

BULLETIN ON ASIA – PACIFIC PERSPECTIVES

2001/02

**ASIA-PACIFIC ECONOMIES; COPING WITH NEW
UNCERTAINTIES**



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ESCAP WORKS TOWARDS REDUCING POVERTY AND MANAGING GLOBALIZATION

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

BULLETIN ON
ASIA – PACIFIC
PERSPECTIVES
2001/02

**ASIA-PACIFIC ECONOMIES: COPING WITH NEW
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FOREWORD

This is the inaugural issue of the *Bulletin on Asia-Pacific Perspectives*. Its objectives are twofold. One is to provide 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 publication *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 as well as other international organizations.

The mid-term review comes at an opportune time. The economic mood at this time last year was certainly upbeat – with growth rates being revised upwards in many economies and regions, including Asia. However, it has become much more sombre since the first quarter of 2001 – along with a sharp deterioration in the economic performance of the United States of America, for several years the pillar of the global economy. In addition, there has been a slowdown in the economies of the European Union zone, while the modest economic recovery in Japan has become feeble of late. Moreover, a heightened sense of uncertainty now prevails in many parts of the world, in the aftermath as well as in consequence of recent events in the United States.

The second objective of the *Bulletin* is to shed some light on the pressing issues and feasible options in the management of constant change – a process that government, the private sector, civil society organizations and communities at large are still grappling with. The dynamics of global and regional interdependence is transforming the world and regional economies in ways that are not yet fully understood, or predictable. For developing countries – particularly smaller developing countries, least developed countries and Pacific island countries – rapid globalization, while providing new opportunities, also poses formidable challenges.

All of these factors highlight the need for countries to strengthen their economic fundamentals and adopt poverty reduction policies. These are critical parameters in the promotion of sustained economic growth and social development. The shorter articles in the *Bulletin* provide some perspectives on some of the challenges of change and their management in an increasingly integrated world.

This inaugural issue of the *Bulletin* is a concrete manifestation of the concerted efforts that are being made to enhance the role and relevance of the secretariat in the ESCAP region. In this context, 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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Experts from outside the ESCAP secretariat have contributed to the *Bulletin* in signed articles and in comments and suggestions at various stages of preparation. Chapter I, as the anchor article on international developments and regional implications, and chapter VI, on the “new” poor, were discussed at a Meeting of Eminent Persons on Current and Prospective Economic Performance in the ESCAP Region held at ESCAP, Bangkok, on 18 and 19 October 2001. The Eminent Persons, who attended the Meeting in their personal capacities, and other participants were: Peter G. Warr (Australia), Rehman Sobhan (Bangladesh), Lu Aiguo (China), Suman K. Bery (India), Djisman Simanjuntak (Indonesia), Shinichi Ichimura (Japan), Jomo K. Sundaram (Malaysia), Tilak Bahadur Rawal (Nepal), Bernardo M. Villegas (Philippines), Suk Bum Yoon (Republic of Korea), Victor Y. Rosin (Russian Federation), Linda Low (Singapore), Amarakoon Bandara (Sri Lanka), Thirachai Phuvanat-Naranubala (Thailand) and Pisit Leeahtam (Thailand). J.K. Robert England (UNDP, Bangkok), Ejaz Ghani (World Bank, Bangkok), Lorenzo Giorgianni (IMF, Bangkok) and C. Houser (ADB, Manila) also participated in the Meeting.

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I. GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: PATTERNS, IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION¹

Perspective

The slowdown in 2001 is the most geographically synchronized since the Second World War

Although evidence of a sharp slowdown in the economy of the United States of America and an interruption in the recovery of the Japanese economy had emerged in late 2000, the consensus was that only a modest deceleration in the rate of growth of the global economy was to be expected from these developments in 2001. Moreover, ESCAP member countries would remain largely unaffected by any deceleration given the resilience of the regional economy. In the event, the slowdown in the United States has turned out to be much sharper than predicted and its adverse impact on the ESCAP region has been very severe. Furthermore, recovery has petered out in Japan and the slowdown is now becoming apparent even in the European Union (EU) so that this could be the most geographically synchronized since before the Second World War. The terrorist attacks of 11 September 2001 are likely to intensify the global downturn in the short term through a major loss of business and consumer confidence in the United States and elsewhere. The extent of the global slowdown and its impact on the developing countries are likely to remain uncertain for some time. Nonetheless, several issues of critical importance arise for the ESCAP region.

In the ESCAP region, the slowdown could delay progress in the reform process

One, the 2001 slowdown comes at a time when the reform process set in train after the 1997 crisis in many countries in areas such as the financial and corporate sectors, issues of governance, poverty alleviation and social safety nets had made only limited progress. There are strong concerns that further progress could be much delayed in the months ahead. Indeed, there is some evidence that recovery in 1999 and 2000 had already dampened somewhat the enthusiasm for reform; a slowdown could reduce it further. It is essential therefore that Governments in the region remain committed to addressing the post-1997 reform challenges since they otherwise risk facing even more intractable problems in the future.

Two, the 2001 slowdown provides an opportunity to review and modify the reform agenda and policies adopted for its implementation after the 1997 crisis in a number of economies, to concentrate on the most urgent tasks such as financial sector reform, to protect those most vulnerable to the impending downturn, to ensure social cohesion and, above all, to maintain commitment and progress towards the goals of the Millennium Declaration with regard to poverty alleviation.

Achievement of the Millennium Declaration's goals on poverty reduction could be adversely affected

Three, slow or negative growth would inevitably have an adverse impact on social conditions in many countries, either through rising unemployment or lower public sector expenditures in health, education and social protection. This would pose a major setback to the critically important goal of poverty reduction in the region. Up to the 1997 crisis, most ESCAP economies had made impressive progress in reducing poverty. This was partially reversed in 1998 but rapid recovery in 1999 and 2000 enabled most countries to address the issues of social

¹ Prepared by Shahid Ahmed, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

protection and social safety nets in some measure. A slowdown in the region could seriously interrupt progress in this area. In fact, the fear is that a deep slowdown could damage progress to such an extent that the goal of the United Nations Millennium Declaration to halve, by the year 2015, the proportion of the world's people whose income is less than one dollar a day may become unattainable in some countries.

The slowdown calls into question the long-term rationale of the export-led strategy of growth

Four, from a domestic perspective, it is clear that economies which have grown successfully over two decades via an export-led strategy will have to develop alternative means to sustain growth in the near term. Alternative policy options are essentially countercyclical fiscal and monetary stimuli but there are limits to which either or, indeed, both can be utilized without putting at risk the strong macroeconomic fundamentals that the majority of ESCAP economies have built up over the years. The public sector has already taken on major fiscal responsibilities in the area of financial sector reform and higher expenditures for social protection; adding to these financial commitments, while unavoidable in the short term, could damage macroeconomic fundamentals and adversely affect longer-term growth in the region. Loose monetary policies might do the same.

Five, more generally, the role of the public sector in the new, more uncertain, global economic environment in protecting output and employment in developing economies deserves to be re-examined. Without the provision of significant public sector support, both financial and institutional recovery after the 1997 crisis would have been well-nigh impossible. A similar effort will be needed from the public sector now.

The costs and benefits of globalization have been brought into sharp focus

Six, from an international perspective, the downturn brings into sharp focus the debate on the costs and benefits of globalization. There can be little doubt that both the 1997 crisis and the 2001 slowdown have been significantly intensified by the trade and financial market linkages between countries that globalization has facilitated since the mid-1990s. The adverse effects of financial market integration and of trading links have been found to be so severe that few countries have the ability to shield themselves from the ravages of financial market contagion or from downturns in main export markets. These have generated major output and welfare losses for several economies in the region. While ESCAP economies, by and large, are less susceptible to the conditions that led to the 1997 crisis, significant problems may still be unavoidable.

Seven, after the terrorist attacks in the United States all countries are likely to be faced with higher security costs virtually across the board as well as significant, ongoing costs for insurance and air travel. World stock markets have tended to weaken involving large wealth reductions for holders of shares and generating major losses of business and consumer confidence. These effects will be deleterious both for immediate recovery after the slowdown and for long-term growth.

There is a strong need for a coordinated international response to the slowdown

Eight, at the international level, a question to be faced is whether these additional costs, such as higher insurance premiums, should be borne nationally or whether there could be an international facility established to deal with these problems, or an existing one extended, such as the Compensatory and Contingency Financing Facility at the International Monetary Fund (IMF), if only on a temporary basis. In any event, there is a strong need for a coordinated response by the developed and developing countries, and involving multilateral agencies like IMF and the World Bank, to deal with the current slowdown. Official development assistance (ODA) donors should ensure that while humanitarian assistance rightly takes

precedence in the current circumstances this should not be at the expense of ODA for longer-term development purposes.

Greater regional cooperation offers an effective addition to international coordination

Nine, greater regional cooperation offers a viable and effective adjunct to more coordinated effort at the international level, first between the developed countries themselves and second between the developed and developing countries to boost trade and financial cooperation, including in the crucial area of money laundering.

Ten, a balanced trade agenda, reflective of the needs of all developing countries but pushing forward the process of liberalization in both goods and services, would give a strong and positive signal to the world community of international cooperation involving developed and developing countries. In this regard, developed countries should accelerate the implementation of commitments already made to improve market access for developing countries.

The global setting

Gross domestic product (GDP) estimates for 2001 and forecasts for 2002 and other pertinent information are summarized in table 1. At this stage, these numbers do not take account of the economic impact of the terrorist outrages. The world's principal central banking authorities have reduced interest rates in unison and have provided substantial additional liquidity to their respective financial markets to counter the downturn. Other stimulative measures are in the offing in various countries, but major uncertainties remain, i.e. whether the world economy is facing a short-term cyclical and shock-related downturn or is facing longer-term structural problems.

The terrorist attacks will reduce global growth and increase the number of people in poverty

IMF, for its part, has so far not reduced its forecast for global economic growth of 2.5 per cent for 2001 with a rebound to 3.2 per cent in 2002. The World Bank, however, has stated that the ripples from the 11 September events will be felt across the world, particularly in countries dependent on tourism, foreign remittances and foreign capital. Some 10 million more people could be condemned to live in poverty in 2002 as a result.² Whatever the precise extent of the slowdown, ESCAP developing countries are faced with a major challenge to preserve the post-1997 momentum of growth in the medium term. The many factors impinging on the pattern of events in 2002 and their implications for the ESCAP region are discussed in the following sections.

The global slowdown began in the United States

After a relatively gentle recovery in 1999 world economic growth accelerated sharply in the first half of 2000. This was primarily on account of continuing above-trend growth in the United States, which reached an annualized rate of 5 per cent by the second quarter of 2000. Thereafter, United States growth slowed abruptly to an annual rate of 1.5 per cent in the second half of the year and further to 1.2 per cent by the second quarter of 2001. The United States slowdown in 2000 spread with remarkable speed to other countries and regions, not only via trading links but also through dramatically weakening stock markets and their adverse knock-on effects on new capital issues and business confidence. This was particularly evident in the Asian economies with large information and communications technology (ICT) sectors and reliant on exports of such equipment to the United States.

² The World Bank has estimated that the terrorist attacks could shave 0.50 to 0.75 percentage points from the GDP growth of developing countries in 2002. World Bank, *Press Release*, 1 October 2001.

Table 1. Selected indicators of global economic conditions, 1998-2002

	1998	1999	2000 ^a	2001 ^a	2002 ^b
Economic growth (percentage change of GDP)					
World	2.2	2.9	4.0	2.4	3.1
Developed economies	2.1	2.7	3.5	1.3	2.1
Japan	-1.1	0.8	1.5	-0.4	0.5
United States of America	4.4	4.2	5.0	1.6	2.6
European Union	2.6	2.4	3.3	1.8	2.2
Developing economies	1.6	3.5	5.7	4.3	5.3
Developing economies in the ESCAP region	0.1	6.2	7.0	3.7	5.3
Growth in volume of trade (percentage)^c					
World	4.1	5.3	12.4	4.0	5.7
Developed economies					
Exports	3.9	5.0	11.5	3.0	5.2
Imports	5.8	7.7	11.5	3.6	5.3
Developing economies					
Exports	5.1	4.6	15.1	5.0	6.6
Imports	-1.6	2.1	16.6	6.4	8.0
Inflation rate (percentage)^d					
Developed economies	1.5	1.4	2.3	2.4	1.7
Developing economies	10.5	6.8	6.0	5.9	5.1
Exchange rates (nominal units per US dollar)^e					
Yen per US dollar	130.9	113.9	107.8	123.0	124.0
Euros per US dollar		0.939	1.085	1.103 ^f	

Sources: United Nations, "Project LINK World Economic Outlook: World Aggregate Tables" (April 2001); IMF, *World Economic Outlook* (Washington, DC, October 2001); Economist Intelligence Unit (EIU), *EIU Country Forecast: Japan* (London, August 2001).

^a Estimate.

^b Forecast.

^c Exports and imports (goods and services).

^d Developed and developing economies ratios weighted at purchasing power parity.

^e Period average.

^f January-May.

Japanese growth faded in 2001

The slowdown in the United States was accompanied by a similar downturn in Japan. As in the United States, Japanese GDP grew until the second quarter of 2000 though at the more modest annual pace of 1.5 per cent. Japanese growth was driven by the fast pace of growth in the United States and by the still-buoyant Asian economies; a surge of ICT capital expenditures by corporations also played a part. However, as the external stimulus faded, domestic corporate investment expenditure came to a halt and long-standing structural problems of the Japanese economy again came into sharp relief, reinforcing the already weak business and consumer confidence once more. The result was that by mid-2001 the Japanese economy had slid into recession registering negative growth of 0.7 per cent in the second quarter on a year-on-year basis. Reflecting these negative developments, Japanese stock prices fell to their lowest level since 1984 in the second half of 2001 with further deleterious effects on business and consumer confidence in the economy.

The EU was also affected, after initial resilience

Hopes that slow growth in the United States and Japan might be offset by faster growth in the EU or elsewhere have not been realized. The euro area seemed for a time to be insulated from developments in the rest of the world. Despite the slowdown in the United States and Japan, GDP growth in the EU 11 declined

marginally from 3.5 per cent in the first half of 2000 to 3.0 per cent by the end of 2000 and to a similar extent in the United Kingdom of Great Britain and Northern Ireland. Thereafter, the weak euro combined with high oil prices to raise headline inflation above the European Central Bank's (ECB) target range of 0-2 per cent and led to some policy tightening by ECB. The latter served, however, to slow investment expenditures, particularly in Germany, the largest economy in the EU. By the second quarter of 2001, overall growth in the euro area had declined to 1.7 per cent on a year-on-year basis and in the United Kingdom to 2.3 per cent. It is worth mentioning here that while the EU trades primarily with itself, falling demand for EU exports in non-EU markets has meant that GDP growth in the EU has weakened perceptibly in 2001.

