be sufficient to allow the Agreement to realize its full potential. For example, much will depend on the long-term commitment shown by the Ministerial Council. Further, even though the third round will no doubt contribute to trade liberalization between members, negotiations in the round are limited to tariff concessions on goods. Given that tariffs worldwide continue to be brought down through multilateral negotiations, limiting the scope of the Bangkok Agreement in this way will not allow trade flows to increase as much as they could. It should also be noted that the positive list, product-by-product, approach to liberalization may be too narrow in scope to generate large increases in trade. It is perhaps more realistic, therefore, to view the revitalization measures as the building blocks, albeit important ones, necessary to turn the Agreement around.

Ways forward

With the formation of several preferential trade agreements, the regional trade picture is becoming increasingly complex

The Asian and Pacific region, like other regions, has in the past decade or so seen the emergence of several PTAs. BTAs in particular are increasing in number. BTAs typically have a much more comprehensive coverage than traditional PTAs such as the Bangkok Agreement, which only offer tariff concessions on goods. In addition to liberalizing intra-member trade to an extent to which they can be termed FTAs, the new BTAs typically also offer economic and technical cooperation in a wide range of areas (Bonapace, 2001). The level of integration between BTAs is therefore much higher than that which can be achieved through more traditional approaches to trade liberalization. Aside from the emerging phenomenon of BTAs, other trade liberalization proposals linking ASEAN member countries with China, India, Japan and the Republic of Korea could profoundly affect trade in the region. BIMST-EC[11] also seems to be moving towards becoming an FTA (BIMST-EC, 2003).

As the number of PTAs increases in this manner, it becomes difficult to gain a clear picture of the value added by each agreement. For example, Bangladesh, India and Sri Lanka are members of the Bangkok Agreement, BIMST-EC and SAPTA. Furthermore, India and Sri Lanka recently entered into a bilateral FTA, which would seem to make their common membership in other PTAs largely redundant. More generally, as the number of PTAs in the region continues to increase, overlap between agreements will be inevitable and the significance of many will be lessened.

[11] Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Cooperation, which at this time is a sectoral cooperation arrangement rather than a PTA (Kelegama, 2001).

The Bangkok Agreement could play an important role in promoting regional economic cooperation

In this scenario, it is valid to ask where the Bangkok Agreement can fit in. It has been suggested (see, for example, Bonapace, 2001) that the fact that the Agreement is the only truly "regional" trade agreement in Asia and the Pacific, not only in terms of its current membership (it is the only PTA with representation from different subregions), but also, more important, in terms of its potential membership (all developing member countries of ESCAP are eligible to join), gives it scope to eventually develop into a regionwide trade agreement. Following this line of argument, it could be further suggested that the Agreement can play an important role in promoting regional cooperation between developing countries in trade matters. The forum could perhaps even be broadened over the course of time to cover related issues, for example, in the investment area.

The issue of how best to exploit the Agreement's potential to promote regional cooperation in trade and investment is one that warrants further thought and analysis. For a start, the Agreement could be used by developing countries in the region as a mechanism not only to provide mutual support in dealing with economic challenges but also to form common positions on specific negotiating issues in WTO. The turn of events at the Fifth WTO Ministerial Conference, held at Cancún, Mexico, in September 2003, while not the best of outcomes, shows that a group of countries with diverse concerns such as the Group of 21 developing countries (which, from the Asian and Pacific region, includes the two major Bangkok Agreement member countries of China and India), can come together on a single issue, remain united and drive home an important message, in this case the need for the reduction of agricultural subsidies by developed countries.[12]

The cohesiveness shown by the Group of 21 could be used as a model for constructive cooperation between developing countries in Asia and the Pacific within the framework of the Agreement, but in addition to this aspect of cooperation, the question is posed here as to whether the role of the Bangkok Agreement could be further enhanced. It has been pointed out (see, for example, WTO, 2003) that the increasing complexity in the global trade regime brought about by the growing number of PTAs in force with differing, and perhaps in many cases mutually inconsistent, provisions increases the transaction costs of engaging in international trade, while also potentially causing uncertainty on the application of the rules in any given situation. In view of this observation, might there be a need in the future for a common format for PTAs in the region, so as to encourage rather than hamper trade? Could the Bangkok Agreement evolve into a common framework mechanism under which all subregional PTAs between developing countries in Asia and the Pacific could be placed? Or could the Agreement perhaps serve as a platform for the eventual amalgamation

[12] This being said, the outcome of Cancún should not be allowed to represent the demise of the multilateral trading system. All countries are aware of the benefits of multilateral trade liberalization and a rules-based trading system, and the poorest countries risk paying the highest price for a breakdown in multilateral trade talks (see, for example, *The Economist*, 20 September 2003). Negotiations under the Doha round, launched by WTO members in 2001, should therefore continue, though it is clear that more work will be required to find a way forward that is satisfactory to groups of countries with differing positions.

of various subregional PTAs? Lloyd's (2002) vision of the coalescence of PTAs being one possible direction that regional trade policy might take could thus materialize within the framework of the Agreement. While the idea is still in its infancy, the role the Agreement could play in this context, should the need arise, is presented here for possible future consideration.

China's accession makes membership more attractive to countries in the region ...

In practical terms, the idea of the Bangkok Agreement as a forum for regionwide cooperation can only take form if and when countries in the region begin to consider membership in the Agreement seriously. China's recent accession, and the fact that the Agreement is the only PTA currently in force that allows preferential access to the markets of China, India and the Republic of Korea, has of course generated some interest from countries in the region, and it may be only a matter of time before a number of countries take the step of joining the Agreement. The ongoing revitalization process provides a valuable opportunity for members of the Agreement to demonstrate to observer countries that efforts have been made to introduce change within it. Even if the third round does not bring sweeping liberalization, a speedy conclusion to the round with adequate depth and breadth in concessions will show that the "new" Bangkok Agreement is dynamic and that the prospects for future liberalization and cooperation remain positive. Given that this is the first attempt at trade liberalization within the Agreement since the end of the second round more than a decade ago, and that this is the first round in which China will participate as a full member, the level of interest from observer countries will no doubt be high.

... but Bangkok Agreement members should ensure that the revitalization process is seen through to a successful conclusion ...

The membership potential of the Bangkok Agreement, while important in its own right, should not, however, be seen as the main justification for its existence, at least in the short run. It should not be forgotten that the Agreement was originally established with the purpose of expanding trade between member countries, and this objective has not as yet been satisfactorily achieved. The most fundamental concern for members in the immediate future should be to see through the revitalization measures for the purpose of putting in place the building blocks for a PTA that will be relevant in the twenty-first century. If the ongoing revitalization measures within the Agreement are successful, countries in the region will themselves be attracted to join. New membership should thus follow logically from the course of events, and should not necessarily be the measure by which the progress of the Agreement is evaluated. Given that some of the most important economies in the region are members of the Agreement, it would seem that a well-functioning PTA between current members would be enough to justify the Agreement's existence, in spite of the proliferation of PTAs in the region. To be sure, the significance of the Agreement may be diluted relative to a hypothetical scenario with fewer trade agreements, but this holds true for all trade agreements in the region, and particularly those with multi-country membership.

... and should also consider eventually broadening the scope of the Agreement

The full implementation of the current revitalization measures will not guarantee a place for the Bangkok Agreement in the regional trade picture over the long run, but will at least give the Agreement the means to achieve this objective. Once all measures in the revitalization process have been fully implemented, it will be up to the member countries to decide how to steer the Agreement forward. Continued moves towards liberalization can only be of benefit to the Agreement, first because this will be the only way in which the trade potential between members of the type estimated by Mukherji (2003) can come close to being realized, and second because dynamism of this nature is what will attract other countries in the region to the Agreement. Ideally, therefore, Bangkok Agreement members should move forward fairly quickly to launch a fourth round of negotiations, preferably based on the negative list approach. Serious consideration should be given to moving beyond tariffs to also include non-tariff measures and trade facilitation issues as topics for discussion. Members should further keep the possibility open for eventual talks on services trade as well as on broader topics such as trade-investment linkages.

Combining overlapping agreements could be one way to move the regional trade agenda forward

If member countries steer the Bangkok Agreement along the path of deeper liberalization and cooperation in trade and investment, the Agreement will have much of what will be required to maintain its relevance in the region. The eventual establishment of an independent secretariat would be a useful complementary step and would perhaps follow naturally from the course taken by the Agreement. As already mentioned, however, the fact cannot be avoided that the preponderance of PTAs in the region will inevitably lead to overlap between agreements, diminishing the relevance of many, while straining the capacity of countries to manage them all effectively. The question was posed in this paper as to whether there might be an eventual need for some kind of common structure for PTAs, but clearly such an idea will take time to formulate properly, let alone implement, and may not be feasible any time soon. As a first step in this direction, however, and drawing on Lloyd's (2002) discussion, countries in the region might consider moving the regional trade agenda forward by combining some agreements that have common membership. While recognizing that member countries of various agreements may not all at this time see the need for such mergers, in the context of the Bangkok Agreement it is worth noting the interesting proposal of Kelegama (2001), who suggests that the Agreement and BIMST-EC are similar enough in membership for them to be joined. The presence of two additional South-East Asian countries, Myanmar and Thailand, in the Agreement would no doubt be welcome, as it would provide a more solid bridge within the Agreement between South and East Asia.[13] At the Fourth BIMST-EC Trade/Economic Ministerial Meeting, it was agreed to establish a group of experts to start work on a framework agreement on a BIMST-EC free trade area (BIMST-EC, 2003). With Bangkok Agreement member countries having demonstrated a similar desire for trade liberalization, the time may be right to consider a merger between these two agreements.

[13] Thailand was in fact one of the original signatory countries of the Bangkok Agreement, but did not subsequently ratify it. The Agreement would benefit from Thailand's entry, but a recent study (TDRI, 2003) shows that Thailand also stands to gain from membership in the Agreement, particularly if further trade liberalization within the Agreement were to take place.

With PTAs continuing to be formed in the region, and worldwide, it is unclear what the final outcome of the process will be, and which of these will remain standing in the long run. The outcome of the Fifth WTO Ministerial Conference has also led to talk concerning the possibility of an even stronger push towards regionalism and bilateralism (see, for example, Peters, 2003; Knowlton, 2003). From a welfare point of view, free or freer trade for all through multilateral liberalization is a first-best scenario (Bhagwati, 1992), and ideally the formation of PTAs should serve as building blocks, and not stumbling blocks, to global free trade.[14] Be that as it may, PTAs are a fact in the emerging trade picture, and in this complex scenario the potential of the Agreement remains a reality. If member countries stick to their commitment to the Agreement and build on the revitalization measures, the Bangkok Agreement may not only maintain its relevance as a PTA in the region but could also eventually contribute to defining the pattern of trade in Asia and the Pacific.

[14] Useful summaries of the issues involved in assessing the relationship between PTAs and the multilateral trading system can be found in Laird (1999) and Panagariya (1999).

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V COPING WITH EPIDEMIOLOGICAL DISEASE OUTBREAKS: LESSONS FROM SARS[1]

Introduction

The outbreak of SARS in March 2003 put considerable strain on a number of countries, in particular China, Hong Kong, China, Singapore, Taiwan Province of China and Viet Nam. Within a short space of time, over 8,400 persons were infected with the virus, resulting in over 800 deaths worldwide. However, the pronounced economic and social impacts of SARS were largely the result of the fear and panic that arose in the absence of proper information and the lack of a cure. The increased flow of people, goods, services and information in a globalized world economy has quickened and intensified such impacts. Aggressive media coverage also provided a favourable environment for such developments.

SARS was contained within a relatively short period but uncertainties remain high

The spread of SARS was contained by June 2003 but uncertainty remains high, particularly as there is still no cure or proper diagnostic test. The emerging side effects of the drugs used in treating the disease, its episodic reappearance in some affected countries and possible return during the winter season, together with the reported presence of the virus in the environment, prevent a definitive conclusion being placed on the outbreak. Moreover, the potential threat of the disease re-emerging in epidemic proportions has not been completely ruled out, particularly in a scenario of an outbreak in populous developing countries such as India, Bangladesh or even rural China, where health systems with limited resources may not be able to cope. Therefore, a review of the experience of the countries affected by SARS in handling the outbreak may provide insights for managing similar incidents in the future and help to mitigate the resulting economic and social impacts.

The economic impact of SARS

Economies in East and South-East Asia suffered short-term losses in output

Estimation of the economic impact of SARS is not an easy task as several other factors, such as geopolitical tensions in West Asia and the weak recovery in industrial countries, were affecting countries in the region in 2003. Moreover, a shortfall in output as a result of postponement of economic activities in a given period could be offset by improved performance in the following period, while some output losses may not be recovered at all,

[1] Prepared by Amarakoon Bandara, Economic Affairs Officer, Poverty and Development Division, ESCAP.

making it difficult to assess the net output loss due to the disease outbreak correctly. Some of the methodological issues involved in estimating economic losses in the region owing to SARS are discussed in a recent ADB publication,[2] in which the overall cost of SARS for East and South-East Asian economies is estimated as being equal to US$ 18 billion in 2003, or approximately 0.6 per cent of GDP. Economies such as Singapore and Hong Kong, China are estimated to have lost as much as 3 per cent of GDP to SARS. However, the economic impact of the disease on some countries may not be as severe as initially feared, as indicated by the GDP growth rates for the third quarter of 2003 in China and Thailand, which were better than expected.

Although there is no firm evidence, the disease appears to have had mixed implications for countries in the region not directly affected by SARS. Some of those countries benefited as export orders for garments and leather, for example, were shifted to them from SARS-affected countries, while most were hit by the slump in tourism.

There were several channels by which SARS affected economies in the region. The fear and panic caused by uncertainties about the transmission mechanism of the disease, lack of information and the absence of a cure caused a demand shock in the short run. Private consumption demand fell as the demand for services such as travel, tourism and entertainment was adversely affected. The East and South-East Asian subregions, in particular, which depend heavily on tourism for employment and foreign exchange earnings, are especially vulnerable to the spread of diseases such as SARS.

Capital flows to the region were not significantly affected by SARS

While the short-term impact of SARS on economies in the region was clearly visible, whether or not diseases such as SARS could have long-term effects depends to a large extent on the ability to contain the spread of the disease and efforts to restore public confidence by eliminating the uncertainties surrounding it. In this regard, there is no firm evidence of a significant negative impact on capital flows to the region as a result of SARS. Most of the stock markets in the region, which registered declines in the initial stages of the disease, recovered quickly, signalling that investors were not too worried about its long-term effects. In addition, FDI, which is usually based on a long-term investment plan, is unlikely to be permanently affected by adverse short-term developments, particularly when macroeconomic fundamentals are as strong as they have been in the region.

Transparency in managing risks

Timely and accurate dissemination of information can minimize the costs of an epidemic

The importance of disease surveillance and the dissemination of accurate information was highlighted by the gravity of the spread of the disease. Lack of accurate information on the transmission mechanism of the disease was a prime factor in the undue panic and fear caused among the public and

[2] Asian Development Bank, "Assessing the impact and cost of SARS in developing Asia", in *Asian Development Outlook 2003 Update* (Manila, Asian Development Bank, 2003), available at <http://www.adb.org/Documents/Books/ADO/2003/update/sars.pdf>.

the dissemination of accurate information in time could help to minimize such negative effects. Governments and the media, as well as international organizations such as WHO, were constantly engaged in the dissemination of information on SARS and on appropriate precautions that the public could take after its outbreak. However, information on the overall low morbidity and mortality associated with SARS tended to be underreported in the media compared with more sensational stories of individual cases and clusters.

The delayed recognition of the disease in China contributed to its rapid spread

The delayed recognition of the disease in China and the delay in full disclosure of information to the public and to the international community are considered to have contributed to the rapid spread of the virus worldwide. China's initial delay in the disclosure of information could very well be due to its lack of experience in handling unexpected crises of the magnitude of SARS and the present stage of its transition.[3] Considerations of political economy are also likely to have played a role, as the trade-off between transparency and economic growth might have compelled Chinese authorities to be cautious in the full disclosure of information for fear of large economic costs and social disruption. However, from a global welfare point of view, full transparency at the expense of a drop in growth would have been socially optimal. Such an approach would also have strengthened the rights of individuals to basic information.

The public good nature of information makes it vital for Governments wishing to retain credibility and the public's trust to ensure that full and accurate information is made available as soon as possible, so as to minimize panic and mitigate economic and social costs. This is particularly so when alternative channels for the diffusion of information, accurate or otherwise, such as the Internet, are readily available to the public. Governments need to work closely with medical and health professionals, as well as the media, in disseminating accurate information so as to convince the public of their transparency and reduce needless conjecture and apprehension.

Public health issues

SARS highlighted the inadequate preparedness of public health systems to deal with a sudden crisis

The negative externalities relating to infectious diseases make government intervention in the prevention of diseases a rational strategy. The general acceptance of these rules was amply evident during the recent outbreak of SARS with unprecedented public sector involvement in the fight against the deadly disease. However, the outbreak of SARS highlighted the inadequate preparedness of public health systems to cope with outbreaks of epidemiological diseases. There was no effective mechanism, not only at the country level but also at the global level, to face the challenges posed by SARS. This was a reflection of weaknesses in public health policies and poor coordination and cooperation among relevant institutions, both at the national level and within countries. Lack of financing and commitment, shortage

[3] Chi Fulin, "Lessons learned from China's SARS crisis", in World Bank, *Transition Newsletter*, vol. 14, Nos. 4-6, April-May-June 2003, available at <http://www.worldbank.org/transitionnewsletter/aprmayjun03/pgs8-11.htm>.

of trained health personnel and inadequate and insufficient R and D were additional problems.

Public-private partnerships could play a vital role in the health sector

The outbreak of SARS was a reminder of the fact that growth by itself is insufficient and well-functioning public health systems are essential for sustainable development. The lack of a proper diagnostic test and a cure for the disease reflected the inadequate focus on health research even at the global level. As such, reorientation of public health systems to meet the emerging challenges of an increasingly integrated global economy with a focus on institutional development, R and D, financing and capacity-building is vital. Public-private partnerships could be an effective mechanism for the sustainability of public health systems, particularly in the areas of R and D, health insurance and financing.