Making predictions remains hazardous

What of the immediate future? As stated earlier, there are major uncertainties ahead and making predictions for the next 15 months remains hazardous in the extreme. A huge element of uncertainty for the global economy has obtruded from the terrorist outrages in the United States in September 2001. Most forecasts concede that the effects on overall activity will be negative both in the United States and elsewhere, at least for the immediate future. A major uncertainty also lies in how consumer expenditure in the developed economies, badly dented by the disasters in the United States, might behave once the current slowdown begins to translate itself into significant job losses. This is already visible in the travel and travel-related sectors of the economy in the United States, including aviation. Such uncertainties notwithstanding, there are clues in the manner in which the global economy has behaved in the past four quarters that may shed light on how events might unfold in the coming months.

Factors bearing on recovery

No obvious “engine” in sight

First, on present evidence, this is likely to be the first truly global downturn since the Second World War, affecting virtually all regions with both developed and developing economies slowing down at the same time. From the perspective of how recovery and growth might be regenerated in 2002, a feature of concern at the present juncture is that there is no obvious “engine” of recovery immediately in view.

Further monetary easing may not help

Second, although inflation has remained low despite the rise in energy prices, this may have paradoxically put a limit on further policy easing on the monetary front. Other than the normal lags in monetary policy transmission through interest rate cuts, there is some worrying evidence from both the United States and Japan that lower interest rates by themselves are not having the desired stimulating effect on investment and consumption. Interest rates are now quite low (0.01 per cent in Japan and 2.45 per cent in the United States for 3-month money market rates) and cannot be lowered much further. Interest rate reductions thus may not produce the desired effects in a low inflationary environment.

The downturn has both cyclical and structural features

Third, the current slowdown in the world economy, although initially triggered by an inventory correction in the United States, is in essence an investment-led downturn. Such downturns reflect previous debt-financed excesses in investment, in this case in ICT and, more particularly, in telecommunications in the EU. As such, they tend to be deeper and to last longer as excess capacity cannot be eliminated very quickly. However, recent experience with ICT suggests that rates of obsolescence can be very high in this class of technology so that capital expenditures could recover quickly when the rebound starts.

Impact on the ESCAP region

What impact is the downturn likely to have on the developing economies of the ESCAP region? Notwithstanding the huge diversity of ESCAP economies in geography, population size, level of development and approaches to development, certain similar and dissimilar features are present.

First, economies with a large domestic element, such as China and India, or those with a preponderance of traditional commodity production with low price and income elasticities in their exports, are likely to be only marginally affected in the short term. In any event, commodity prices have been low for some time, have been tending to weaken and could weaken further in the months ahead depending upon the depth of the slowdown. However, most of the fastest-growing economies, and especially the crisis economies of East and South-East Asia, with their high trade-to-GDP ratios and relatively large involvement in international capital, are likely to be adversely affected to a significant extent. By the same token, economies with low trade-to-GDP ratios are likely to be less affected.

Second, the higher is the trade-to-GDP ratio and the greater the dependence on the United States economy as an export destination, such as for Malaysia, Singapore, Taiwan Province of China and the Republic of Korea, the deeper the downturn is likely to be. However, all economies of the region are ultimately likely to experience declining growth rates as the global economy slows down. The uncertainty at this stage lies in predicting the depth and length of the decline.

Third, most ESCAP economies are not as vulnerable to the current slowdown as they were in 1997. They have, in general, improved their balance of payments current account positions, built up their reserves and reduced short-term indebtedness.

Recent developments and prospects: developed economies

United States: the engine is stalling

Given the large weight of the United States economy in the global economy and its critical role as an engine of growth for much of the rest of the world in the last 4-5 years, it would be appropriate to look at recent developments in the United States more closely. It is noteworthy that the current economic expansion that began in the second quarter of 1991 is the longest on record. While all expansions come to an end, the duration and depth of the ensuing slowdown depends on many factors, some structural, some transitory. Both in 1999 and 2000 there was concern that the United States economy was growing unsustainably fast. A slowdown was therefore only a matter of time. It is not entirely clear at this stage whether the present slowdown in the United States is primarily cyclical or primarily structural.

Signs of a slowdown in the United States economy first emerged in the third quarter of 2000. Several factors appear to have contributed to the slowdown. Persisting high oil prices in 2000 had triggered a slight rise in inflation in the first half of the year. The emergence of incipient inflationary pressures caused the Federal Reserve to raise interest rates modestly in May 2000. Coincidentally or otherwise, equity prices fell substantially from their historical highs from April 2000 onwards and, interest rate reductions and minor rallies notwithstanding, have kept falling ever since. Moreover, such is the level of integration in global equity markets, that the bear phase in United States equity markets has been replicated the world over. Another important influence was a

slowdown in United States productivity growth in the second half of 2000. The overall effect of these twin developments was that corporate capital investment fell in the last quarter of 2000 and has shown few indications of recovery thus far.

The slowdown and productivity trends

One of the notable structural features of the performance of the United States economy since the mid-1990s is that above-trend GDP growth has been associated with benign inflationary pressures, in strong contrast to previous expansions. This phenomenon has been attributed to a marked acceleration in the rate of labour productivity growth. As a result, earnings growth has remained modest and this has obviated the need for any significant policy tightening over the last few years. Labour productivity growth in the non-farm business sector increased by an impressive 4.25 per cent in 2000. However, it decelerated abruptly towards year-end and actually contracted by nearly 1.25 per cent in the first quarter of 2001.³ Given the strong role played by productivity growth in the United States economy during the recent expansion, the reasons for its sharp reversal in 2001 and conditions for a resumption in productivity gains in the near term, via an upturn in capital spending by corporations, are regarded by many analysts as having a crucial bearing on the timing and pace of recovery in 2002. The pointers in this regard are, however, somewhat ambiguous at this stage.

While there is broad agreement that a significant improvement in productivity has occurred in recent years, there is less agreement as to how much of the improvement is structural and how much cyclical. The two views have implications as to what might happen in the months ahead as output growth slows further and unemployment rises. If the former is accepted as the primary cause, then recent share price trends involving very high price/earnings (P/E) ratios would have a firmer basis and the extraordinary bull run in equity markets between 1998 and April 2000 would be more or less justified. However, regaining such a rate of productivity growth in 2002 would, in turn, require that capital spending by corporations resume at the high rates recorded in the second half of the 1990s, a rather more doubtful proposition, given their weaker balance sheets now.

As a counterpoise to the above view, if productivity growth is also partly cyclical in nature, it would appear that long-run output and productivity growth, and by inference share prices, have been overstated in the recent past. Hence, any recovery in 2002 would be less the result of an investment rebound and more the beginning of a new inventory cycle. Furthermore, the inventory build-up would need to be financed in the normal way: internal cash flow or debt rather than new equity. On the basis of past experience, this could be more gradual than an investment-led rebound depending more upon consumer confidence.

The current account and savings deficits and the stock market decline

The slowdown in the United States has also drawn attention to some of the latent fragilities in the economy that have been masked by rapid growth over the last 4-5 years. These relate to the private sector imbalance, that is, the decline in private saving by households aided by the rise in equity prices and its associated wealth effects and the rise in corporate debt caused by debt-financed share buy-backs and other expenditures. The two phenomena are reflected in the ever-widening current account deficit, which now exceeds 4.5 per cent of GDP. At this level it absorbs nearly 8 per cent of the world's gross savings.⁴ At these

³ IMF, *United States: 2001 Article IV Consultation*, IMF Staff Country Report No. 01/145 (Washington, DC, August 2001).

⁴ Bank for International Settlements (BIS), *71st Annual Report* (Basel, June 2001).

orders of magnitude such imbalances are unsustainable. Their correction accordingly has implications for United States recovery, for world financial markets and for all developing countries in the near term.

A restoration of private savings to historical norms, for instance, could presage a significant decline in private consumption or a sell-off of private equity holdings or both. Likewise, a reduction in the current account deficit would necessitate some depreciation of the dollar exchange rate. The question from the perspective of the global economy is whether these imbalances are likely to be corrected rapidly or gradually. In either event, the world economy would not be able to rely on the United States as an engine of growth for some time; this would apply even if the considerable risk of disruption in the international financial markets that the correction will inevitably generate can be discounted. Some disruption has already occurred in the United States markets following the New York terrorist outrages and has cascaded into virtually all the world's financial markets. The United States stock markets, having fallen significantly since the beginning of 2001 (the Dow Jones by 11 per cent and NASDAQ by 31 per cent), fell further after 11 September (the Dow Jones by 8.8 per cent and NASDAQ by 9.9 per cent) in the following week, a pattern repeated in the ESCAP region. There has also been a significant increase in dollar-yen and dollar-euro exchange rate volatility. If prolonged, such volatility is likely to push recovery into the background.

How long could the present instability last? In previous episodes of political events bearing upon the financial markets, the effects have not been long-lasting, for example, the Gulf War in 1991, when markets stabilized within 3-4 months. However, once instability subsides the evidence still indicates that positive impulses are likely to remain weak in the United States economy for some time despite the boost from the tax rebates in fiscal 2001/02 and the extra spending approved by Congress in the wake of the terrorist atrocities. Unwinding excess inventories and overinvestment in ICT by corporations cannot be achieved overnight. Moreover, the decline in corporate profitability and increase in unemployment are likely to dampen output growth and consumer confidence in the months ahead.

**Prospects for
2002: consumer
confidence
is the key**

Against this analysis, prospects for the United States economy in 2002 at this point in time are extremely uncertain. The balance of probable risks appears to be on the downside. Prior to the 11 September events, for example, notwithstanding signs of a slowdown the likelihood of a recession was not regarded as high. Manufacturing activity appeared to be bottoming out with the National Association of Purchasing Managers' (NAPM) monthly index in August 2001 registering its biggest jump in five years. At about the same time, though, the NAPM index of non-manufacturing activity had plummeted to 45.5 in August. A number below 50 is a sign that activity is contracting. Hence, the two numbers were sending out somewhat contradictory messages. Following the terrorist attacks, negative influences, led by downturns in airlines, insurance and tourism, are bound to be strengthened in the short term. The first survey of consumer confidence after 11 September shows a fall from 114 to 97.6, its lowest level since 1996 and its sharpest one-month decline since the Gulf War. In the last two quarters of 2001 and possibly well into 2002, GDP growth is either likely to remain flat at around an annualized 1.6 per cent or, as seems more likely at this time, the economy could dip into recession.

Japan: no sign of a revival in consumption

The Japanese economy has displayed a pattern of growth not unlike that of the United States in 2000 and 2001. Following barely measurable 0.2 per cent growth in 1999, GDP growth, led by industrial production, reached the respectable level of 2.4 per cent in the first quarter of 2000 only to decline to a mere 0.1 per cent in the second, overall growth in 2000 reaching 1.5 per cent. In the first and second quarters of 2001 there was barely discernible growth and unemployment began to climb upwards towards the psychologically significant 5 per cent. The principal culprit in the poor performance of the Japanese economy is the consumer. Having suffered massive losses in personal wealth in recent years and faced with threats to both earnings and employment, Japanese consumers have become far more inclined to save than to spend. Since 1999, deflation has been both a cause and an effect of such consumer behaviour.⁵

Still grappling with the “bubble” economy

Japanese corporations, too, are faced with a difficult environment. Although productivity in manufacturing remains enviably high in the larger corporations, the problem of overcapacity and overinvestment in the sector as a whole has critically weakened corporate balance sheets, especially of small-scale subcontracting companies. The economy is still grappling with the consequences of the bubble economy of the 1980s in the shape of low profits, weak asset values and chronic problems in the financial sector arising from impaired assets and under-capitalization. The financial system remains in a particularly precarious condition with grave systemic consequences. Given the continuing failure of the authorities to deal decisively with the post-bubble problems facing the Japanese economy, popular perceptions have become mired in chronic pessimism regarding the future.

Fragile banks and low consumer confidence

For their part, the authorities have adopted the standard macroeconomic remedies to revive growth and rehabilitate insolvent banks. In the process, gross public debt, after a series of stimulus and rescue packages, now stands at an extraordinary 130 per cent of GDP. By way of comparison, at this level it exceeds the EU benchmark of 60 per cent of GDP for participation in the euro by more than a factor of two. Continuing slow growth has gravely weakened the financial system. In April 2001 the Japanese Financial Services Agency disclosed that banks and other financial institutions were still sitting on a massive 150 trillion yen (US\$ 1.2 trillion approximately) of potentially problematic loans equivalent to about a fourth of Japanese GDP.⁶

In view of these extraordinarily severe financial constraints and the seeming inability of both fiscal and monetary measures to revive growth, short-term prospects for the Japanese economy are very bleak indeed. Consumer confidence remains stubbornly weak while a renewed bout of stock market declines has raised fears that Japan could re-enter a long-term phase of slow or no growth, rising bankruptcies and intensified fragility in the banking system. A major package to accelerate bank and corporate restructuring was unveiled in April 2001 but it remains to be seen what impact it will have in terms of reviving consumer and investor confidence. On the basis of present trends, private consumption is likely to experience little or no growth and both private and public capital spending will either be flat or, more likely, decline in the months ahead. With a global slowdown on the horizon, the contribution of net exports will also decline. GDP could therefore decline by around 0.4 per cent

⁵ IMF, *Japan: 2001 Article IV Consultation*, IMF Staff Country Report No. 01/144 (Washington, DC, August 2001).

⁶ *Bangkok Post*, 20 July 2001.

in 2001 with the possibility of only a gentle upturn in 2002. The overall outlook is thus extremely poor.

The EU has not been immune to the global slowdown

The EU economy enjoyed relatively brisk growth in the first half of 2000 although the pace was significantly slower than in the United States, a reflection, as in Japan, of the slower uptake of ICT in the EU. However, helped by a competitive exchange rate and favourable global conditions in 2000 and the first half of 2001, net exports not only provided a positive contribution to growth but also stimulated investment spending, some of it in ICT. In addition, declining unemployment boosted private consumption. In common with developments in the United States and Japan, the EU also experienced a degree of cooling during the second half of 2000, which has persisted into 2001.

The EU slowdown has, however, been less pronounced than that of the United States so far and has differed widely across the member countries. The four largest economies – Germany, the United Kingdom, France and Italy – are in general less involved with ICT. Consequently, with the exception of telecommunication equipment, the EU has been exposed to a much smaller risk of downward adjustments in capital stock and associated corporate balance sheet deterioration than the United States in 2001. However, three of the smaller economies – Finland, Ireland and Sweden – considered to be at the forefront of ICT in the EU, have suffered a sharp growth slowdown led by a major reversal of corporate investment in ICT. This has produced significant adverse spillover effects on the high-tech sectors of the United Kingdom, Germany and the Netherlands.

Developing ESCAP economies

Exports fall sharply and GDP growth falters

Table 2 gives GDP growth rates for the 15 largest ESCAP developing economies in 2000, the latest available estimates for 2001 and forecasts for 2002. As with prospects for the United States and the global economy, forecasts for 2002 are highly provisional. Paralleling global trends, most developing countries experienced strong growth for much of 2000 but with slackening export growth, the pace slowed sharply as the year progressed. Nevertheless, average growth for 2000 was the highest recorded in the last four years. Despite the strong growth and high oil prices, inflation remained muted and although the situation varied from country to country the balance of payments continued in a sound position. These trends were in evidence over much of the ESCAP region, barring one or two important exceptions, and were especially true in the crisis economies. However, from the last quarter of 2000 and continuing into 2001 several economies in the region were acutely affected by the slowdown in the United States. As mentioned above, this had a dramatic effect on export growth, as table 3 shows.

The high-tech sector is the most affected

In this phenomenon, the performance of the high-tech sector was by far the most important element. High-tech manufacturing has increasingly come to dominate the exports of many ESCAP economies, as table 4 and the figure show. In particular, exports of such goods to the United States have grown fourfold in the past decade. For some ESCAP economies electronic goods have accounted for two thirds of the recovery in industrial output in the region since the 1997 crisis. Beginning in the last quarter of 2000, however, many economies in the region suffered reduced global demand for ICT products, as illustrated below.

The importance of the high-tech sector varies in the region but some of its characteristics should help to explain the nature of its contribution to the regional

Table 2. Rates of economic growth of selected developing economies of the ESCAP region, 1999-2002

(Percentage)

	Real GDP				
	1999	2000	2001 ^a	2001 ^b	2002 ^c
South and South-West Asia^d	5.2	5.2	6.2	4.4	5.3
Bangladesh	4.9	5.9	6.0	5.8	6.1
India	6.4	5.2	6.5	5.0	5.6
Iran, Islamic Republic of	2.4	4.5	5.5	4.0	4.0
Pakistan	3.1	4.5	5.0	3.3	3.9
Turkey	-5.1	7.6	4.8	-5.2	4.5
South-East Asia	3.7	6.0	5.2	2.0	4.2
Indonesia	0.8	4.8	5.0	3.1	4.3
Malaysia	5.8	8.5	7.0	2.0	4.1
Philippines	3.3	3.9	3.4	2.3	3.2
Singapore	5.9	9.9	6.3	-0.5	5.0
Thailand	4.2	4.4	4.6	1.7	3.9
Viet Nam	4.8	6.8	7.0	6.0	6.3
East and North-East Asia	7.6	8.1	6.4	4.2	5.7
China	7.1	8.0	7.8	7.5	7.6
Hong Kong, China	3.0	10.5	6.1	1.3	3.8
Republic of Korea	10.9	8.8	5.1	3.2	5.5
Taiwan Province of China	5.4	6.0	5.8	1.4	3.7
Memo:					
Russian Federation	3.2	8.3	..	4.5	3.8

Sources: ESCAP, based on IMF, *International Financial Statistics*, vol. LIV, No. 7 (Washington, DC, July 2001); Asian Development Bank (ADB), *Key Indicators of Developing Asian and Pacific Countries* (Oxford University Press, 2000) and *Asian Development Outlook 2001* (Oxford University Press, 2001); United Nations, "Project LINK World Economic Outlook", April 2001; and EIU, *EIU Country Forecast* (London), various issues; and national sources.

^a Economic and Social Survey of Asia and the Pacific 2001 forecast.

^b Latest available estimate (before 11 September 2001).

^c Forecast.

^d The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2000/01 = 2000 for Bhutan, India and the Islamic Republic of Iran; and fiscal year 1999/00 = 2000 for Bangladesh and Pakistan.

Table 3. Rates of growth of exports and imports of selected ESCAP economies

(Percentage)

	1999		2000		2001 ^a	
	Exports	Imports	Exports	Imports	Exports	Imports
China	6.09	18.05	41.48	35.64	43.90	15.37
Hong Kong, China	0.06	-2.68	13.32	19.93	-11.51	8.43
India	5.99	5.85	14.24	9.34	5.69	-0.52
Indonesia	-0.39	-12.20	27.64	39.62	11.69	2.91
Iran, Islamic Republic of	17.07	-8.52	49.48	17.92	-3.40	7.45
Malaysia	15.08	12.30	16.09	25.51	2.39	6.70
Pakistan	0.07	10.63	8.49	7.31	8.69	2.42
Philippines	20.27	-0.08	19.85	43.33	9.77	27.97
Republic of Korea	8.25	28.24	15.16	27.38	8.27	7.75
Russian Federation	1.49	-29.47	42.16	11.78	35.92	37.16
Singapore	4.41	9.31	17.35	21.17	7.12	5.70
Taiwan Province of China	9.96	5.76	21.98	26.49	-3.56	-10.02
Thailand	13.41	23.43	5.44	6.97	0.50	16.92
Turkey	5.61	-7.36	-0.03	31.53	7.92	9.85
Viet Nam	15.21	5.42	20.41	21.56	8.20	13.06
Memo:						
United States	1.51	10.99	11.77	18.10	10.00	12.50
Japan	8.06	10.49	14.00	21.35	-4.36	6.21
European Union	2.85	4.32	2.52	8.38	0.89	6.73

Sources: IMF, *Direction of Trade Statistics CD-ROM*, August 2001, and national sources.

^a Data for first quarter of 2001.

Table 4. High-tech exports of selected Asian economies
(Percentage)

	Share of economy's total exports to OECD countries								
	China	Hong Kong, China	Indonesia	Republic of Korea	Malaysia	Philippines	Singapore	Thailand	Taiwan Province of China
Computers ^a	6	7	2	13	19	22	54	16	28
Telecommunications ^b	7	4	5	6	15	6	5	7	4
Components ^c	8	18	2	23	24	33	17	11	17
Total	20	30	9	41	58	60	77	34	50

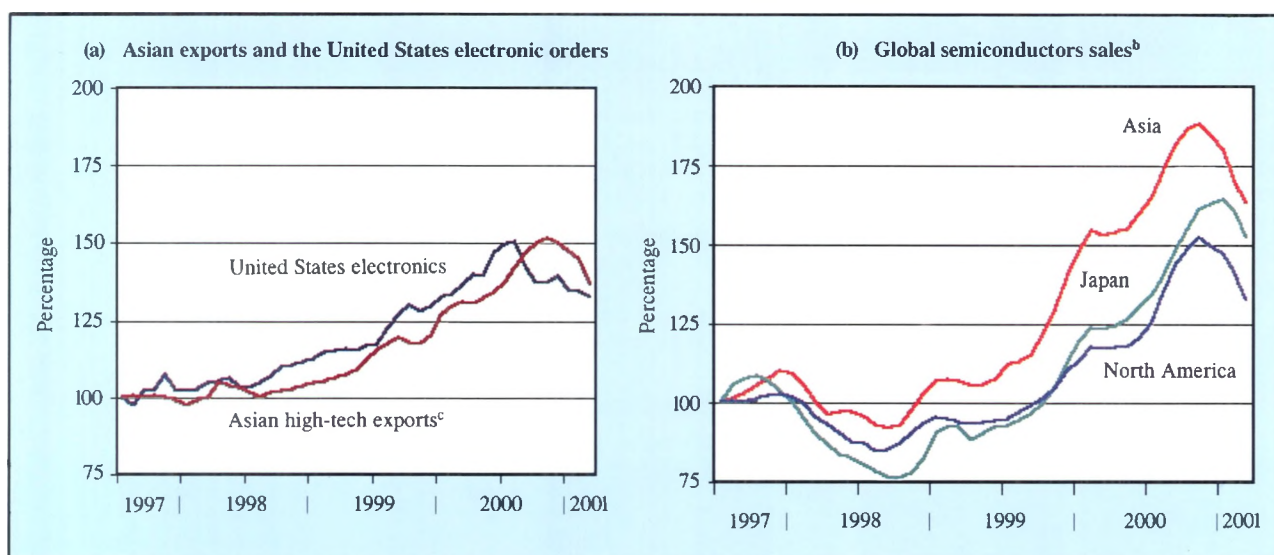
Source: Reproduced from BIS, 71st Annual Report (Basel, June 2001).

^a Refers to SITC division 75: office machines and automatic data processing machines.

^b Refers to SITC division 76: telecommunications and sound recording and reproducing apparatus and equipment.

^c Refers to SITC division 77: electrical machinery, apparatus and appliances not elsewhere specified and electrical parts thereof.

Figure. High-tech activity in selected Asian economies^a



Source: Reproduced from BIS, 71st Annual Report (Basel, June 2001).

^a June 1997 = 100; three-month moving average.

^b Including domestic sales.

^c To the United States of America; defined as the sum of trade classifications SITC 75, 76 and 77. Asia refers to China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taiwan Province of China; and Thailand.

economy. Because of “componentization” – the location of various component manufacturing facilities in different countries rather than in one large facility in one country – shipments of components between countries account for the bulk of intraregional trade. This has tended to magnify the effects of trade-induced contagion in the region.

Could recovery be “V” – shaped?

The high-tech sector has thus not only contributed to high growth rates of exports in several countries but has also accentuated cyclical pressures, via its production linkages, across these countries simultaneously. Furthermore, the product cycle of ICT, embodying rapid technological obsolescence, appears to be significantly

more volatile than that of traditional manufactured goods with the amplitude of its fluctuations greater than that for manufacturing as a whole. Thus, a substantial slowdown of the world economy could lead to an even deeper downturn in the high-tech sector. This has two implications: one, exports are likely to decline severely in the short term with adverse knock-on effects on GDP growth and, two, recovery, when it comes, could be quite fast, as in 1999 and 2000. The question that remains is what is to be done in the interim.

The level of public debt, overcapacity and systemic risks

The ESCAP economies in general, with the exception of South Asia, ran budget surpluses before the 1997 crisis. In the wake of the crisis, fiscal deficits have become the norm; public debt as a ratio of GDP has risen significantly and interest payments to service the debt are taking an increasing proportion of revenues. Fiscal sustainability has accordingly become an issue in the region: it will almost certainly be aggravated by the current slowdown. A simultaneous slowdown in export growth and high public debt mean that for most Governments, the room for policy manoeuvre has become more constrained and is likely to remain so for some time, at least well into 2002. This is particularly relevant in the context of the still unresolved problems of the financial sectors in many countries and the ongoing credit problems in the region, irrespective of whether the phenomenon is supply- or demand-driven.

One of the striking features of the current situation lies in the suddenness with which the slowdown came in 2000, often catching Governments unawares, exposing the fragilities in the financial and corporate sectors once again and giving minimal opportunity to take corrective measures. For instance, just as economies were beginning to reduce non-performing loans (NPLs) to a manageable level and corporate restructuring was showing signs of movement the sharp slowdown in exports has stopped progress in its tracks. There is no doubt that banking sector reform has proceeded somewhat slowly in the region. One reason for this is that falling capital markets have limited the capacity of banks to recapitalize, far less to raise new capital to expand their operations. Another factor has been the continuing NPLs problem and the fact that some restructured loans have become non-performing. This has plunged banks into further rounds of provisioning and capital reductions.

In this context, it is worth remembering that prior to the 1997 crisis investment levels in several economies were in excess of 35 per cent of GDP and led to overinvestment in many sectors. In the aftermath of the crisis new production and sales have been sourced from existing capacity with little new investment thus far. As a result, the corporate sector is in many instances now in financial surplus but with “dead” assets on the books. In much of the region, it is the credit-sensitive sectors, like construction and real estate, that continue to remain depressed. A weakening external environment, plus unresolved domestic problems, mean that prospects for the region in 2002 will remain poor as there is unlikely to be an investment rebound or a thorough write-down of dead assets for some time. However, economies like China and India with large domestic markets would in all likelihood be less directly affected. All the same, they too will not escape the ripple effects of a global and regional slowdown entirely. Likely scenarios in the main subregions are outlined below.

South-East Asia: the most vulnerable subregion

This subregion is the most vulnerable to the current global downturn. Its prospects are intimately bound up with developments in the United States and Japan, as summarized in tables 5(a) and 5(b) below. The heavy dependence on exports means that a revival of growth in the last quarter of 2001 or early 2002

Table 5(a). Indicators of linkages between the United States and Asia*(Percentage, as of 2000)*

	Share of exports to the United States	Exports to the United States (percentage of GDP)	External debt/ GDP	Share of bank lending from United States banks	Share of FDI from the United States ^a
China	24	6	13	2	3
Hong Kong, China	22	27	37	3	11
Indonesia	14	6	93	8	..
Malaysia	21	23	49	7	1
Philippines	29	17	69	14	..
Republic of Korea	22	8	27	12	..
Singapore	17	25	11	1	87
Taiwan Province of China	23	11	12	17	18
Thailand	23	12	69	4	25

Table 5(b). Indicators of linkages between Japan and Asia*(Percentage, as of 2000)*

	Share of exports to Japan	Exports to Japan (percentage of GDP)	External debt/ GDP	Share of bank lending from Japanese banks ^b	Share of FDI from Japan
China	16	4	14	18	7
Hong Kong, China	6	7	..	32	..
Indonesia	22	8	97	25	13
Malaysia	13	13	48	27	14
Philippines	14	7	76	18	7
Republic of Korea	11	4	28	18	16
Singapore	7	11	..	27	23
Taiwan Province of China	10	6	..	17	10
Thailand	16	9	66	37	25

Sources: BIS, *BIS Quarterly Review* (Basel), various issues; IMF, *International Financial Statistics* (Washington, DC), various issues, *International Financial Statistics CD-ROM* (Washington, DC, 2001) and *World Economic Outlook* (Washington, DC), various issues; Organisation for Economic Cooperation and Development (OECD), *International Direct Investment Statistics Yearbook 2000* (Paris, 2001); and EIU, *EIU Country Finance* (London), various issues, and *EIU Country Reports* (London), various issues.

^a 1999.

^b Calculated from BIS data (December 2000).

is unlikely to occur, particularly following the terrorist attacks in the United States. Another possible growth-dampening event on the horizon is China's accession to WTO with a probable erosion of market share in a range of manufactured goods for economies in this subregion.

Consumer confidence has not fully recovered after the 1997 crisis, with the result that domestic demand has not been able to compensate for falling exports. As mentioned earlier, the scope for further fiscal stimuli is limited even in the short term. However, inflation should remain muted, encouraging a further easing of monetary conditions. Exchange rates, too, have remained broadly stable on a trade-weighted basis over the last 12 months though tending to lose ground against the dollar to some extent. This could change now as the dollar has weakened against the yen. With still comfortable current account positions and ample reserves, vulnerability to a new economic crisis is low but growth could remain slow for some time. In any event, growth is unlikely to revive much

East and North-East Asia is also vulnerable but China is a pillar of strength

in the first half of 2002. This would generate adverse social consequences as unemployment rises in several countries and the ranks of the poor are swollen once again, as in the aftermath of the 1997 crisis.