Health workers have become highly vulnerable to diseases such as SARS owing to the lack of proper diagnostics and infrastructure.[4] The service provision capacity of health-care systems in most developing countries is already strained owing to weak infrastructure and the high cost of medicines and, as a result, the systems are not in a position to cope with unanticipated surges in the demand for health services emanating from diseases such as SARS.[5]

The strong fiscal position in most of the countries affected by the disease facilitated its management without causing serious macroeconomic instability. The outcomes would have been different had the disease spread to developing countries which are financially constrained by large fiscal deficits and are technically incompetent in dealing with diseases such as SARS.[6] To compound the difficulties, many of these countries are dependent on tourism, an important factor in disease transmission, for foreign exchange earnings. This highlights the need for the availability of contingency funds to assist poorer countries in the event of the outbreak of a similar disease.

Disease surveillance

Disease surveillance is key to the prevention of epidemics

Historical experience demonstrates that epidemiological diseases spread rapidly owing to close contact among people. The increased flow of people, goods, services and information across borders in an increasingly integrated global economy implies that adverse developments are quickly transmitted within a country and spread to neighbouring States. This was clearly evident in the case of the SARS epidemic. In such a scenario, surveillance is clearly vital in preventing the spread of diseases. Many

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[4] For example, about 86 per cent of total SARS infections in Singapore were initially contracted in hospitals, while several medical workers in Viet Nam died of SARS.

[5] The health system in China's countryside, where 70 per cent of the total population of 1.3 billion people lives, was ill-prepared to cope with the SARS outbreak. Not all suspected SARS patients could be hospitalized in a timely manner owing to the shortage of beds at designated hospitals.

[6] World Health Organization, "WHO SARS Scientific Research Advisory Committee concludes its first meeting", available at <http://www.who.int/csr/sars/archive/research/en> (2003).

countries affected by SARS appear to have failed in their surveillance of the disease. Countries with effective surveillance mechanisms and information dissemination channels were able to contain the spread of the disease at a relatively low social cost, while those lacking such mechanisms paid a greater price for their failure.

Strong political commitment was behind the success stories

The strategies adopted by Singapore and Viet Nam are good examples of the effective containment of SARS. While efforts to control the spread of the disease were backed by strong political commitment in both countries, each country adopted a strategy suited to its means. In Singapore, surveillance measures involved (a) mandatory notification of suspected cases, (b) enforcement of effective contact tracing, (c) isolation of all suspected cases in the SARS hospital, (d) daily monitoring of fever clusters in all hospitals and nursing homes and (e) temperature screening by thermal imaging scanners at points of entry and in the community. Viet Nam, with limited resources, used basic surveillance tools supported by a good information dissemination system to achieve similar results. The immediate dissemination of information on the recent SARS case that emerged in Singapore several months after the spread of the disease was controlled reflects the country's firm commitment to transparency and prevention and the aftermath illustrates the market response to transparency.

The strict measures adopted by Singapore in its attempt to control the spread of the disease were thought to be the world's harshest and possibly to have violated the fundamental rights of the public. However, in assessing their desirability, the circumstances as well as the overall social cost in the absence of those measures need to be taken into account. Considerations of political economy, as well as the trade-off between human rights and the potential threat of extinction of an entire small city-State in an extreme case scenario, make even draconian preventive measures rational in a crisis situation, in the short run.

Early warning systems and travel advisories

Early warning played an important role in alerting countries to the impending threat

The importance of the existence of an early warning system in alerting countries around the globe to impending epidemics was evident during the SARS outbreak. The global alert issued by WHO in March 2003, for the first time in its history, gave every country in the world time to prepare for a potential epidemic. However, the global alert on SARS was declared five months after the emergence of the virus in China, reflecting inadequacies in the present system. The delay in the identification of the disease where it originated and the lack of a positive response from some countries, which made the global warning less effective, provided room for the disease to spread rapidly within the region. Early identification of diseases and dissemination of information on outbreaks when they are still in their initial stages to global watchdogs such as WHO could help to contain epidemics sooner.

The potential for the rapid spread of the disease through travel made travel advisories an important element of disease prevention. In the case of SARS, travel advisories were mainly initiated and issued by WHO, warning the public to avoid travelling to affected areas. Many countries issued travel advisories in line with the WHO travel warnings.

The negative effects of travel advisories on domestic economies made such warnings offensive to local authorities, leading to disputes in many cases. These could divert authorities in affected countries from giving priority to disease prevention to focusing on dispute settlement. These incidents demonstrate the importance of global cooperation in setting standard rules for such global warnings. Lack of cooperation in adhering to such warnings and the prioritizing of domestic economic considerations at the expense of global health have proved to be costly.

Regional and global cooperation

International travel makes disease prevention a global exercise

The involvement of international travellers in the spread of the disease made its prevention a global exercise. The strategies adopted by some countries in the screening of international travellers, quarantine procedures, restriction on re-entry of migrant workers and travel warnings during the outbreak of SARS led to disputes between countries, making individual country efforts on disease prevention less effective. This highlighted the fact that the fight against diseases such as SARS, which spill over across borders, requires a cooperative effort. Focus on common screening and quarantine procedures for international travellers by all affected countries and cooperation with WHO with regard to the issuance of travel warnings may improve preparedness for effective disease prevention in future disease outbreaks.

Regional and global cooperation can enable countries to maximize resources in the fight against epidemics

The outbreak of SARS illustrates the importance of regional and global cooperation in handling epidemics that have far-reaching implications at the regional and global levels. Regional cooperation enables countries to restrict the spread of the disease through a common strategy based on mutual understanding of the issues involved. It also enables countries to make maximum use of available technology in the treatment of patients and to collaborate in R and D and in financing. Regional cooperation could also facilitate early preparedness for preventing epidemiological diseases that could emerge as a result of, for example, bioterrorism, lapses in laboratory biosafety and environmental pollution. The high cost of treating SARS also gives added impetus to the global debate on the provision of drugs at affordable prices to developing countries. The latter is particularly important with regard to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) and its bearing on public health and the fight against diseases in developing countries.

The existence of a subregional alliance, ASEAN, facilitated cooperation in the regional fight against SARS. The leaders and health ministers of ASEAN and their counterparts from China, Japan and the Republic of Korea (ASEAN+3) were able to map out a common strategy to fight the virus in East and South-East Asia and agree on a set of standard practices for all countries dealing with SARS at several meetings held in 2003. Additional important outcomes of these meetings were a proposal for the establishment of an ASEAN disease control unit that would be responsible for coordinating technical information on emerging diseases; collaboration between the ASEAN Expert Group on Communicable Diseases with experts from China, Japan and the Republic of Korea in developing a plan for regional cooperation in conjunction with relevant centres under WHO or the Centers for Disease Control and Prevention in the United States; and the setting up of a special SARS fund by ASEAN and China to fight the disease. The web site maintained by the ASEAN Secretariat on SARS is an important resource for countries in the subregion.[7]

Meanwhile, the Asia-Pacific Economic Cooperation ministers endorsed the APEC Action Plan on SARS (see box) with the objective of building public confidence through (a) promoting a common set of guiding principles for health-screening of travellers, (b) encouraging cooperation in the prevention and treatment of SARS along with other emerging diseases and (c) exchanging accurate and timely information and best practices, on such measure as credible communications strategies. Although countries in South Asia were not directly affected by SARS, SAARC also took several steps to strengthen preparedness for preventing the spread of the disease.

Salient features of the APEC Action Plan on SARS

Immediate steps

Information-sharing	Hyperlink to the Ministry of Health in each economy, or equivalent agency responsible for SARS, to facilitate instant information exchange and cooperation
	Hyperlink to the APEC Emerging Infections Network to provide information for health officials and researchers on SARS and other emerging infectious diseases
	Link to other relevant international organizations, such as WHO, and to the ASEAN SARS Containment Information Network
Strengthening a credible infectious disease strategy for APEC	Coordination with WHO on how it could best be used to support international and national efforts to combat SARS
Promoting common guiding principles for health-screening of air, land and sea travellers	Pre-departure screening of all passengers from SARS-affected areas to prevent the spread on SARS to other economies. Pre-departure screening is conducted in conformity with WHO guidelines and may involve the completion of a standard health declaration card and a temperature check before boarding the vessel.
	Screening of all arriving passengers from areas with recent transmission of SARS
	Sharing of information in a timely manner on SARS cases that have travelled between member economies to enable contact tracing

[7] Available at <http://www.aseansec.org/your_sars.htm>.

	Promotion of best practices and good ethics among officials to enable others to learn and benefit from such practices
Medium- and long-term steps	
Communications strategy	Developing a communications strategy, including travel advisories and best practices for tour operators and relevant agencies
Trade facilitation	Preparation of a plan of action with a focus on promoting overall transparency in the implementation of measures in response to SARS
	Promotion of mutual recognition of screening procedures to minimize inconvenience for travellers
	Streamlining of border controls to ensure that screening procedures and appropriate health safeguards are implemented in a manner which does not unduly restrict business mobility
Information dissemination	Dissemination of scientifically based, timely and transparent information on SARS both within the business community and among the general public
Regional cooperation	Strengthening of cooperation in developing common standards for monitoring and reporting infectious diseases, as well as other public health issues
	Setting up of networks among medical institutions of member economies to provide prompt information on emerging infectious diseases

Source: <http://www.apecsec.org.sg/apec/ministerial_statements/sectoral_ministerial/trade/2003_trade/action_on_ sars.html>.

Effective implementation of regional action plans is necessary for future disease control

The growing disparities between some of the disease prevention strategies adopted by countries, which often led to disputes, were evident during the initial stages of the outbreak of SARS. The settlement of most of these issues at the meetings of ASEAN+3 and APEC ministers was a testimony to the importance and effectiveness of regional cooperation in handling similar diseases. However, the mere existence of disease prevention mechanisms makes little sense if they are not put into action, as was seen during the SARS outbreak. Effective implementation of the proposed APEC Action Plan would provide a sound basis for future disease control.

Conclusion

Dealing with SARS was a learning experience for many countries. While some were successful in containing the spread of the disease with basic tools supported by aggressive surveillance, others were able to control it with sophisticated instruments. For some countries, fighting SARS was a painful experience as the lack of transparency, inadequate health-care systems and the public's fear and panic prevented them from taking the measures required to control the spread of the disease in its initial stages. However, the experience has provided an opportunity for Governments to reconsider policies and practices in public health and in the dissemination of information. Re-examination of health policies, streamlining practices in disease surveillance and in the dissemination of information to the public, and strengthening regional cooperation, are essential to ensuring preparedness for the effective control of similar outbreaks in future with minimal economic and social damage.

VI THE DEVELOPMENT OF E-FINANCING: IMPLICATIONS FOR SMEs[1]

Introduction

SMEs have traditionally been important to economic development in Asia

Small and medium-sized enterprises have traditionally played an important role in economic development in Asia by creating a large share of new jobs, especially outside urban centres where the incidence of poverty is greatest. Thus, promoting SMEs can contribute to poverty alleviation and help to improve the distribution of income in a country.

Despite their importance to the economies of the region (table 1), most SMEs in Asia are not quite ready to face the ongoing process of rapid globalization or reap its fruits owing to various difficulties, particularly in the area of financing. In this paper, some problems in the financing of SMEs and other related issues are reviewed. Recent trends in financial markets are highlighted and the implications of developments in financial services for SMEs, particularly with regard to ICT, are assessed and policy recommendations made.

Financing and related difficulties of SMEs

The financial difficulties that SMEs face have become more acute in a globalized environment

As rapid globalization and emerging new technologies reduce the importance of economies of scale in many activities, the potential contribution of SMEs has increased. However, many of the problems traditionally facing SMEs, lack of financing, difficulties in exploiting technology, constrained managerial capabilities, low productivity and a heavy regulatory burden, have become more acute in a globalized, technology-driven environment. The main issues regarding SME financing are the following:

- Financial institutions assess SMEs as being inherently high-risk borrowers owing to their low capitalization and limited assets, vulnerability to market fluctuations and high mortality rates.
- While large firms comply to a large extent with high standards of disclosure requirements, most SMEs do not.
- The significant administrative and transactions costs associated with lending or investing small amounts do not make SME financing a profitable business for private commercial banks.

[1] Prepared by Seok-Dong Wang, Economic Affairs Officer, Poverty and Development Division, ESCAP.

Table 1. The importance of SMEs in selected Asian countries

(Percentage)

	Share of SMEs	
	Total output	*Total employment*
Brunei Darussalam	98.0 (1997)	92.0 (1997)
China	99.0 (1993)	78.8 (1993)
Hong Kong, China	98.2 (1995)	60.7 (1995)
Indonesia	98.0 (1996)	88.3 (1996)
Japan	98.8 (1996)	77.6 (1996)
Malaysia	84.0 (1997)	12.3 (1997)
Papua New Guinea	n.a.	52.9 (1997)
Philippines	99.5 (1988)	66.2 (1996)
Republic of Korea	99.0 (1993)	69.0 (1993)
Singapore	91.5 (1995)	51.8 (1995)
Thailand	95.8 (1997)	18.1 (1996)
Viet Nam	n.a.	8.0 (1998)

Source: Asia-Pacific Economic Cooperation, *Guide for SMEs in the APEC Region, 2000* (Singapore, APEC Secretariat, 2000), available at <http://203.127.220.67/apec/publications/all_publications/small_medium_enterprises.html>.

Note: n.a. = not available.

- Financial institutions charge higher interest rates to SMEs than to larger companies in order to compensate for the higher costs of information collection, the smaller volume of external financing and the greater risk of failure.

- External financial institutions usually do not possess better information about the expected profits of established SMEs than the entrepreneurs or managers connected with those enterprises. This lack of information leads to higher market rates to compensate for risk, which may crowd out low-risk, low-return borrowers, leaving a relatively greater number of high-risk, high-return borrowers in the market. Charging higher interest rates may not, however, be in the interests of the banks because low-risk borrowers, who are most likely to repay loans, are driven from the market.

- In the case of new enterprises, experienced bankers or other specialized financial intermediaries can, in many cases, assess the risks involved with the activities proposed better than the relatively inexperienced SME owners. A specific disadvantage of young firms is that they cannot point to credit histories that provide important signals and help to facilitate access to debt financing.

- Lending to SMEs is more likely to be backed by collateral than lending to larger firms so as to reduce moral hazard and adverse selection. This may lead to situations in which the decision to extend loans is based not on expected returns but rather on access to the necessary collateral. Many SMEs lacking access to "good collateral" suffer from credit rationing.

Faced with these constraints, many SME owners rely on their personal savings or those of their family members and friends, as well as on private equity, leasing and factoring, in addition to bank loans to finance their activities.

Access to management and technological know-how is another problem area for SMEs

One of the key constraints on the development of SMEs is access to technological and management know-how. While this reflects limited access to finance to some extent, there are additional dimensions. One of the key drivers encouraging some SMEs to look for international partners is the increase in competitive pressure with globalization. Compared with larger firms, SMEs typically have less ability to influence external relationships with customers, suppliers and factor markets. As a result, their ability to survive and grow depends on their flexibility in responding to the forces of change in the external environment by forging reliable partnerships. In addition to securing their working capital, SMEs need to upgrade management skills, as well as their technological base, and enhance their capacity to gather market information.

Recent developments in the financial service industry

Growth in world trade has boosted international demand for financial services

The forces of rapid globalization and technological change have largely driven recent trends in financial services. With reduced trade barriers and transport and transaction costs, advances in communication technology have accelerated international economic integration. Between 1987 and 1997, world trade in goods increased from 21 to 30 per cent of global GDP.[2] There has been a corresponding increase in the demand for financial services, given their complementarities with trade in goods, as well as an increase in the ability to trade services across borders.

Cross-border capital flows have been the most important financial service delivery mechanism. Commercial banks claims on foreigners, the largest conduit of international capital flows, increased from US$ 7.7 trillion in 1980 to US$ 11.0 trillion in 1999, while private capital flows to emerging markets quadrupled in the same period to reach US$ 200 billion in 1999.[3] However, capital flows are just one way in which financial institutions in one country can provide a loan to, or facilitate a security issue for, an entity in another country. A financial institution can also establish a physical presence in another country by acquiring a financial institution or by opening a branch or subsidiary. The costs of establishing such a presence have declined and cross-border entry has increased.

[2] World Bank, *World Development Report 1998/99: Knowledge for Development* (New York, Oxford University Press, 1999).

[3] World Bank, *Global Development Finance 2000* (Washington, World Bank, 2000).

Deregulation and technology are reshaping the financial service industry worldwide

The dismantling of regulatory barriers separating banking, insurance and securities activities has fostered consolidation within financial services. Boundaries between different financial intermediaries are being blurred and universal or integrated banking is becoming the norm. Technology is also revamping the ways in which financial services are produced and delivered and fundamentally changing the structure of the financial service industry worldwide. New types of service providers, such as online banks, are entering the market within and across countries, allowing consumers to compare financial services.

Non-financial entities such as telecommunication and utility companies are also entering the market, offering payment and other services through their distribution networks and customer relationships. To reap the benefits of the new technology and in response to this new entry, banks and insurance companies are joining in the electronic delivery of financial services. Integrated financial service companies are growing rapidly and creating synergies by combining brand names, distribution networks and financial service production. These developments are changing the competitive landscape for financial services and will continue to erode the franchise value of existing financial service providers that are inefficient or do not adopt competitive business models.

ICT is also reshaping securities trading nationally and internationally

Driven by advances in communication technology, even trading systems are consolidating and going global. Trading is moving towards electronic platforms, not tied to any location. New electronic systems have lowered the transaction costs of trading and allowed for better price determination because electronic execution and matching techniques reduce the chances of market manipulation. Combined with globalization, these forces are putting pressure on incumbent stock exchanges. They have responded with mergers and alliances. Because many exchanges are self-regulating organizations, the pressure for change does not usually come from within the industry; rather, it comes from users or investors who want to pay smaller commissions and effect trades more quickly and anonymously.