Next after South-East Asia, the subregion most vulnerable to a global downturn is East and North-East Asia, which includes China, Hong Kong, China, and the Republic of Korea. Of these three, China is the least vulnerable given the size of its economy and its low exports-to-GDP ratio and Hong Kong, China the most vulnerable as a result of its role as a regional and international financial and services centre and its high exports-to-GDP ratio. While closely linked with China, Hong Kong, China, is also very dependent upon the United States and Japan in this role. A downturn in these economies would inevitably impact negatively on its economy.

In the case of China, the prognosis remains broadly positive for now. Although rapid export growth since the mid-1990s has been a major contributor to China's remarkable record of sustained GDP growth, the economy is still primarily driven by domestic consumption and investment. On both these counts, there is unlikely to be a slowdown in the 12 months ahead. Nevertheless, weaker export growth will inevitably impact on the GDP growth rate in 2002, if only marginally for the time being. At the same time, while room for fiscal stimulus is technically available, given China's low domestic debt-to-GDP ratio, the problem of non-performing loans, unfunded pension liabilities of the Government and rapidly rising social security obligations means that China must tread the path of fiscal stimulus warily.

In the Republic of Korea growth slowed dramatically in 2001 with industrial production declining by nearly 6 per cent in mid-2001 on a year-on-year basis. Export growth suffered a sharp slowdown and rising unemployment badly affected consumer confidence. Corporate investment expenditures are expected to contract over the year as a whole and probably into 2002. Corporate and financial sector restructuring, now in its second phase after the 1997 crisis, has been beset by a lack of qualified personnel to implement the ambitious improvements in governance envisaged by the authorities. While the authorities have instituted a temporary tax credit on investment and small- and medium-sized enterprises (SMEs) are to be given a 5 per cent tax break, corporate debt-equity ratios are still high, NPLs have started to rise again and corporate profitability has begun to decline following the downturn. As such, the economy remains extremely vulnerable to a United States slowdown.

South and South-West Asia is affected by increased uncertainty

Along with China, India's economy remains relatively immune to external developments, at least in the short term. However, there is no doubt that the optimism that prevailed over much of 2000 has faded visibly in the face of unfavourable weather, sluggish growth in manufacturing and long-standing structural impediments such as the fiscal position, the inexorable rise in public debt, debt-servicing obligations and poor infrastructure. In this connection it is worth mentioning that the lack of progress with privatization remains a major political problem. Exports performed well in 2000 but continued growth remains inherently vulnerable to conditions in markets like the United States. The Reserve Bank of India has recently announced a special financial package to boost the exports of six high-value categories: pharmaceuticals, agro-chemicals, transport equipment, cement, iron and steel and electrical machinery. It is too soon to predict its impact. In any event, the present export slowdown is primarily a demand-driven phenomenon. On the

assumption that no major internal or external difficulties arise in the next 12-15 months, beyond what is foreseeable at this stage, the economy should continue to grow, at 5.0 per cent in 2001 and 5.6 per cent in 2002. However, identifiable risks appear to be on the downside given India's rapidly rising involvement with the United States via its computer software industry.

Pakistan's economy is coming to the end of its IMF standby arrangement, having successfully carried out a number of structural reforms over the last few years. Drought has had a major growth-reducing impact in 2001; a global slowdown is likely to reduce growth of exports and put pressure on the balance of payments and the exchange rate with adverse consequences on the burden of debt servicing. GDP growth is, however, expected to revive in 2002 given better weather, although much depends upon the resolution of the crisis in Afghanistan and the impact of the refugee problem.

It needs to be emphasized that the crisis in Afghanistan has introduced a major new element of uncertainty in the entire South and South-West Asian subregion. Within the subregion, Pakistan and the Islamic Republic of Iran will have to bear the brunt of the crisis as refugee numbers grow, straining their financial and physical resources, and entailing additional security and environmental risks. The costs of these burdens can only be guessed at for now. Pakistan has estimated them at between US\$ 1.0 and US\$ 2.5 billion depending upon how long the crisis lasts.

In India, Bangladesh, Sri Lanka and Nepal, the effects of the crisis will be more indirect. Nonetheless, these are likely to be significant in the months ahead. The airline industry and tourism to Sri Lanka and Nepal, for example, have already suffered through higher security and insurance costs and fewer international visitors travelling to these countries. These developments will in due course impact negatively on a variety of other activities, principally hotels, but also services and goods providers to hotels and to foreign travellers, particularly handicraft manufacturers. India is also likely to suffer, although to a lesser degree.

An especially fraught development for the subregion, if the Afghanistan crisis is prolonged, could emanate from higher shipping costs as shippers levy insurance surcharges for calling at ports in the subregion, principally Pakistan. These surcharges would adversely affect export competitiveness and reduce foreign earnings. Over a period of time, the crisis could therefore produce wide-ranging impacts on the subregion. GDP growth will almost certainly be negatively affected and unemployment could rise, the exact repercussions becoming clearer in the months ahead. It should be stressed here that all countries in the subregion have high debt-to-GDP ratios. Hence, their ability to deal with the crisis through additional public spending is limited. The crisis and its aftermath is likely to pose a major challenge for the subregion in 2002.

Russian Federation: progress with reforms and benefits of a large energy sector

The Russian Federation is geographically the largest ESCAP region economy, straddling Europe and Asia and with close links to the economies of Central Asia. A steady improvement in the investment climate and more diligent implementation of the reform programme is beginning to pay handsome dividends. Nonetheless, growth will decline in 2001 and 2002 in line with global trends. However, on the plus side, the exchange rate has stabilized and foreign reserves have been rising. The stock market has performed exceptionally well in 2001. All foreign debt payments due in 2001 and 2002 are expected to be met and adequate funds are expected to be raised in order to meet peak debt repayments in 2003. Any deterioration in financial market conditions will impact negatively on the economy only if the deterioration is prolonged.

This state of affairs is attributable in part to the high oil prices in 2000 and the reforms that enabled GDP to grow at over 8 per cent in 2000. On the debit side, however, inflation and interest rates remain very high, inhibiting private sector investment and, with a relatively stable exchange rate, a loss of competitiveness. As of now, the Russian Federation is shielded from the global slowdown to some degree in view of its limited trading links. These are offset by a substantial energy sector that is not immune to significant price fluctuations emanating from external sources. Energy exports constitute around 35 per cent of export earnings and a substantial portion of the revenues of the Government. Stable prices are vital for continued growth in the economy and for the long-term diversification of the output mix.

Trade and capital market trends

A close relationship between trade and growth

In the first half of 2000 world trade in volume terms expanded by over 12 per cent, more than twice its growth rate in 1999, and by slightly less in US dollar terms. Trade as a proportion of global GDP also rose, continuing a trend that has been one of the hallmarks of the globalization process, especially in the 1990s. Over the last few years this trend has embodied rapid changes in the production arrangements of companies, a transformation partly driven by intensified global competition and partly by the attempts of individual companies to exploit the benefits of returns to scale to their fullest. As a result, production processes have become increasingly decomposed, vertically as well as horizontally. Compared with the past, however, each process now involves a growing number of intermediate stages that are spread across countries and have thus contributed to the growing share of trade in national output as well as of regional trade across a broad swath of economies in the ESCAP region. In addition, thanks to technological progress and lower communication costs, more and more services have also become tradable and this too has contributed to the rise in foreign trade shares in relation to GDP. Economies are thus no longer constrained by the size of the domestic market in an increasingly wide range of activities. Trade was a major contributor to growth in the ESCAP region in the 1990s both before and after the 1997 crisis. Its sharp slowdown in the latter half of 2001 poses a major challenge to the region as a whole.

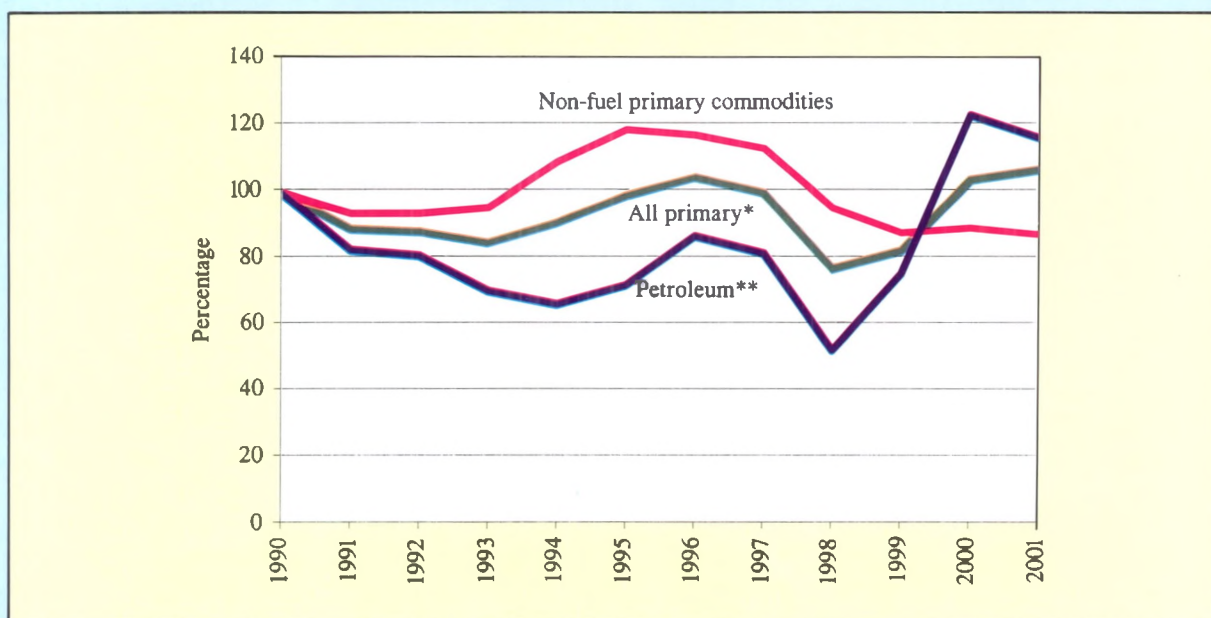
Continuing commodity price weakness

The acceleration in foreign trade in volume terms has been accompanied by a decline in international trade prices, affecting both the bulk of agricultural commodities and manufactured goods observed since the mid-1990s. This phenomenon has continued apace in 2000 and 2001. Its continuance suggests excess capacity both in commodity production and in manufacturing, phenomena that have limited the ability of producers to increase prices. This is consistent with excess production and/or supply overhang of various primary commodities as well as of manufactured goods like steel, motor cars, computers and microprocessors. This does not apply to oil and oil prices as well as to certain base metals that are currently in short supply. As a result of production restraints and low inventory levels in the United States, oil prices rose sharply in 2000 and, apart from occasional bouts of weakness, have remained relatively high compared with their levels of the 1990s, in the US\$ 22-26 per barrel range (see box 1). These trends are expected to continue into 2002. Furthermore, prices in the spot market remain very sensitive to political developments involving West Asia. The broader phenomenon of excess capacity and over-supply in both manufacturing and commodity production suggests that growth is likely to come from a recovery in demand, at least in the short term, and not via investment.

Box 1. Oil price volatility^a

The fluctuations in oil prices since 1997 are remarkable compared with the movement of overall primary commodity prices in recent years. According to the indices of primary commodity prices published by IMF, overall primary commodity prices in late 2000 exceeded an earlier peak reached in 1996 (see figure). However, while prices for non-fuel primary commodities generally remained stable after a substantial decline recorded in 1998, the price of petroleum, which constitutes 42.3 per cent of the index, more than doubled, averaging US\$ 28 per barrel in 2000. This rise in the petroleum price and its impact was even more noticeable as petroleum prices had reached historical lows in 1998 of around US\$ 11 per barrel as the Asian economic crisis deepened, reducing the demand for oil, and production by members of the Organization of the Petroleum Exporting Countries (OPEC) exceeded targets. Oil prices again started weakening substantially in mid-2001 in the face of the global slowdown and a build-up in stocks of oil and oil products.

Indices of primary commodity prices, 1990-2001
(1990 = 100)



Source: Based on data from <http://www.imf.org/external/np/res/commmod/table1.pdf>

Note: Data for 2001 are averaged by first two quarters.

* Petroleum and non-fuel primary commodities index. The weights are 57.7 per cent for the index of non-fuel primary commodities prices and 42.3 per cent for the index of petroleum prices.

** Spot crude. Average of UK Brent, Dubai and West Texas Intermediate, equally weighted.

Crude oil prices rose by 13 per cent on 11 September 2001 after the terrorist attacks in the United States. This was followed by a more than 5 per cent jump on 14 September 2001 to reach nearly US\$ 30 per barrel over fears that oil supplies from the Middle East would be disrupted. However, as the threat to oil supplies receded, fears of a global recession reasserted themselves, and oil prices dropped to just above US\$ 20 by the end of September. Crude oil use in the United States fell by 930,000 barrels a day, or about 6 per cent, in mid-September as the economy stalled, according to the Energy Information Administration. The question remains whether the economic slide will continue, and if so, for how long and what its impact will be on oil prices.

^a Prepared by Hirohito Toda, Associate Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

OPEC collects pricing data on a basket of seven crude oils to monitor world oil market conditions. Under the informal price band mechanism adopted at its March 2000 meetings, OPEC basket prices higher than US\$ 28 per barrel or lower than US\$ 22 per barrel trigger production adjustments. Prices sustained above the price band's target range for 20 trading days are to result in a production increase of 500,000 barrels per day while prices below the target range for 10 trading days are to result in cuts of 500,000 barrels per day. Facing political constraints and economic uncertainty following the events in the United States, however, OPEC decided to hold to its current production level of 23.2 million barrels a day at its 117th ordinary meeting, held at Vienna on 26 September 2001, after three consecutive cuts in production earlier in the year totalling 3.5 million barrels per day. The decision by OPEC was widely expected, partly as a sign of solidarity with the United States, and also because any cuts in production to raise oil prices could accelerate the softening of economies worldwide and further diminish the demand for oil. Since high oil prices are thought to be a major brake on economic growth, a fall in prices below US\$ 20 a barrel could eventually help to lift the global economy out of its recession. (Some estimates suggest that a fall in the price of oil by US\$ 1 per barrel will put US\$ 28 billion back into the pockets of consumers.)^b These changes will have varying impacts on countries in the Asian and Pacific region, some of which are among the major oil exporters while others are significant importers of this commodity.

The current 11 OPEC members produce about 40 per cent of the world's oil and control more than 77 per cent of the world's proven oil reserves. OPEC also contains most of the world's excess oil production capacity and controls a significant portion of world oil trade. OPEC, especially its Persian Gulf members, has the world's lowest oil-finding and -lifting costs. Among regional ESCAP member countries, the Islamic Republic of Iran is an original member of OPEC while Indonesia joined in 1962.