With barriers between markets being lowered, there has been large migration of securities-trading and capital-raising activities to international financial centres. The share of capital raised abroad and traded offshore has increased sharply, especially in emerging markets. In 1990-2000, equity capital raised internationally jumped from less than US$ 5 billion a year to nearly US$ 30 billion. This trend has been accompanied by an even sharper increase in offshore trading. Emerging markets such as China, India and the Republic of Korea have seen a particularly rapid rise in offshore financial activities in recent years.

Migration has been accompanied by increased variety in trading systems and electronic communication networks. In the past, most trading in securities occurred on a single official market in each country but today many new systems for trading securities and routeing orders have been introduced. With remote access to global trading systems and widening access to financial services around the world, institutional and individual investors can now execute their trades on the platforms with the best prices and execution.

The spread of e-finance has accompanied the growing integration of financial markets

The rapid growth in electronic financial delivery channels complements the large and growing overseas migration of securities-trading and capital-raising. Through channels such as computers and cellular phones, e-finance is spreading around the globe, including to emerging markets. Although online-only banking has been less successful than was anticipated, with several online-only banks running into difficulties, incumbent banks are starting to offer financial services electronically under increasing pressure. The threat of new entrants has led many banks to offer e-finance, ranging from basic to fully integrated Internet services, which may in turn provoke a migration of customers attracted to this type of service from other banks and across borders.

Internet and wireless communication technologies are more than just new ways of marketing and providing financial services. Using credit-scoring and other data-mining techniques, for example, providers can create and tailor financial products over the Internet without much human input and at very low cost. They can stratify their customer base better through analysis of data also collected on the Internet and allow consumers to build preference profiles online. This not only permits the personalization of information and services but also allows greater personalization in pricing and increases the effectiveness of credit risk identification.

Implications for SMEs of recent developments in financial services

Despite inadequate infrastructure, the popularity of electronic services is strong in developing countries

Around the world, consumers and countries are becoming increasingly connected. This is also becoming important in some of the world's least developed countries and is not limited to advanced emerging markets. The new technologies not only allow the countries to enhance connectivity but also open new channels for delivering e-finance services. In India and Malaysia, as well as in a least developed country such as Cambodia, financial service providers use mobile phones to deliver financial services. However, many developing countries still need substantial regulatory reforms to improve the enabling environment and allow the private sector to deliver effectively various financial services that are in demand.

Despite institutional disadvantages (such as weaker telecommunication infrastructure) and more adverse demand and supply factors, Internet-based services are sometimes as popular in emerging markets as in developed countries and occasionally even more so. This suggests that, around the globe, e-finance is fairly easy to introduce and to assimilate. It may also suggest that in countries with weak financial services, customers have a strong incentive to move to e-finance providers. Banking services may still be limited in these countries but e-finance offers an opportunity to expand access.

As noted, e-finance has been growing quickly in many markets. This growth reflects expansion patterns with network externalities and e-finance could grow even faster under the right conditions. Although the penetration of online banking and brokerage services in most emerging markets is expected to rise steadily, this could accelerate further with a more conducive environment, such as a wide telecommunication network. Poor financial services and weak financial infrastructure could accelerate the move to e-finance in cases where migration offshore has taken place as a response to these inadequacies. This suggests that reforms to increase the competitiveness of telecommunication infrastructure should be given priority if developing countries are to reap the fruits of rapid globalization.

Advances in ICT facilitate the delivery of a broad array of financial services and technology needed by SMEs. E-finance will lower the costs of providing financial services and also allow greater access to those services. Thanks to the new technology, more financial institutions will be able to extend credit to a wider range of consumers, including SMEs. The vast opportunities and low costs of the Internet make e-finance an ideal tool for SMEs seeking information and financing for growth.

The Internet is a powerful tool for building networks between entrepreneurs and investors

As discussed earlier, financing is one of the toughest challenges for the owners of SMEs. In many cases, entrepreneurs invest their own savings or those of their relatives and friends when setting up such an enterprise and then obtain additional capital, either from a venture fund or from commercial banks or institutional investors. Sometimes they seek "business angels", that is, private individuals willing to invest their money and their skills in a business in which they believe. The Internet is a very convenient tool for finding business angels, venture capitalists and even banks. It is also a powerful tool for building networks linking entrepreneurs for information and knowledge. Networks of business angels and venture capitalists can mobilize substantial amounts of informal venture capital by pooling funds that were formerly fragmented and invisible. In doing so, they stimulate latent demand for equity finance and facilitate investment in SMEs by creating communication channels between investors and entrepreneurs.

With a more limited internal resource base compared with larger firms, particularly with respect to management and financial resources, cooperation with other firms or external organizations represents a potentially important strategic response for SMEs. When SMEs wish to enter foreign markets, they can establish formal links with local SMEs in the host country through e-financing institutions or directly through the Internet. By doing so, they can have more of an idea of local market conditions and potential distribution channels, as well as more experience of dealing with other aspects of the local operating environment with relative ease. In addition, SMEs under threat in their own traditional markets from lower-cost producers abroad can react by sourcing from lower-cost foreign producers through joint ventures, franchising and licensing operations. International networking offers SMEs more than just an opportunity to reduce costs through outsourcing; it also allows these firms to develop the type of higher order competitive advantages by focusing on those types of activity where the flexibility that small size offers can be exploited to best advantage.

In this regard, Governments need to encourage improved SME access to e-financing and information and knowledge infrastructure, supported by appropriate use of ICT, in order to help them to be better prepared for rapidly changing international markets. The swift provision of regulatory, legal and financial frameworks conducive to the start-up and growth of SMEs is a priority for Governments when markets are changing fast.

National and cross-border partnerships will aid in the development of the SME sector

Fostering SME networks and clusters as well as public-private and cross-border partnerships is also important in helping the development of this sector. Grouped in local systems of production, SMEs are often more flexible and responsive to customer needs than larger firms. In well-maintained networks and clusters, they can pool resources and share the costs of training, research and marketing more effectively. Networking and clustering help to facilitate the exchange of personnel and the diffusion of technology and create new possibilities for efficiency gains. In an era of rapid globalization, these local networks and support systems are of particular importance in helping SMEs to meet the challenges of a changing world. For SMEs seeking international opportunities, strategic alliances, along with a wide range of joint ventures, are other important issues.

Policy recommendations

With regard to the extent of e-financing, there are significant variations between industrial and emerging markets, and the differences are not clearly related to the level of development (table 2). In some countries, developed as well as developing, the electronic delivery of financial services is still in its infancy. Others, such as India and the Republic of Korea, show rapid penetration of e-finance. This means that Governments can promote e-financing for SMEs as an effective development strategy regardless of the

Table 2. Indicators of e-finance in selected Asian countries, 1999

	Internet users as a percentage of all inhabitants	*Mobile phones per 100 inhabitants*	*Percentage of bank customers using online banking*	*Electronic brokerage transactions as a percentage of all transactions*
China	1	3	n.a.	3
Hong Kong, China	36	64	2	1
India	<1	<1	n.a.	2
Japan	21	45	n.a.	32
Malaysia	7	14	<1	n.a.
Republic of Korea	23	50	n.a.	65
Singapore	24	42	5	10
Thailand	1	4	n.a.	n.a.

Source: Setsuya Sato and John Hawkins, "Electronic finance: an overview of the issues", in Bank for International Settlements, *Electronic Finance: A New Perspective and Challenges* (Basel, BIS, 2001), available at <http://www.bis.org/publ/bispap07.htm#pgtop>.

Note: n.a. = not available.

stage of development. Although Internet technology is not a panacea, it has a demonstrated and powerful potential to contribute to the rapid creation and growth of knowledge and social networks.

A supportive policy environment can foster the adoption of Internet technologies

Internet technologies need to be underpinned by a policy and institutional framework conducive to a dynamic infrastructure and human capacity-building. In this sense, Governments need to adopt market-friendly laws and regulations. Although e-finance does not eliminate borders, it makes them more porous. Creating a supportive environment in the early stages of implementation of e-finance ventures could help in reaping the benefits of the coincidence of globalization with the advent of the new technology. The Internet can have a dramatic impact on the achievement of specific social and economic development goals and play a major role in broader national development strategies, although it can also create inequalities through the persistence of the digital divide.

Since direct government intervention is a contentious issue, it is safe to say that Governments need to focus first on providing the infrastructure and platforms that are needed for e-finance, such as telecommunication services, an environment that safeguards security and privacy, information standards and a legal framework for contract enforcement. Creating and maintaining a trusted local environment is essential to fostering e-finance and attracting private foreign capital and know-how, as well as financial and technical assistance from international sources.

International policy initiatives to promote SMEs and develop e-finance need better coordination

So far, international public initiatives for promoting SMEs have not been as successful as expected, because there has been some overlapping of global, regional and national initiatives. International cooperation efforts have not always been well-coordinated. Given the international dimension of e-finance, efforts to harmonize global standards and practices need to be properly coordinated to facilitate e-finance further.