Non-OPEC countries, including the Russian Federation and China, have been increasing their share of oil production steadily since 1993 but their output is especially susceptible to price collapses owing to relatively high production costs. The decrease in non-OPEC exploration and delays in new production activity after the 1998 price collapse partially explains the sharp increase in oil prices in 2000. Non-OPEC production is now expected to rise, with the greatest increases coming from Central Asian countries. However, many major non-OPEC oil producers, the Russian Federation and China among them, are also some of the largest consumers, resulting in very low exports. In the case of China, further imports to satisfy domestic consumption are required. Since the smaller reserves of non-OPEC countries are being depleted more rapidly, their overall reserves-to-production ratio is also much lower, at about 15 years as against 80 years for OPEC.

To stabilize prices effectively by reducing the supply of oil, OPEC would need to be able to enforce quota levels and address the current informal overproduction of oil estimated at 700,000 to 1.3 million barrels per day. As oil prices climbed throughout 2000, the lack of extra capacity at the well head (with the exception of Saudi Arabia) prevented producing countries from exceeding their official quotas. However, despite the quota reductions agreed earlier in the year and the decline in prices, the pace of production continued to remain high throughout mid-2001 as countries tried to profit from the relatively high price of around US\$ 25 a barrel. The Organization therefore turned to major producing countries outside its ranks to seek cooperation. However, with the exception of the Russian Federation, most non-OPEC countries already lack the capacity to increase production owing to stagnant exploration activity in the late 1990s.

Before the events of 11 September 2001, world oil demand was generally expected to grow by at least 1 million barrels per day. This estimate has been revised downwards. Jet fuel consumption in particular has been hard hit and Deutsche Bank has estimated that the fall in airline fuel requirements alone will reduce global demand by 300,000 barrels a day in the fourth quarter.^c Commercial stocks in industrialized countries were estimated to be at the upper end of their normal range in spring 2001 and have ballooned following the attacks. This has caused oil price futures to drop. A revival of economic growth during 2002 could put upward pressure on prices, and it is no secret that OPEC would like to see a stable price closer to US\$ 25 per barrel. Few Governments in Asia have oil stockpiles, which could be a matter of some concern should oil prices spike upwards again.

^b David Buchan, "Saudi Arabia oil chief puts stability first", *Financial Times*, 4 October 2001.

^c Lex column, *Financial Times*, 25 September 2001.

Foreign capital becomes more risk averse

Other than continuing stagnation of private capital flows, the global economic slowdown gave rise to reappraisals and repricing of financial risk and asset prices in a wide range of financial markets during the 12 months between mid-2000 and mid-2001. In contrast to 1998, when the fear of a global credit crunch was pervasive, very different market sentiments have prevailed in 2000-2001. The fear in the latter period is the impact on capital flows as a result of the speed of the slowdown first in the United States, the interrupted growth momentum in Japan, slower growth in the EU and then a slowdown in much of the ESCAP region. What is likely to happen to capital flows, especially corporate and sovereign equity and bond issues and bank loans as a result of these developments? These are not required for recovery per se but more for balance sheet restructuring.

In this regard, the growth slowdown is bound to impact negatively on both the ability of companies to raise capital in foreign capital markets and in being able to attract bank loans to the region. Private capital is likely to become risk-averse seeking more “safe haven” type outlets such as precious metals, Swiss franc-denominated assets and even cash for the foreseeable future. The implications of these phenomena for the ESCAP region are considered in the following paragraphs.

Stock markets turn bearish

One, the initial impact of a growth slowdown is normally felt by corporations in the form of lower demand for their output, lower production and lower profits. Lower profits then put pressure on share prices. The financial repercussions emanating from downward corporate earnings in 2001 would therefore automatically impact the capital markets adversely, as has already been observed in the United States and elsewhere. Additionally, since a portion of capital market activity is influenced by cross-border flows of funds there is the likelihood of significant fluctuations in and, eventual realignment of, the exchange rates of the world’s major traded currencies in the light of the global slowdown. These developments imply a very uncertain environment for investors.

Two, a further element of uncertainty lies in the possible large-scale repatriation of United States dollar-denominated assets from the United States by non-United States investors. Such instability will have a negative influence on cross-border flows with investors increasingly taking refuge in safe havens rather than in the ESCAP region.

Credit spreads widen

Three, equity prices have fallen steadily in 2001, especially those of high-tech company shares. The general deterioration in equity markets has been, in turn, compounded by economic and financial strains in Turkey and Argentina that have spilled over onto debt markets in other countries, causing interest rates to firm significantly in some cases. Indeed, for a variety of borrowers credit spreads have widened to their highest levels since the early 1990s⁷ and new issues, whether of equities or bonds, have dried up almost completely. Global equity and bond markets rebounded briefly in the early months of 2001 following monetary easing in the United States but fell back as the depth of the United States slowdown become more pronounced. The overall trend is clearly bearish though with occasional bouts of strength.

Exchange rates are more volatile

Four, the outlook for the next few months in the foreign exchange markets also remains very uncertain. The United States dollar remained strong on both a

⁷ *The Economist*, 22 September 2001.

multilateral and bilateral basis until the terrorist atrocities in September 2001. Apart from minor wobbles, its trade-weighted exchange rate had appreciated by about 5 per cent in the 12 months to September 2001 while that of the yen had weakened by about 12 per cent over the same period. The euro and pound sterling had remained broadly stable against the dollar while the Swiss franc had strengthened. Regional currencies have followed a roughly similar pattern. The Chinese yuan renminbi, Malaysian ringgit and Hong Kong dollar have fixed parities with the United States dollar and these have been maintained. Other currencies have, however, tended to weaken against the United States dollar as the prospects of the countries concerned have deteriorated. The weakening has, by and large, reflected their dependence on the United States economy or an indication of long-standing political problems, as in Indonesia and the Philippines.

ODA flows stagnant

Five, trends for ODA are more difficult to discern in that data for 2001 are not yet available. Up to the end of 2000, however, ODA was on a declining trend vis-à-vis 1999 with the largest falls registered in the category of multilateral non-concessional loans and IMF assistance. This was largely the result of the ending of IMF-led assistance to the crisis economies in the ESCAP region. These trends are likely to have been temporarily reversed in view of the large emergency financial packages arranged for Turkey and Brazil by IMF in 2001. On the whole, however, ODA is unlikely to rise except for emergencies, such as the one affecting Afghanistan and its neighbours, or for natural disasters. This has major implications for three important groups of ESCAP member countries, the least developed countries, the economies in transition and the Pacific island economies.

The challenges ahead: short-term issues

As discussed earlier, growth is expected to slow sharply in 2001 in a number of economies with the actual downturn depending upon their cyclical positions, precise level of vulnerability to external developments such as trade-to-GDP ratios and country-specific factors like political uncertainty and the pace of domestic reform. For 2002 additional uncertainties come into play in a sharper-than-expected downturn in the United States following the terrorist atrocities, a deeper recession in Japan and any associated periods of turmoil in exchange rates.

The principal policy issue for the next 12-18 months is therefore maintaining the momentum of growth in the face of an increasingly unfavourable external environment. This means sustaining growth without the stimulus provided by net exports as in 1999 and 2000 and much of 2001. In other words, it involves the creation of stronger domestic growth stimuli, through either fiscal or monetary measures or a combination of the two.

Higher state spending and macroeconomic prudence: squaring the circle

In the fiscal policy area an obvious concern is the fact that over the last few years the fiscal positions of a large number of economies in the region have become less healthy. Indeed, poor public finances have been a chronic problem in South Asia. However, in many countries the costs of banking sector restructuring – as yet incomplete in most countries hit by the 1997 crisis – and off-budget guarantees also need to be added to the overall fiscal bill. Rising public debt tends to put upward pressure on interest rates. Additionally, rising public debts eat into revenue in the form of servicing costs and thus reduce resources for other important needs, in particular social safety nets, social protection for the poor and other expenditures in social capital formation. (See chapter III on public debt management below.)

Until the picture is clearer, Governments should take measures, as appropriate, to preserve growth through countercyclical fiscal and monetary policies. This should be accompanied by measures to achieve a sustainable tax-to-GDP ratio over the medium term, although this would need to be carefully balanced between maintaining fiscal stimulus for growth in the short term while keeping a firm commitment to fiscal and overall macroeconomic prudence. In the short term, hence, there is not much scope for pump-priming via the budgetary route but some front-loading of expenditures will be necessary to counter the export slowdown (see box 2). Well-targeted State spending – with emphasis on quality rather than quantity – should be initiated, such as spending on infrastructure. Countries with high public debt could use monetary policy to stimulate activity in their respective economies.

An impending downturn is not the most propitious time for undertaking fiscal reform, but the experience of the last 2-3 years suggests that the overall impetus for reform tends to lose momentum when the bad times have gone or appear to be going away. Without reform, the succeeding upturn could well be less robust if the reform process has faltered in the interim.

It is essential therefore for Governments in the region to re-examine the priorities of both revenue raising and revenue expenditure from the standpoint of medium-term sustainability, with a view to avoiding in particular the debt trap in which the public debt begins to rise faster than revenues. The overall balance between direct and indirect taxes, involving trade-offs between efficiency in revenue raising and cross-sectoral equity, also has to be carefully considered.

Is privatization a viable option?

A much-discussed but still insufficiently implemented policy option in the above context is the privatization of State-owned enterprises. Most economies in the region still have large State-owned sectors, including the crisis economies. Indeed, the size of the State sector has actually risen in recent years in many Asian countries through the nationalization of insolvent financial institutions and provision of liquidity support to the financial system. Through a prudent programme of divestment, the State sector can be a significant source of revenue to the Government and be instrumental in reducing the level of public debt. In addition, by widening the availability of good-quality securities to investors privatization could lend support to domestic capital markets at a time when bearish sentiments are in the ascendancy.

Indeed, privatization could also assist in the deepening of financial markets in these countries by the securitization of corporate debt through the issue of bonds for shorter-term maturities at least, as has occurred in the Republic of Korea. Other areas requiring review are tax incentives or disincentives at the enterprise level, specifically for SMEs. Such policy actions often involve long lead times, for instance, the preparation of prospectuses, information memoranda and impact assessments of tax changes. It would be prudent to do this preliminary work now and be in a position to take advantage of the upturn in economic conditions without delay.

Need to preserve external balance and exchange rate stability

One of the striking features of recovery after the 1997 crisis was the huge turnaround in the external positions of several economies in the region. This was reflected in large improvements in the current account of their balance of payments. Prior to the crisis the current accounts of most economies were in substantial deficit and usable foreign exchange reserves were uncomfortably low, thus causing significant investor nervousness.

Box 2. Is a fiscal stimulus an effective option for countries in the region in the face of an economic downturn?^a

Following the financial crisis of 1997, many countries in the Asian and Pacific region turned to fiscal stimuli to offset falling demand. These countries are now faced with another downturn in economic activity due to the global slowdown aggravated by the terrorist attacks on the United States. In this note, the fiscal measures that have been introduced by some of these countries are compared and the room available to them for further action on this front is examined.

The provision of a fiscal stimulus to revitalize an economy is based on the Keynesian technique of pump priming. However, the world has changed since the 1930s and the behaviour of consumers and investors in response to such a stimulus is no longer easily predictable. The impact of fiscal action on economic growth will be conditioned by a number of factors, for example, demographic changes that influence savings and expectations formed in a globalized world. Moreover, it can be argued that the quality of the stimulus is more important than the quantity. Expenditures targeted to areas where the impact on consumption and investment is quickly realizable with higher multiplier effects, while at the same time maintaining progress towards the achievement of other development objectives, such as equity and price stability, are to be preferred. Fiscal stimuli which benefit the poor and low-income groups strengthen domestic backward linkages and contribute to economic growth. Similarly, stimuli aimed at increasing the knowledge base and technological capability will expand medium-term growth prospects. However, providing a fiscal stimulus is not without cost. A Government's ability to engage in non-inflationary deficit financing will be limited by its ability to borrow, and those Governments with high public debt ratios will have little room to manoeuvre.

The purpose of this note is to undertake a simple review of the budgets of four selected Asian countries – Thailand, Malaysia, the Republic of Korea, and Japan – that are pursuing well-publicized fiscal stimulus programmes. An analysis of economic linkages and possible impacts will be presented in the concluding section. Limitations on using fiscal stimuli for generating growth will also be discussed. A perspective on the fiscal situation of these countries before and after the 1997 crisis is given in the figure.

(a) Thailand: a pro-poor focus in the fiscal stimuli is expected to boost consumption of goods and services of domestic origin

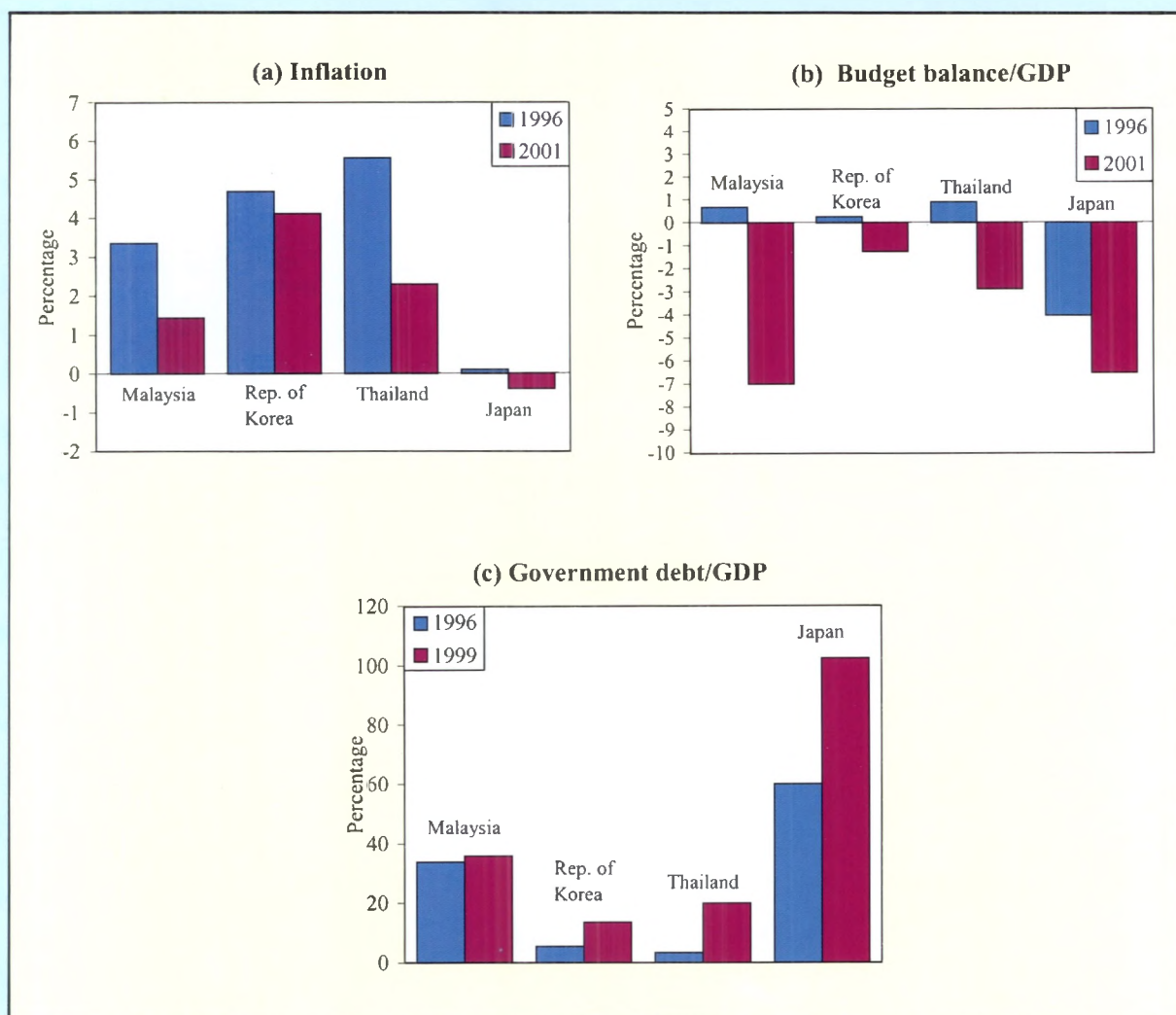
Thailand has adopted an expansionary fiscal policy for rejuvenating the economy since the 1997 crisis. This is reflected in the fact that the budget surpluses of the pre-1997 years turned to deficits subsequently. In the current year, several fiscal initiatives for enhancing domestic demand have assumed special significance in the wake of falling export demand. All these initiatives have the potential for generating substantial multiplier effects, which should contribute to the strengthening of economic growth in 2001 and 2002. One point can be noted here. A major part of the initiatives is for the benefit of the poor and low-income groups, either to increase their consumption of basic goods and services (for example, through the provision of low-cost health service) or to increase their investment (funds for local communities) or disposable income (suspension of farm debt of small farmers). These measures should lead to an increase in consumption expenditures of persons whose consumption basket contains more goods and services of domestic origin (unlike the rich, whose consumption leads to more imported goods and services) and thus contribute to economic growth.