VII BASEL II: THE PATH TO PROMOTING FINANCIAL STABILITY IN THE ASIAN AND PACIFIC REGION?[1]

A third consultative paper was issued by the Basel Committee in April 2003

Although the Basel Capital Accord of 1988 (the existing Accord, or Basel I) was a milestone in ensuring effective banking supervision, subsequent changes in the banking industry, financial markets, risk management and bank supervision, as well as financial crises such as that in South-East Asia and East Asia in 1997-1998, led the Basel Committee on Banking Supervision to issue a revised consultative paper (CP2) in January 2001 containing a set of proposals for replacing the existing Accord. Work on a new set of international standards for capital adequacy (the new Accord, or Basel II) has been continuing since then to consider the numerous comments received. On 29 April 2003, the third consultative paper (CP3) was released, on which comments were due by 31 July 2003.

Several countries from Asia and the Pacific participated in the quantitative impact study

The Committee also initiated a series of quantitative impact studies in April 2001 to gather the data necessary to gauge the impact of the proposals on capital requirements across a wide range of banks in a number of countries. The third such study (QIS3), focusing on the proposed minimum capital requirements under pillar I of Basel II, was launched in October 2002. The results of the study, in which over 350 banks from 43 countries participated, were released on 5 May 2003, and further supplementary information was made available later in the same month. In the Asian and Pacific region, the following countries participated in QIS3, which may give some indication of the countries that might implement the new Accord:

Subregion	*Country*
South-East Asia:	Indonesia Malaysia Philippines Singapore Thailand
East Asia:	China (including Hong Kong) Republic of Korea
South Asia:	India
Developed countries:	Australia Japan

[1] Prepared by Lene Andersen, former staff member of the Development Research and Policy Analysis Division, ESCAP.

However, in the aftermath of QIS3, China and India have formally rejected Basel II, stating that it does not take adequate account of the particular circumstances of banks in developing countries. Accordingly, China will exclusively implement the new rules regarding supervision and disclosure and India will exclusively implement the new Accord for major international banks, at least initially. In fact, during the latest hearing process, India urged the Basel Committee to define "internationally active banks".

The European Union sees the new Accord as a global standard

Reactions from the EU and the United States have been mixed. The European Commission has drafted a new Capital Adequacy Directive (CAD3), which is quite similar to the proposed new Accord, which European regulators perceive as the new global standard. However, American regulators made it clear at a congressional hearing in May 2003 that they only intended to apply the new rules to fewer than a dozen banks. However, together with the 10 banks that are expected to implement the new Accord voluntarily, the market share of implementing banks will be considerable. The thousands of other American banks would continue to use the existing Accord and not even the standardized method under Basel II, which is only slightly different.

The new Accord is to be implemented by 2006. The Basel Committee has realized that although regulators may wish to introduce the new Accord, some of the countries that have implemented Basel I have done so fairly recently and may need more time to implement the new framework. This is underscored by the fact that banks in the Asian and Pacific region have not yet entirely overcome the problem of non-performing loans or completed the restructuring needed in the aftermath of the financial crisis.

Background

The primary objective of the new Accord is to make it more risk-sensitive and thus strengthen banking systems even in periods of financial crisis. Consequently, the new proposal moves ahead of the "one-size-fits-all" approach and adopts a methodology for gauging capital adequacy ratios based on credit risk, while also incorporating charges for operational risk.[2] Proposals for a stringent supervisory review process and recommendations for increased levels of market discipline are also included. The three pillars of the new Accord are illustrated in the figure below:

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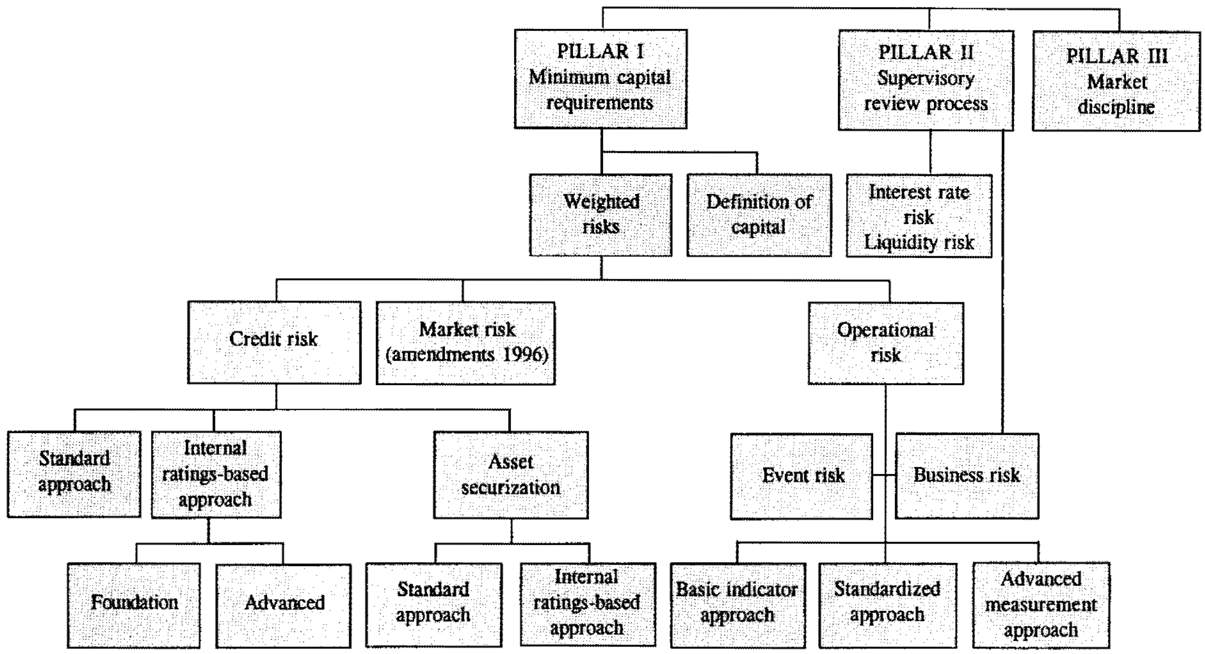
[2] See, for example, Vimala Aldis and Fareeda Maroof Hla, "Implementation of the New Basel Capital Accord in the Asia-Pacific region: potential challenges and rewards", *Bulletin on Asia-Pacific Perspectives 2001/02* (United Nations publication, Sales No. E.02.II.F.2).

Outline of the New Basel Capital Accord



Concerns raised by CP2 have not been fully addressed in CP3

Whereas it is generally sound to link capital requirements to actual risks, two concerns have been raised in respect to the implementation of the new Accord. First, more cyclical lending could be a direct consequence of a more precise risk assessment and second, capital flows and international bank lending to developing countries might be constrained by the new Accord, particularly as project finance, which is often the type of lending used to finance development projects, will be subject to high capital requirements in the new Accord. However, as the distinction between borrowers that are members of OECD and other countries has been eliminated in the new Accord and credit risk is to be evaluated directly, this may lead to increased lending at lower cost to higher-rated sovereigns. Lending costs to developing and emerging market countries are nevertheless expected to rise under Basel II as regulatory capital for borrowers rated below B- will increase significantly. It is worth noting, however, that new techniques such as credit derivatives might be more widespread in the future, thus allowing banks to go into risky loans and sell off part of the risk.

Counteracting a new financial crisis ...

One of the major credit risks for banks is concentration of exposures and the new Accord emphasizes portfolio diversification. Further, more attention is paid to maturity and fluctuations in real estate prices, mainly in response to the 1997-1998 financial crisis. As mentioned in the *Bulletin on Asia-Pacific Perspectives 2001/02*, a bias in favour of short-term loans is part of the existing Accord[3] and the consequences of this were illustrated

[3] Ibid., pp. 78-79.

during the financial crisis. In the new Accord, rules are added in an effort to counteract these risks. For example, under the standardized approach to measuring credit risk, supervisors are responsible for assigning credit assessments by eligible external credit assessment institutions to the risk weights available under this approach, and credit risk mitigation (collateral, guarantees and credit derivatives) is only fully recognized for capital purposes in cases where there is no maturity mismatch. Maturity is one of the characteristics that banks have to monitor in order to avoid excessive risk concentration. Under pillar II of the new Accord, it is explicitly mentioned that risk concentration is arguably the single most important cause of major problems in banks and it is thus a requirement that banks should have in place effective internal policies, systems and controls to identify, monitor and control it.[4]

The use of commercial property as collateral for risk mitigation is strictly regulated

In East and South-East Asia, the demand for commercial and residential space made real estate a robust growth sector in the boom years of the early to mid-1990s. However, the highly leveraged lending connected to that rapid growth led to a property price bust that contributed to the collapse of Thailand's economy in 1997, setting off the financial crisis in the region. The sharp decline in the value of real estate given as collateral against loans played a significant role in the subsequent weakening of banking systems. In the new Accord, it is proposed to counteract these risks in the following ways. First, although the Basel Committee holds the view that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades and that mortgages on commercial real estate justify a 100 per cent weighting of the loans secured, in the light of comments received on CP2 this rule may be relaxed under strictly defined conditions.[5] Supervision of credit risk concentrations under pillar II of the new Accord and of correlations between the credit quality of the counterparty and the value of the collateral is also to be enhanced.