(b) Malaysia: a pro-poor and pro-education emphasis can be observed in the fiscal measures

The Malaysian Government has also been using fiscal expansion aggressively since 1997 to improve economic growth, as indicated by the budget balance. In 2001 further fiscal measures, generally with a pro-poor focus, were introduced to meet some of the basic needs of low- and middle-class families (health facilities and low-cost housing for the poor) as well as to develop human resources (construction of schools, colleges and universities). Tax rebates also accrued to low- and middle-income groups. The current year necessitated additional measures for strengthening economic growth. Measures included enhancing construction activity (low-cost housing and educational institutions) and private consumption expenditures through a reduction in mandatory forced savings. Although the pro-poor emphasis continued, these additional measures also aimed at consumers across the board. Encouraging the use of credit cards by abolishing taxes on their use is an example.

^a Prepared by Hiren Sarkar, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

Inflation, budget balance and government debt in selected Asian economies



Sources: IMF, *International Financial Statistics* (Washington, DC, 2001), *World Economic Outlook* (Washington, DC, 2001), *Government Finance Statistics Yearbook 2000* (Washington, DC, 2000) and *Malaysia: Statistical Appendix*, IMF Staff Country Report No. 00/130 (Washington, DC, October 2000); ADB, *Key Indicators of Developing Asian and Pacific Countries 2001* (Oxford University Press, 2001) and *Asian Development Outlook 2001* (Oxford University Press, 2001); and EIU, *EIU Country Reports* (London), various issues.

Notes: Data for 2001 are estimates. Inflation refers to changes in the consumer price index. In case of Japan, budget balance/GDP refers to general government fiscal balance excluding social security transactions.

In October 2001, the Government reiterated its commitment to fighting the economic downturn and announced an expansionary budget, incorporating income tax cuts and increased spending. Taxes were cut by 1 to 2 per cent and various tax deductions or exemptions were introduced, aimed at stimulating businesses particularly in agriculture. The country's 850,000 civil servants will be awarded half a month's salary as a bonus, along with a salary increase of 10 per cent. The latter measures are expected to boost consumption immediately and so stimulate economic growth.

(c) Republic of Korea: fiscal stimuli have been directed towards building a knowledge-based competitive economy and reducing economic vulnerability

The major thrust of the expansionary fiscal policy in the Republic of Korea to counter the recent downturn has been to increase investment, including investment in human resources development, and reduce economic vulnerability. Increasing expenditure on education has been given priority. The generation of physical and human capital

in the information technology sector, as well as in biotechnology and environmentally “clean” production technology, has been the other objective of the fiscal expansion. The Government has been very proactive in promoting knowledge-based industries. Attempts have also been made directly to provide limited support to augment consumption of lower- and middle-income groups, and the Government also plans to boost consumption expenditure across the board by encouraging the use of credit cards.

(d) Japan: fiscal stimulus through a new taxation system includes support for research and development expenditures of small and medium enterprises, information technology and social welfare

Japan's economic difficulties and aggressive use of fiscal stimuli pre-date the 1997 crisis by many years. Currently, Japan is following a path of caution, which is understandable given the size of its fiscal deficit and its high level of public debt. For capping the issuance of new bonds, attempts are being made to reduce the budget deficit through controlling public expenditure. In contrast to the other countries, an emphasis on providing fiscal stimulus through tax breaks is evident. In this manner, the decision to expand demand is left to private investors and consumers. The incentives are expected to boost investment in priority areas (such as information technology) and social welfare (particularly the welfare of the aged). Government expenditure is, nevertheless, prioritized and an emphasis on education, science and social security is noticeable.

In response to the downgrading of the economic outlook after the events of 11 September, the Government of Japan plans to promulgate a supplementary budget, to be formally adopted in mid-November 2001, to revitalize the economy. It will include expenditure on job creation measures, financial assistance to the unemployed in job-training programmes and subsidies to companies hiring the unemployed. It is hoped that the frontal attack on unemployment will be effective in boosting consumer confidence and so contribute to economic growth.

Conclusion

In this review of a limited number of countries, it is still possible to identify several findings that have relevance to expansionary fiscal management during economic downturns in general. Fiscal stimuli can take two major forms – an increase in government expenditure to stimulate the economy directly or a tax cut to induce the private sector to invest or consume more. All the countries reviewed in this paper have used both modalities. The extent and purpose of use have, however, varied.

Government expenditure increases have been directed at improving access to basic needs (low-cost health services in Thailand, building of housing quarters in Malaysia), human resources development (setting up educational institutions in Malaysia), assisting investment by small and medium enterprises (Republic of Korea, Thailand) and encouraging physical and human capital development in future knowledge-based industries (information technology and biotechnology in the Republic of Korea). Such expenditures, in addition to generating current output and income also increase future growth potential. The latter objective has also been addressed through prioritizing (restructuring) government expenditure (as in Japan, where the increase in general government expenditure was minimal) in favour of science, information technology and so on. This could be considered as implicit stimulus to future growth.

Tax breaks, in the form of a reduction in rates, freezing of rates and various exemptions including increased depreciation allowances, were used extensively as fiscal stimuli. Two modalities can be identified. First, tax breaks have been used to boost consumption in general (freezing of value-added tax rates in Thailand, tax concessions on credit card use in the Republic of Korea and Malaysia). Second, tax concessions have been used to induce investment in socially desirable areas (increasing the depreciation allowance for new houses for the elderly in Japan) and in general industries including construction (increased tax credits to small and medium enterprises in Japan, extension of tax breaks on investment and reduction of taxes on new housing units in the Republic of Korea). Various types of forced savings and mandatory expenditure requirements have been eased to stimulate household expenditures. Suspension of farm debt (Thailand), reduction in employees' contributions to the provident fund (Malaysia) and freezing of health insurance premiums (Republic of Korea) are some examples.

One of the major issues associated with the use of fiscal stimuli is to ascertain the circumstances under which they can be used and the limits to their use. There are two major preconditions for using fiscal stimuli as instruments for generating growth. These are: the existence of economy-wide excess capacity and a sustainable level of public debt. The first ensures that inflationary pressures will be kept in check and the second that

financing the current budget deficit will not add to an unsustainable increase in “involuntary” expenditures in the form of future interest payments.

The rate of inflation, budget balance and the ratio of government debt to gross domestic product (GDP) are shown in the figure. Inflation in all four countries is currently low and has declined from 1996, signifying excess supply (capacity) under which a demand expansion can lead to real economic growth. Budget deficits have increased in all countries, markedly so in Malaysia and Japan. The ratio of government debt to GDP in 1999, although higher than in 1996, is still low, except for Japan. In Japan, the ratio is well above 100 per cent, and the option for generating economic growth by expanding fiscal stimuli is fast hitting the limit even though growth remains depressed.

Current account positions have been significantly strengthened in 1999 and 2000 with exports growing much faster than imports. The combined current account surpluses of the 10 largest developing economies of the ESCAP region as a whole improved from an average of 0.5 per cent of GDP in the period 1993-1998 to 4.1 per cent in 1999. With the help of large current account surpluses, short-term indebtedness was reduced, reserves were rebuilt, exchange rates were stabilized and interest rates came down, a process that played a major part in the recovery and growth of the region in 1999 and 2000.

The present growth slowdown has been driven by a marked reduction in the growth rate of exports. Import growth has also slowed but by less than the slowdown in exports. Current accounts surpluses have narrowed, from 4.1 per cent of GDP in 1999 to 2.9 per cent in 2000 and possibly further in 2001. Thus, while overall surplus positions have been maintained and short-term debts have been repaid, reserves have stopped growing. Interest rates have remained stable but the strain has, in part, been taken by exchange rate weakness. A moderate depreciation in the exchange rate is helpful to exporters and, by loosening monetary policy to some degree, is beneficial to growth. However, it tends to amplify the “flow-through” effect of higher prices of imported inputs, specifically oil. Hence, depreciation poses a threat, albeit modest at this stage, of some increase in inflationary pressures.

Taking the region as a whole, with two exceptions such as Indonesia and Turkey, inflation has remained benign by historical standards. The need to “fine-tune” monetary policy is obvious against this background but the real problem to be confronted is one of high interest margins, that is, the difference between saving and lending rates, rather than the level of interest rates per se. Here, financial sector reform is the main element as NPLs have caused interest margins to remain stubbornly wide.

Preserving the momentum of financial and corporate sector reform

An ongoing issue for the region remains the agenda of financial and corporate sector reform. This applies in virtually all economies of the region regardless of the level of development, with the possible exceptions of Hong Kong, China, and Singapore, and whether or not they were directly affected by the 1997 crisis. Over the last four years, the 1997 Asian crisis and ensuing contagion have provided graphic evidence of how problems in the financial and corporate sectors can multiply in an uncontrolled fashion with devastating macroeconomic effects. Some of these problems lie in individual institutions; others with market failures of different sorts and magnitudes caused by asymmetric flows of information to market participants. The latter pose system-wide risks with domestic parameters. Still others have their origins in the international financial system. The present slowdown has brought problems at all levels to the surface once more and will intensify them in the months ahead.

Addressing these problems is undoubtedly a daunting task requiring concerted action at many different levels. Apart from continuing improvements in oversight and supervision for sustained improvement in governance, further changes in the law and legal framework are needed as are improvements in the functioning of the court system and strengthening the effectiveness of regulatory institutions. Such improvements require financial resources as much as changes in the socio-economic milieu. Above all else, they require strong political will and some degree of consensus in society, a daunting agenda to implement for most developing country Governments, at least in the short term.

However, even when due regard is paid to all these difficulties, progress has been unreasonably slow. In the crisis economies Governments have often pinned their hopes, it would appear, on recovery as a substitute for cleaning up financial sector and corporate balance sheets and for generally pushing forward the process of reform. In the case of weak individual institutions, consolidation through merger without decisive action to clean up the balance sheet of the merged financial institutions, for example, has unfortunately implied maintenance of the status quo. The overall level of NPLs has continued broadly unchanged except for bookkeeping purposes. In this context, the performance of asset management corporations requires much more critical evaluation.

Notwithstanding an improvement in supervision and regulation and the institution of more transparent accounting standards, the perception is that in much of the ESCAP region banking and corporate governance continue to remain weak, with long-term profitability and asset quality still highly problematic and interest margins very high. It is a truism that healthy financial systems are a sine qua non of stable, broad-based recovery and essential for long-term growth in the region. The question, however, remains whether instituting ever-stricter capital adequacy standards is currently appropriate for the region or whether a looser regime, supported by more diligent supervision, might be preferable (see chapter VIII on the revised Basel Accord below). This is a difficult policy choice confronting financial sector regulators in the region.

Near-term challenges: managing globalization

The speed with which weakness in the United States economy has been transmitted to the rest of the world is a direct consequence of the integration in trade and finance that has been a hallmark of the process of globalization. There is broad agreement that the process has offered significant new opportunities to developing countries to integrate into the world trading system, have access to a bigger pool of international private capital and thus benefit from the technology, modern management practices and marketing know-how that this access facilitates.

At the same time it has posed substantial new challenges for many countries. The challenges have emanated from the fact that economic downturns or episodes of financial instability in one region, or even one country, have had immediate repercussions in other countries, magnifying the initial fall in demand or financial instability significantly. This was witnessed in 1997 and once again in 2001.

An examination of the 1997 crisis and the 2001 downturn suggests that apart from increasing the complexity of economic policy-making for Governments enormously, there is unmistakable evidence of the huge costs of globalization,

Globalization increases the complexity of policy-making and makes economies vulnerable to financial market contagion

via externally-induced macroeconomic and financial instability, for nearly all economies. Globalization has clearly increased the frequency and intensity of episodes of financial market instability and of financial market contagion. This applies to increased volatility in exchange rates and to fluctuations in stock markets that have, by and large, tended to occur independently of domestic developments.

Indeed, the fear of financial contagion is now all-pervasive in the minds of investors and policy makers, as events in Turkey and Argentina have so starkly demonstrated. No country can afford to regard itself as wholly immune from it. The management of globalization is thus a major challenge for many, if not all, developing economies regardless of their level of development and/or geographical location.

**Governments
should judge
their strengths
and weaknesses
realistically**

What are the policy options available to ESCAP developing countries? At a general level, it should be emphasized that globalization is an exogenous reality over which individual countries have little or no control. It is, however, interesting to note that France and Germany have taken a new interest in the Tobin tax as a means of reducing the volatility of international capital flows. Nevertheless, any attempt at insulation by an individual country, say, by introducing new tariff or other restrictions on trade and capital flows, is likely to be counterproductive. On the contrary, it is likely to increase the risk of retaliatory trade restrictions and possible exclusion from international financial markets. At the same time, in dealing with globalization, Governments clearly need to devise better policy responses that take more realistic account of their own unique circumstances. In other words, Governments need to be aware of both the strengths and weaknesses inherent in their own economies, in the institutional set-up and in the availability of human resources for policy implementation purposes.