The Basel Committee has chosen to provide incentives for lending to SMEs rather than relax risk management

A number of countries in Asia and the Pacific, including India, Malaysia, Thailand and the Republic of Korea, have reacted to CP2 and CP3: extracts from their comments are given in table 1. Real estate lending still constitutes a substantial portion of bank lending portfolios in the region and, further, many SMEs are dependent on using real estate as collateral to obtain funding. The Basel Committee has chosen to give incentives to lend to the retail

[4] In the view of some commentators, this issue should also be dealt with in pillar I. See, for example, IMF, "IMF staff comments on the April 2003 Consultative Paper (CP3) on the New Basel Capital Accord (Basel II)", available at <www.bis.org/bcbs/cp3comments.htm>. Furthermore, in the view of IMF, concentration of foreign currency exposures, especially in dollarized countries, has not been addressed in CP3.

[5] For well-developed and long-established markets, mortgages on commercial property can receive a 50 per cent risk weight for the tranche of the loan not exceeding the lower of 50 per cent of market value or 60 per cent of the mortgage lending value. See Basel Committee on Banking Supervision, Bank for International Settlements, *The New Basel Capital Accord,* "Part 2, The First Pillar – Minimum Capital Requirements", p. 12, available at <www.bis.org/bcbs/cp3part2.pdf>.

and SME segment rather than loosen up on portfolio risk management, which is perceived as a necessary precondition for the stability of the banking sector. In the new Accord, SMEs are to be treated as either retail or minor corporates. That means lower capital requirements under the internal ratings-based (IRB) approaches as well as under the standardized approach, where they attract a risk weighting of only 75 per cent. From a development perspective, this incentive for banks to lend to SMEs is commendable but the definition of SMEs as firms with annual sales below 50 million euros is more suited to developed economies and may work to reduce the risk sensitivity of Basel II.[6]

The improvements achieved as regards SME financing are, however, imperilled by the introduction of the so-called "granularity criterion". This criterion relates the exposure to each individual SME to the total size of the retail portfolio, setting a maximum of 0.2 per cent, thereby limiting the ability of smaller banks to obtain preferential treatment in respect of their SME lending, as their retail portfolios are simply not large enough. In the latest CAD3 from the European Commission in July 2003, the granularity criterion is omitted and Asian supervisors could choose the same approach.

Table 1. Extracts from comments made by countries in Asia and the Pacific on the second and third consultative papers on the New Basel Capital Accord

	Comments on CP2	*CP3*		*Comments on CP3*
A. Implementation date				
India Indonesia	Time constraint with respect to readiness of the FSAs[a]	Implementation by 2006	China India	Formally rejecting the new Accord. China will remain on Basel I for "at least a few years" after 2006
Republic of Korea	Implementation should be postponed from 2005 to 2006			
B. Pillar I: minimum capital requirements				
(a) Credit risk				
China India	A simplified standardized approach, based on internal rating systems, for domestically oriented, relatively smaller banks should be included	Annex 9 to CP3: The simplified standardized approach. The approach should not be seen as another approach for determining regulatory capital; rather it collects in one place the simplest options for calculating risk-weighted assets (i.e. based on external risk assessments)	India	Restating the need for a simplified approach based on internal rating systems which might serve as an initial step towards complying with the IRB[b] approaches

[6] See, for example, Asian Bankers' Association, "Comments on the third consultative paper on the New Basel Capital Accord", p. 4; and China Banking Regulatory Commission, "Comments on the third consultative paper on the New Basel Capital Accord", p. 3, available at <www.bis.org/bcbs/cp3comments.htm>.

Table 1 *(continued)*

Comments on CP2		*CP3*	*Comments on CP3*	
India Japan Thailand	The 150 per cent risk weight for past-due loans (net of specific provisions and any eligible collateral or guarantees) leads to a pre-emption of scarce capital not reflected in the historical loan loss experience	The treatment of past-due loans under the standardized approach is amended; for example, a risk weight of 100 per cent applies when specific provisions are not less than 20 per cent of the outstanding amount of the loan	Malaysia	The preferential risk weight should be based on the size of provisions against the unsecured loan amount instead of against the entire outstanding amount of the loan
Indonesia Republic of Korea	Standardized approach biases incentive for borrowers to remain unrated Unrated claims carry a risk weight (100 per cent) lower than claims with a B- rating (150 per cent)	No change from CP2 to CP3; however, the "mapping process" will be at the discretion of the national supervisors	Malaysia	Biases incentive for institutions to encourage clients (borrowers) to remain unrated
India Malaysia	Higher funding costs for Governments due to risk weights based on sovereign ratings Today, foreign currency funds from locally incorporated foreign banks offer better rates than in the global market	As above	China India	More flexibility at national discretion to reflect conditions in non-G10 markets better
India Malaysia Republic of Korea Singapore Thailand	A lower than 40 per cent LGD[c] floor on real estate collateral under the IRB approach should be applied Non-financial collateral under the standardized approach should be recognized	35 per cent LGD floor on real estate collateral under the IRB approach in CP3; however, CP3 introduces an LGD floor of 10 per cent on retail mortgages. Under the standardized approach, no change in the rules on real estate collateral, except under strict conditions, but the risk weight on residential mortgages is reduced from 40 per cent in CP2 to 35 per cent in CP3	Thailand	50 per cent risk weight applied to claims secured by commercial real estate under the standardized approach to be reduced (to match the 35 per cent LGD under the IRB approach)
Singapore	Riskier assets might gravitate to institutions using the standardized approach (higher risk weights under IRB)	Portfolio diversification might counteract this problem		

Table 1 *(continued)*

	Comments on CP2	*CP3*		*Comments on CP3*
B. Pillar I: minimum capital requirements				
(b) Operational risk				
Indonesia	Various regulations with respect to operational, legal and reputational risks should be taken into account	Under pillar II, the supervisor should consider whether the capital requirement generated by the pillar I calculation gives a consistent picture of the individual bank's operational risk exposure		
Malaysia	Financial indicators, business line weights and structure should be calibrated against regional norms			
India Republic of Korea	New capital charge on operational risk is a burden	Changes with respect to the advanced measurement approaches: • Partial adoption • 20 per cent ceiling on insurance mitigation	Malaysia Thailand	Insurance mitigation should be allowed under the standardized approach as well
			India Malaysia Thailand	The alternative standardized approach is welcomed but adds to the capital charge and should be applied with more flexibility
C. Pillar II: supervisory review process				
China Thailand	More guidance needed with respect to pillar II		Japan	Comments as for CP2 Recommends less conservative approach (for both pillars I and pillar II)
			Thailand	Comments as for CP2 Recommends further emphasis on supervisory transparency and accountability
D. Pillar III: market discipline				
Indonesia Japan Thailand	Too much information Full disclosure in imperfect markets may create market distortions		Japan Thailand	Comments as for CP2 Recommends that disclosure requirements be set at national discretion

Sources: <http://www.bis.org/bcbs/cacomments.htm> and <http://www.bis.org/bcbs/cp3comments.htm>.

[a] Financial supervisory authority.
[b] Internal ratings-based.
[c] Loss given default.

Quantitative impact study

In QIS3, the options for estimating credit risks were as set out in table 2. The parameters in the capital formula, which could either be estimated internally or given by the financial supervisory authority (FSA), are the probability of default (PD); loss given default (LGD); exposure at default (EAD); and maturity (M).

Table 2. Parameters for estimating credit risk under alternative approaches

Approach	*PD*	*LGD*	*EAD*	*M*	*Capital*
Standardized	FSA	FSA	FSA	FSA	FSA
IRB foundation	internal	FSA	FSA	FSA	FSA
IRB advanced	internal	internal	internal	internal	FSA

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *The New Basel Capital Accord*, "Part 2, The First Pillar – Minimum Capital Requirements", p. 12, available at <www.bis.org/bcbs/cp3part2.pdf>.

The number of banks that participated in QIS3 by region and approach used is given in table 3. Except for Japan, which is a member of the Basel Committee, all participating Asian and Pacific countries are included in the "others" category.

Table 3. Number of banks participating in QIS3 completing each approach, by region

Approach	*Basel Committee members*[a]	*EU*	*Others*	*Total*
Standardized	185	166	140	365
IRB foundation	109	89	28	159
IRB advanced	57	32	11	74

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *Supplementary information on QIS3*, 27 May 2003, p. 2, available at <www.bis.org/bcbs/qis/qis3sup.pdf>.

[a] Nine EU members are also members of the Basel Committee.