In the realm of trade, as the slowdown through 2000 and 2001 amply demonstrates, over-dependence on particular markets and on a narrow range of export items has been shown to carry enormous downside risks and moving up the value chain is unlikely to offer much respite. Likewise, in the financial sector, the sequencing and speed of liberalization measures require special attention. Domestic banks have poor risk management capabilities and are, in general, under-capitalized. Regulatory and oversight functions are also fairly rudimentary. Liberalization measures should therefore not merely seek to implement an external blueprint but keep in view the financial, institutional and human resource capacities available in individual countries. In a period of turmoil, the option of capital controls as a temporary measure with a strict timetable for their removal could be useful in calming the situation.

**More regional
and subregional
cooperation
needed in trade
and financial
matters**

While externally induced fluctuations in capital markets and exchange rates have become a fact of life in the 1990s and little can be done to avoid them entirely, there nevertheless appears to be some justification in proposing that, in the area of financial contagion and external shocks, the coordination of policies and institutions between countries can be more effectively addressed at the regional than at the international level. This applies also to cooperation, through information sharing, in the crucial area of money laundering.

By and large, it seems inappropriate, at least from a practical point of view, to burden global institutions such as IMF or the World Bank with yet more mandates and responsibilities. Interest in the regional approach attracted

attention following the 1997 crisis based upon a perception that the advice and conditionality of IMF were not sensitive to the regional nuances of the crisis and may even have aggravated it to some extent. This perception gave rise to the proposal for an Asian monetary fund. Even though the Asian fund has not materialized, the Chiang Mai initiative of 2001⁸ can be seen as a response on how to deal with a new bout of financial market volatility through the regional provision of liquidity.

Exchange rate stability

In the same vein, tentative discussions on ensuring greater stability in exchange rates, specifically on the merits and demerits of a common currency peg system in the region along the lines of the European Exchange Rate Mechanism, are also a regional response to the dilemma of having to choose between fixed and floating exchange rates and to the policy complications created by the floating rate regimes that have come into vogue after 1997. There is a presumption that some ESCAP economies could avoid their current difficulties more successfully by establishing a common exchange rate peg and supporting it collectively with their considerable foreign exchange reserves. In Europe, this approach, as reflected in the European Monetary Union and euro, is now encouraging policy harmonization in other areas, an additional bonus. Above all, it has created a zone of financial stability within the euro zone. Some subregions within ESCAP certainly have the resources and institutional sophistication to make considerable progress in the area of exchange rate cooperation. In any event, there is a strong case for greater consultation between all countries on financial issues.

Regional trade agreements

In the area of trade, despite recent progress, countries of the region remain less keen to cooperate in a regional trading arrangement, since a significant proportion of their trade is with the United States. The position is, however, changing quickly. China, as it prepares for entry into WTO, has signified its interest in joining ASEAN in a free trade arrangement with tariff reductions to be achieved over a comparatively short period, i.e. 2003-2009. Other subregions could take similar initiatives. The Bangkok Agreement⁹ is available as an instrument to make an advance in this area. Both financial market and trade cooperation initiatives reflect a desire to regain the economic stability and vitality that characterized the region prior to 1997 and which globalization appears to have undermined. There is also an underlying fear that small economies on their own do not have the resources to cope with major global downturns and instability and risk being marginalized from the mainstream of global economic developments. This would apply particularly to the Pacific island economies and most of the least developed countries. Special measures are needed for these countries, such as duty-free access to developed country markets and increased ODA. The evidence is that well-directed aid, combined with strong domestic reform, can increase GDP growth, reduce poverty and mitigate the effects of crises such as terms-of-trade shocks.

Regional approaches thus offer a viable option for many countries by combining financial cooperation with preferential trade within the region to regain and sustain the momentum of growth lost in the 1997 crisis and likely to be lost again

⁸ Under the Chiang Mai initiative, ASEAN members plus China, Japan and the Republic of Korea have agreed to set up a swap facility to provide liquidity for mutual support in times of need.

⁹ The Bangkok Agreement aims at promoting intraregional trade within the ESCAP region through preferential tariff arrangements among member countries. Six countries, including China and India, have joined the Agreement thus far.

in 2001. There is, of course, no guarantee that regional arrangements are a recipe for long-term success. The regional approach nevertheless offers an important alternative for addressing the challenges of globalization that some countries are clearly finding is difficult to face on their own. While it is understood that the Governments will inevitably need to adjust policy parameters to function in a globalized economy implying a greater reliance on market mechanisms, this process should not be construed as an exclusion of all public sector initiatives and interventions. Cooperative arrangements and intervention are but two sides of the same coin. Indeed, a predictable framework for intervention would reduce uncertainty and allow markets to operate more efficiently.

A new development agenda for the WTO

Finally, at the WTO ministerial meeting in Qatar, delegations will need to consider dispassionately the reasons for the debacle at Seattle and what constitutes a balanced agenda of trade reform for the next few years. While a new round of negotiations is clearly a laudable aim, it would be appropriate to give simultaneous consideration to the faster implementation of agreements of the Uruguay Round. Multilateral cooperation through trade and investment creates mutually beneficial interdependence and trust and is therefore an essential building block for both economic well-being and world peace and security. This implies assisting developing countries in participating more effectively in the world trading system. In this connection, it is pertinent to note that roughly half the membership of ESCAP has still not acceded to WTO.

CHALLENGES FACING THE ESCAP REGION: STATEMENT BY THE EMINENT PERSONS GROUP

A Meeting of Eminent Persons on the Current and Prospective Economic Performance of the ESCAP Region in the light of the current economic slowdown and the impact of the terrorist attacks in the United States of America was held at ESCAP on 18 and 19 October 2001. The following statement was issued by the group on 22 October 2001.

The world economy, which was already showing signs of a significant slowdown in mid-2001, will experience an even sharper loss of momentum following the 11 September terrorist attacks in the United States of America. The current slowdown is the most synchronized among the major economies since the Second World War. The developed economies have taken some measures in the form of coordinated interest rate cuts to counter the slowdown and Japan, along with the United States, has announced new public spending to boost demand in the coming months. However, for Governments across the world, reviving business and household confidence and sustaining employment growth remain key considerations.

In the present climate of uncertainty, it is difficult to ascertain whether countries are facing a short-term cyclical and shock-related downturn, or whether the problem is of a longer-term structural nature. The answer to this question will affect policy choices. Whereas the 1997 financial crisis was limited to some emerging markets, though with wider knock-on effects and repercussions, the 2001 slowdown is a global phenomenon involving sharp reductions in export and GDP growth rates and is likely to affect much of the region through a deterioration in the balance of payments.

Major policy initiatives at the national, regional and international levels are required. Notwithstanding the huge diversity of ESCAP countries in geography, population size, levels of development and approaches to development, certain common problems are also present. In this connection, national Governments have a lead role to play.

At the national level

- It is essential that Governments should reiterate their commitment to addressing reform challenges, including those raised by the 1997 crisis.
- Despite the downturn, Governments should sustain the momentum in achieving greater equity and inclusion, which will promote social cohesion and signify progress in reaching the United Nations Millennium Declaration goals with regard to poverty eradication.
- Until the economic picture is clearer, Governments should take measures, as appropriate to their circumstances, to preserve the momentum of growth through countercyclical fiscal and monetary policies. Well-targeted State spending – with emphasis on quality rather than quantity – should be initiated, particularly with a view to fighting poverty. Increased public spending on

infrastructure, especially in rural areas, is a route that Governments could follow that would improve medium-term competitiveness. Countries with high public debt ratios may prefer to use monetary policy to stimulate private sector investment, for example in industries that have a substantial impact on employment. At the same time, sound medium-term fiscal management should not be unduly compromised.

- It is important that all countries avoid actions, such as protectionism, that would aggravate the risks of a contractionary spiral. Developed countries should accelerate compliance with their commitments on trade liberalization, especially in textiles and agricultural commodities.

At the regional level

- Greater regional cooperation offers a means for ESCAP economies to counter some aspects of the global downturn. The Asia-Pacific region should become a source of stimulus to offset the decline in demand from other regions. This would be facilitated by larger and more developed economies opening their markets unilaterally to the least developed and smaller economies in the region. The region should move forward with growth-enhancing trade agreements and trade facilitation measures.
- Pursuit of the agenda of reform of the financial architecture should continue with due speed in the region. In this connection, proposals for regional and subregional monetary cooperation arrangements should be revived and given serious consideration.
- There should be greater consultation between countries in the region on trade and financial issues. One matter that merits careful consideration is the role that the substantial international reserves, amounting to approximately US\$ 800 billion or almost half the world total, held by countries in the region could play in the present situation.

At the international level

- Specific steps should be taken to soften the effects of the impending global slowdown on the most vulnerable groups of countries. These are the least developed, small Pacific island and landlocked economies.
- It is vitally important that the principal donors enhance their ODA flows, which are currently only 0.22 per cent of the GNP of these countries.
- In this connection, IMF, the World Bank and the regional development banks should speed up disbursements while paying greater attention to a realistic assessment of the economic conditions of individual countries.
- The IMF Compensatory and Contingency Financing Facility used for dealing with commodities could usefully be extended to assist countries experiencing unexpected declines in services receipts, including tourism revenues, and greatly increased insurance and security costs.

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II. INFORMATION AND COMMUNICATIONS TECHNOLOGY AND DEVELOPMENT: AN INDIAN PERSPECTIVE

by Bibek Debroy¹

ICT is like Janus: it boosts exports, output and employment

Information and communications technology (ICT) in India is a bit like Janus. On the one hand, there are studies which estimate that India's exports of information technology (IT) products and services will shoot up to US\$ 50 billion in 2008, accounting for 30 per cent of total earnings from exports and 7.5 per cent of gross domestic product (GDP).² This is the face of Janus that encompasses the link in technology stock prices between the United States of America and India, talks of call centres and medical transcription services moving to India, wishes to tap the comparative advantage of 30 million Indians who possess a working knowledge of English and harps on the fact that 40 per cent of H1-B visas granted by the United States go to Indians.

India's challenge remains development: the other face of Janus

However, 30 million is only 3 per cent of India's population and there is another face of Janus as well. That is the development dimension. Despite over 50 years of planned development, India ranks 115th out of 162 countries on the human development index.³ The adult literacy rate used to be only 52 per cent and has now inched up to 65 per cent.⁴ The combined gross enrolment ratio at the primary, secondary and tertiary levels is only 56 per cent. Twenty-six per cent of the population is under the indigenous poverty line and 44 per cent is under the international poverty line of US\$ 1 per day.⁵ Fifty-three per cent of children under the age of five are underweight. Only 31 per cent of the population have access to sanitation and 35 per cent to essential drugs, while 12 per cent or more do not have access to safe drinking water. The infant mortality rate is stuck at 70 per thousand and refuses to decline further.

India is a large and heterogeneous country and these figures look worse if one brings in the regional and gender dimensions. The poor and backward states of India have conventionally been referred to as the BIMARU (Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh), a pun on the word *bimar*, which, in most Indian languages, means sick or ill. With a further division of states, Bihar now has Jharkhand, Madhya Pradesh now has Chhatisgarh and Uttar Pradesh now has Uttaranchal. After the 1991 reforms, disparities in growth across states have increased and will increase even further. In states like Gujarat and Maharashtra,

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² These figures are based on reports from the National Association of Software and Service Companies and McKinsey. Such figures have also been quoted in the United Nations Development Programme (UNDP), *Human Development Report 2001* (New York, UNDP, 2001).

³ That India has recently moved from the low human development category to the medium human development category is not terribly important, except as a minor signal.

⁴ These are Census figures.

⁵ Poverty figures can only be estimated once expenditure data are available. These are collected by the National Sample Survey (NSS) organization. Unfortunately, NSS collects data with large samples at infrequent intervals, 1993/94 and 1999/2000 being the two latest years. In between, there are the somewhat more unreliable thin samples. The 26 per cent figure is from the 1999/2000 NSS large sample.

for example, real domestic product has grown at rates of 8 per cent and more. So, despite a relatively high rate of population growth, these states have registered per capita income growth rates of 6 per cent and more and this has had beneficial effects on poverty and unemployment.

Among the BIMARU states, however, real domestic product has only grown at around 3 per cent in Bihar and Uttar Pradesh (as in Orissa, a non-BIMARU state). Meanwhile, a relatively high rate of population growth has contributed to per capita income growth rates of 1.0 to 1.5 per cent. As a result, there have been limited beneficial effects on poverty and unemployment. There are variations in literacy levels as well. According to the 2001 Census, Bihar has an overall literacy rate of 47.5 per cent, the only state with a rate below 50 per cent. To a large extent, the literacy problem is a female literacy problem and overall literacy will not improve until the female literacy rate improves. Even among the major states, female literacy is still remarkably low in Chhatisgarh, Andhra Pradesh, Orissa, Madhya Pradesh, Rajasthan, Uttar Pradesh, Jammu and Kashmir, Jharkhand and Bihar. In Jharkhand and Bihar, the figure is below 40 per cent. Figures from the Census for individual districts are not yet available, but when they are, there will be districts where the female literacy rate is below 10 per cent.

**Can ICT help
in meeting the
United Nations
Millennium
Declaration
goals on
development
and poverty
eradication?**

The point is a simple one. Does ICT help the cause of the poor and the deprived, especially in these backward states? Can ICT help in achieving the United Nations Millennium Declaration goals on development and poverty eradication? Will it help to halve the proportion of people living in extreme poverty or those suffering from hunger or those without access to safe water? Will it ensure that all children are enrolled in primary school? Will it empower women and eliminate gender disparities in education? Will it help to reduce maternal, infant and under-five mortality rates? Will it help to provide universal access to reproductive health services? Will it help to prevent infection from the human immunodeficiency virus or serve the cause of environmental protection?

The argument should not be advanced too strongly. ICT is only a tool; it cannot be expected to solve all the development problems of the world, problems that have plagued us for generations. However, these developmental objectives are certainly the yardsticks against which ICT needs to be evaluated. The point about a North-South digital divide, which is increasing, is often made and is valid. There is also a North-South divide of a different kind and that is the divide within India. Out of India's 1.4 million Internet connections, more than 1.3 million are in Delhi, Karnataka, Maharashtra and Tamil Nadu. Per thousand people, Maharashtra may have 43 telephone lines, but Orissa has only 9. It is thus not surprising that, although India has been classified as a dynamic adopter of IT, India's technology achievement index ranked it only 63rd out of 72 countries.⁶ After all, Bangalore is the only hub.