Results from QIS3 suggest an increase in capital requirements primarily due to operational risk

Results for individual countries were not published owing to the confidentiality of the data. However, at the portfolio level, some conclusions on the impact of CP3 on capital requirements can be drawn. Each portfolio's contribution to the overall change in capital requirements is calculated as the percentage change in the capital required for that portfolio, comparing Basel II with Basel I, weighted by its significance as measured by the proportion of capital under the existing Accord accounted for by that portfolio. This gives a measure of the impact of the change in the capital requirements for any area of activity on the overall change in the capital requirements for the bank. The results for the average change in capital requirements for all banks are set out in table 4. It should be noted that there was considerable variation in individual bank results. For example, in the "others" group, which includes countries from Asia and the Pacific, the maximum increase in required capital for an individual bank was 103 per cent and the minimum change −17 per cent.[7]

Table 4. Contributions to the change in average capital requirements, standardized approach core portfolios

(Percentage)

Portfolio	*Basel Committee members*		*Others*
	Group 1	*Group 2*	*Groups 1 and 2*
Corporate	1	−1	0
Sovereign	0	0	1
Bank	2	0	2
Retail	−5	−10	−4
SMEs	−1	−2	−1
Securitized assets	1	0	0
Other portfolios	2	1	3
Overall credit risk	0	−11	2
Overall operational risk	10	15	11
Overall change	11	3	12

Source: Basel Committee on Banking Supervision, Bank for International Settlements, *Quantitative Impact Study 3 - Overview of Global Results*, 5 May 2003, p. 5, available at <www.bis.org/bcbs/qis/qis3results.pdf>.

Note: Group 1 banks are large, diversified and internationally active, with Tier 1 capital in excess of 3 billion euros. Group 2 banks are smaller and more specialized.

[7] Basel Committee on Banking Supervision, Bank for International Settlements, *Quantitative Impact Study 3 - Overview of Global Results*, 5 May 2003, p. 3, available at <www.bis.org/bcbs/qis/qis3results.pdf>.

The results indicate that, in general, the new Accord will increase the level of capital that is required for the banking institutions in the region, mainly owing to the new operational risk charge. The operational risk requirement has a proportionately higher effect on specialized institutions, including, for example, a few banks with large amounts of securitization or activities such as fund management, which are not covered in the existing Accord. The new operational risk charge adds a challenge to banks in estimating unexpected losses. However, on the positive side, it adds more transparency and hence, risk control, which is highly commendable. Further, more capital might increase the banks' external ratings, owing to the increased buffer against risks that are not new but have simply not been explicitly taken into account under the existing Accord.

Under credit risk, the figures are consistent with the intent of the new Accord to provide incentives to lend to SMEs. In general, the risk weights for the retail portfolio have been lowered significantly for all sub-portfolios (excluding past-due assets) relative to the existing Accord.

Major challenges ahead

Measuring risks will become more explicit in the new Accord

As discussed in the *Bulletin on Asia-Pacific Perspectives 2001/02*,[8] measuring credit, market, operational, interest rate, liquidity and other risks in compliance with the new Accord will not be an easy task for either bank managers or supervisory authorities, particularly in the Asian and Pacific region, where there is a lack of ratings agencies and the majority of individual claims remain unrated. Further, banks and supervisors will be required to invest considerable resources in upgrading technology, including adequate data access, technical capacity and human resources to meet the minimum standards in the new Accord.[9] In particular, data requirements under the IRB approaches are extensive; for example, three years' usage of classification models and five to seven years of default data are required. Among others, the China Banking Regulatory Commission has urged the Basel Committee, or other relevant international groupings, to take the lead in disseminating the technical know-how for designing a well-developed internal ratings system for banks in emerging markets and less developed economies.[10]

The greater flexibility of CP3 may lead to competitive distortions between jurisdictions

Whereas the current Accord focuses narrowly on setting minimum capital requirements, the new Accord includes a pillar II on the supervisory review process, which adds further room for manoeuvre at the discretion of the national supervisor. For Asia and elsewhere, this provides an option to develop supervisory institutions further. Whereas the greater flexibility introduced in CP3 has been welcomed by some commentators, others feel that

[8] Op. cit., pp. 79 and 83.

[9] See, for example, Reserve Bank of India, "Comments on the third consultative document of the New Basel Capital Accord", p. 1, and IMF, op. cit., p. 5.

[10] China Banking Regulatory Commission, op. cit., p. 2.

it has not gone far enough in permitting national discretion[11] and yet others hold the view that it will introduce competitive distortions among jurisdictions and should be subject to agreed criteria.[12] In this regard, regional cooperation would be an advantage, in order to ensure a level playing field and minimize distortions for banks operating in several markets. In Asia, most internationally oriented banks are located in Japan, Singapore and Hong Kong, China, whereas the banking systems in South Asia, for example, are more domestically oriented.

The new role of national supervisory authorities under pillar II will require considerable capacity-building

Pillar II leaves a considerable amount of room for manoeuvre at the discretion of national supervisors. Supervisors are entitled to increase required capital, in cases where it is found to be inadequate to cover the risks of the bank. Such an increase would have to be documented by the supervisors. The intention is to increase the authority of the supervisors as compared with Basel I and supervisors will be expected to evaluate the board and management of banks, to look into strategic decisions and to evaluate portfolio diversification as well as the ability to react to future risks and a rapidly changing environment, among other things. Further, default, stress tests and so on are not defined in a clear-cut manner in the new Accord, allowing for interpretation by supervisors. In particular, issues of transparency, corporate governance and efficient markets might pose additional challenges in pillar II enforcement in the region, as also reflected in the comments on the new Accord. The supervision of banks is not an exact science and therefore discretionary elements within the supervisory review process are inevitable. Supervisors must make sure to carry out their obligations in a highly transparent and accountable manner, which is part of the pillar II requirements.

In the aftermath of 11 September 2001, attention to money laundering and terrorist financing has increased. This poses an additional challenge to supervisors of banks. According to pillar II requirements, national supervisors have to monitor banks' management of the reputational, operational, legal and concentration risks, including the risks that can arise from a failure to conduct adequate due diligence. These challenges further underline the need for regional supervisory mechanisms.

Avoiding adverse incentives following the implementation of pillar III requirements

As pointed out by Indonesia during the hearing process, the pillar III disclosure requirements might create market distortions as a result of lack of public confidence in the financial system in markets that are imperfect, as is often the case in developing countries. Likewise, there might be an effect on private capital flows to developing countries owing to the transparency implied in the extensive use of ratings. It is hoped that the improved risk assessment, strengthened supervision and greater disclosure will improve confidence and stabilize capital flows to developing countries over time.

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[11] See, for example, Bank of Thailand, "Comments on the New Basel Capital Accord consultative document issued in April 2003 for comment by 31 July 2003", available at <www.bis.org/bcbs/cp3comments.htm>.

[12] Asian Bankers' Association, op. cit., p. 5; IMF, op. cit., p. 1; and World Bank, "World Bank staff comments on the Basel Committee's Consultative Paper 3 (CP3)", available at <www.bis.org/bcbs/cp3comments.htm>.

Conclusion

Regional cooperation among supervisory authorities is called for

Implementing the new Accord is not an easy task for either supervisory authorities or bank managers. The requirements of pillars II and III call for regional cooperation among supervisory authorities, in order to ensure a level playing field and minimize distortions for banks operating in several markets. For international banks, a "lead regulator" approach has been suggested, that is the "home regulator" coordinates and leads the supervisory process based on inputs from other supervisors. Harmonizing the capital adequacy legislative framework within, for example, ASEAN might also facilitate and strengthen the supervisory process.

In general, banks' required capital will decrease with respect to credit risks and increase with respect to operational risks. However, in Asia, several factors may raise the required capital even for credit risks, as real estate continues to be widely used as collateral for business loans, and the standardized approach, which is the most likely approach for many banks, places a 150 per cent risk weight on non-performing loans. By contrast, the 75 per cent risk weight on retail lending and lending to SMEs, as well as the 35 per cent risk weight on home mortgage loans, might lead to some reduction in capital requirements. However, it is important to stress that higher capital requirements might be desirable, to promote the safety and soundness of individual banks and the overall financial system. The increased capital requirements will safeguard the interests of depositors and reduce the probability of calling on public resources in the event of a crisis. Further, higher capital requirements can improve the external ratings of individual banks if the additional capital buffer is perceived as strengthening a bank's ability to manage risks.

The applicability of CP3 to developing countries and emerging markets has been questioned

China and India have formally rejected the implementation of the new Accord in 2006, but may implement the new rules at a later stage. China fully supports pillars II and III and stresses that banks should improve their risk management beyond the narrow compliance with a minimum capital requirement. However, the China Banking Regulatory Commission believes that Basel II would be only marginally more risk-sensitive than Basel I but would increase overall capital requirements for the entire banking system, while adversely affecting capital flows to less developed economies and disadvantaging banks in emerging markets.[13] India is also concerned about the complexity of Basel II and the difficulties and costs of implementation that would be faced by banks and supervisors in emerging markets.[14] The new Accord is intended to provide a global standard, and hence, criticism is bound to arise, not least owing to the differences in national banking traditions. In the Asian and Pacific region, a regional interpretation of the new Accord would be an advantage, to make proper use of the room for manoeuvre left within the new capital adequacy framework.

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[13] China Banking Regulatory Commission, op. cit., covering letter dated 31 July 2003.

[14] Reserve Bank of India, op. cit., pp. 13-14.

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