The Italian economist and sociologist Vilfredo Pareto (1848-1923) is now mostly remembered for a test he set out in welfare economics, the Pareto efficiency or Pareto optimality test. He also did some work on income distribution, the Pareto law, demonstrating a consistency in income and wealth distribution across history and across societies. Stated somewhat simplistically, Pareto found that regardless of the variable whose distribution was under

⁶ UNDP, *Human Development Report 2001* (New York, UNDP, 2001). Other than dynamic adopter, the other categories are leaders, potential leaders and marginalized.

examination, 80 per cent of the population obtained 20 per cent, while 20 per cent of the population obtained 80 per cent. This 80:20 distribution is the issue. We know what ICT offers to the 20 per cent. What does it offer the 80 per cent?

ICT is a powerful tool for removing information asymmetries

Conceptually, there ought to be no problem. Whichever form of deprivation one has in mind, in the final analysis it can always be reduced to an asymmetry in access to information. Had there been equal access to information, many of the problems of poverty and deprivation would have disappeared. ICT is essentially an information tool and, for the first time in the history of India's development since independence in 1947, we have an extremely powerful tool that can remove this asymmetry in access to information. Obvious instances of this are in sectors like health, education, public governance, empowerment, right to information and disintermediation of the agricultural distribution chain. The last is especially important for a country like India, where two thirds of the population is employed in the rural sector. Poverty in India is fundamentally a rural problem, urban poverty being largely a spillover of rural poverty. Rather paradoxically, India is also a country with one of the longest agricultural distribution chains in the world. For a typical agricultural product, the farmer will not obtain more than around US\$ 0.10 per kilogramme. Yet that same product will be sold to the retail consumer for US\$ 1.50 per kilogramme. While disintermediation is in any case desirable, ICT helps the process.

Examples of success with ICT: cyber-kiosks and e-governance

At an anecdotal level, there are success stories and it is worth mentioning a few. Dhar is a backward district in Madhya Pradesh state. A government-funded *Gyandoot* project was started for Dhar district, with cyber-kiosks or information centres (*soochanalays*) set up in rural villages under the control of local village bodies (*panchayats*) and networked to district headquarters.⁷ Villagers obtain access to information about crop prices through these information centres, and caste and land certificates can be produced. Grievances can be e-mailed to the administration. The kiosks are also used to impart education to schoolchildren and offer them career-related advice.

In Pondicherry, for example, the M.S. Swaminathan Foundation (based in Chennai) provides information through local centres on weather forecasts, tides, wind directions and heights of waves to coastal fishing villages. In Warana district in Maharashtra, information centres record transactions with sugar and milk cooperatives; they also provide information on harvesting times, expected yields and the results of crop sampling. In Thiruvavur in Tamil Nadu, e-governance has made the government delivery system more accountable. Old age pensions and records, land records, community, birth and death certificates have been computerized. These are now available more quickly, as are government loans, and the government is more responsive to complaints. As is inevitable, rent-seeking through middlemen has been weeded out. Such experiments have also taken place in Ratlam district in Madhya Pradesh, Hamirpur district in Himachal Pradesh, the Sonapat and Sirsa districts of Haryana and Kerala. There are also direct employment benefits that these information centres lead to.

Metaphors for India's development

The Confederation of Indian Industry and the Boston Consulting Group recently brought out a document depicting what India might be like in 2010, using four images as metaphors.⁸ The document has nothing to do with ICT, but the images

⁷ This project won the Stockholm Challenge Award.

⁸ "Scenarios for India 2010: putting it together again" (undated). The document can be downloaded at www.ciionline.org or www.bcg.com.

are useful. The first image is that of buffaloes wallowing. “The buffaloes continue to wallow in the swamp. It is time to move on. Who can goad them? The herdsboy yells to them that they will go hungry if they do not make a move. One or two attempt to get out of the water. But they are surrounded by others. So they give up.” The second image is that of wolves prowling. “The land has become a wild jungle. Bands of wolves roam. Small animals, and even big animals, live in fear of these marauding bands. Who can control them? Only the well muscled and armed tiger is safe.” The third image is that of birds scrambling. “Grain is strewn in the courtyard for the birds. They have been waiting for the food. They scramble for it. The pigeons flap their wings and push the smaller sparrows aside. The sparrows hop around the pigeons hoping they will get to eat also. The pigeons peck away at the grain with no concern for the sparrows. A peacock arrives and the pigeons also retreat. The food is over. The peacock and even the pigeons fly off contentedly. The sparrows have gone hungry. Maybe tomorrow they may have a chance.” Finally, there is the metaphor of fireflies arising. “At first, a few bright lights emerged from the darkness. Then many more. Soon the countryside is alight with dancing fireflies. It is wondrous to see how such tiny beings can transform the night. Where did they come from?”

But there have been some failures as well with ICT

One would like to think that what is happening in ICT in India represents the metaphor of the fireflies rising, but this would do violence to the truth. It is tempting to be optimistic, because there is hype about the successes. They tend to get talked about much more and attract media attention. However, there are failures as well. Just as the successes have lessons in terms of their possible replication elsewhere, so do the failures – hopefully, in their non-replication. Nyala village in Rajasthan, which was visited by President Bill Clinton, is an example of such a failure. This was supposed to be a model village, with e-learning and e-business. The United States Agency for International Development donated five Dell computers to the village, but they lie unused. Some of them have yet to be unpacked. It is because there are examples like Nyala that the metaphor of fireflies rising is inappropriate. Equally, the metaphors of buffaloes wallowing and wolves prowling are also inappropriate. What remains is that of the birds scrambling, and the challenge is to convert this metaphor into that of the fireflies.

The issues that shape the contours of this challenge are easily listed.

Issues in ICT success: electricity and infrastructure reform

First, there is the electricity issue. One reason why computers in Nyala lie unused is that the village gets only three hours of erratic electricity supply a day. ICT forms part of the broader issue of infrastructure and, at a sweeping level of generalization, infrastructure reforms in India have become stuck, barring the somewhat high profile area of telecommunications. The arguments for reform are well known. The present system of subsidies, through inappropriate user charges, makes both public and private investment unviable and, contrary to populist perceptions, does not benefit the poor at all. On average, transmission and distribution losses are around 25 per cent. These are State Electricity Board figures and they may be unreliable. Reforms in power distribution, such as those in Orissa, reveal that the losses are in excess of 45 per cent. In addition, the implicit cross-subsidy is also regressive. Unfortunately, despite this recognition, or perhaps because of it, reforms have become stuck. There are also transient problems of lack of reform in other infrastructure areas like telecommunications, where government monopolies and the lack of competition still continue in some areas. However, these are transient problems, because these monopolies are to end in the not-too-distant future.

Issues in ICT success: hardware and software

Second, there is the hardware-cum-software issue. The ICT infrastructure has to be installed in villages. Where is this hardware going to come from? Who will provide it? Usually, a lot is made of the hardware costs, but such costs are probably less significant than is commonly made out to be. For instance, a switch to Linux rather than Windows brings down hardware costs and old machines, which are often donated gratis, can be used. This is over and above the consideration that Linux makes the development of local language applications easier. Using Linux, the Indian Institute of Science in Bangalore has developed a handheld Internet appliance, known as the Simputer, which sells at less than one third the price of an entry-level Pentium III personal computer. Connectivity and bandwidth problems are also solvable. For instance, Wireless Local Loop technology can be used. Once the hardware is installed, software and applications have to be available in vernacular languages, so that users can identify and maximize the benefits associated with using ICT.

Issues in ICT success: government versus private delivery

Third, there is the question of who is going to do all this, the delivery issue. Understandably, there is a great deal of scepticism in India about centralized, government-administered delivery. Primary education is a good example. In 1951, India had a literacy rate of 18.3 per cent. As mentioned earlier, this figure had reached 52.2 per cent by 1991, an improvement of 34 per cent in 40 years, or less than 1 per cent per year. Between 1991 and 2001, when the literacy ratio was 65 per cent, there was an improvement of 1.3 per cent a year, something that had never happened before.⁹ How did this improvement come about? Historically, primary education was the responsibility of the Government. It was not the case that schools were not available. If one has in mind primary schools, there were very few homes that did not have schools within the range of one kilometre. It was not the case that children could not go to school because they had to work. At least at the primary level, there is very little evidence of work pulling children out of school. It was not the case that parents did not want their children to go to school. If returns on primary education are upwards of 20 per cent, as they are, no parent would want children to be out of school. The issue is related to quality, the quality of government schools and government schoolteachers. In fact, there is evidence to show that parents are willing to pay for education, if the quality is high enough.

The following story concerns a Mumbai slum. There is a government school in the slum and children do not attend school. This is not because they have to work. The government school functions in the mornings and, at 11 a.m., the municipal water supply arrives. Queuing up for water is important, since there will be no more water supplied during the course of the day. This is the sum total of the work that children have to do. The government school has been asked several times to switch to classes in the afternoon. Apparently, government rules prevent this. Along came a non-governmental organization (NGO) with a proposition. If it could use the government school's infrastructure in the afternoon, it would run a school then. Thankfully, the authorities agree and this school is now running famously. Free textbooks, obtained by enrolling in the government school, are used to study in the NGO-run school in the afternoon. There is also the true story of another NGO that runs schools for children on railway platforms. These children polish shoes when there is a train on the platform and school is dissolved for that period. Once the train leaves, the school functions again.

⁹ There are indeed people who argue that definitions of literacy do not capture much and have no functional tests. While true, the definition has not changed much, and an improvement is still an improvement.

The point, therefore, is the lack of flexibility and adaptability in government-run schools, even if children do actually work. Government schoolteachers are not always accountable to users, as the district headquarters pays salaries. If salaries are increased, that shows up as an increase in government expenditure on primary education. India spends around 3.5 per cent of the national income on education. This percentage can certainly be increased and obvious comparisons with expenditure on defence can be made. However, a more important point is that expenditure on education is inefficient. Almost all expenditure on primary education goes towards wages and salaries. There is almost no money for chalk, blackboards or textbooks. The Government has concentrated on increasing inputs into the education process through wages and salaries; limited attention has been focused on outcomes. The sharp increase in literacy between 1991 and 2001, noted earlier, was due to two primary reasons – greater NGO involvement and a decentralization of government functions, with greater accountability to users. The Education Guarantee Scheme in Maharashtra is an example of the latter. What is true of education is also true of anti-poverty programmes run by the Government. The public distribution system, which runs a system of ration shops ostensibly for the poor, is another example. There are substantial leakages and the proportion of spending that reaches target beneficiaries is comparatively small, often not more than 20 per cent of what is actually spent in the name of the poor.

Delinking government financing from government delivery

To get back to the point, it is understandable that the Government needs to finance and subsidize the ICT process. However, there is no reason to presume that if the Government finances a process, it necessarily has to run cyber-kiosks on its own. It is possible to delink the two functions. On financing itself, two questions arise. The combined fiscal deficit of the central and state governments is 10.4 per cent of GDP, the worst since reforms started in 1991.¹⁰ If one considers the central Government, three items of expenditure add up to more than total tax and non-tax revenues. These three items are interest payments, subsidies and defence expenditure.

As was mentioned earlier, the subsidies do not benefit the poor as much as they are intended to. The present subsidies amount to Rs 300 billion a year. If these were directly given as cash transfers to households below the poverty line, each household would receive around Rs 7,200 a year. The situation is no different at the level of the states. The trade-off is fairly striking. For the cost of running 1 government car, 10 village primary schools can be operated. Thus, the issue of subsidizing ICT is linked to the broader issue of reforming government expenditure, which is part and parcel of the reform process. Within education, there is also the question of what the Government decides to subsidize – primary or higher education. Unlike East Asia, India has subsidized higher education at the expense of primary education and economic wisdom now argues that this should not be done. However, had it not been for the earlier distorted policy of subsidizing higher education, the present software and H1-B boom would not have happened.¹¹

¹⁰ This figure refers to 1999/2000 and is from the Eleventh Finance Commission. It makes use of the old GDP series. If the new GDP series is used, the fiscal deficit drops to 9.84 per cent.

¹¹ There is the minor question of India suffering from a shortage of skilled human resources now, not only because of the exodus of software personnel, but also because teachers have increasingly begun to emigrate. Obviously, a tax on emigration or an H1-B type export quota is out of the question. This is yet another argument as to why higher education should not be subsidized, because those subsidies eventually benefit developed countries.

**Successful
implementation
will require local
“ownership”**

Hypothetically, it is possible to argue that the ICT boom can be engineered without government subsidies. Commercial streams of revenue can be used to cross-subsidize non-commercial activities like primary education or healthcare. Detailed data are not available. At the anecdotal level, none of the present private experiments suggest that this is plausible in the short run, since commercial revenue streams do not materialize immediately. Subsidization of capital costs is necessary even if current or revenue costs do not need subsidies, and projects can be deliberately designed so that they eventually become self-financing in operation. This is certainly true of rural areas, perhaps less so in urban areas. However, present anecdotal evidence also suggests that any attempt to push ICT in a top-down fashion is unlikely to be very fruitful. There has to be a sense of ownership created at the local level, through involvement of local NGOs, employment of local people to man the information centres and contributions from local bodies through land or housing. For example, a few of the successful information centres are run in village temples. To the extent that e-governance is an integral component, the right of citizens to information is also an issue and a few Indian states (Goa being the first) have enacted right-to-information acts.

**Educational
reform is needed
more than ever**

Finally, a comment on the education system is also in order. The knowledge-based economy of the twenty-first century, with its emphasis on intellectual property rights, requires innovation and invention, the ability to think and question, and the ability to take risks. Unfortunately, the entire Indian educational system, from kindergarten to university is designed to encourage conformity and thus innovation and creativity may become stifled in or through the process. It discourages failure and, hence, it also discourages success. This educational system was primarily designed to serve colonial rule and, as such, needs to be transformed. It has always needed transformation, but ICT imparts a greater urgency to the need.

In sum, from an Indian perspective, the ICT phenomenon can be interpreted as a paraphrasing of “www” as where, who and why. Where will it happen? In urban areas alone, or will the benefits trickle down? Who will do it, private initiatives or the Government, or a combination of the two? Finally, there is the why of the educational system itself.

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III. PUBLIC DEBT MANAGEMENT: A NEW PRIORITY

by Nihal Kappagoda¹

Changes in the international environment have increased the importance of public debt management

Public debt management² has become a priority for many Asian countries, which is a change from the early 1980s. When the debt crisis emerged in 1982, Governments that undertook debt management focused their attention on the control and recording of medium- and long-term external debt but paid little attention to short-term debt. Different institutions within Governments dealt with domestic and external loans. The management of domestic debt was handled separately and was not considered to be a priority. External and domestic debt obligations were consolidated only when government debt service payments were estimated for the budget and the payments accounted for audit purposes.

This approach changed in the 1990s, particularly during the latter half of the decade, as a result of several factors that altered the international environment. The volume and terms of private sector debt were subject to regulation under a regime of exchange controls. The major change that brought about the new approach to debt management was the liberalization of capital accounts in many developing countries. As liberalization was introduced, the control of private sector debt was replaced by a system of registration that was used mainly for monitoring purposes. Later, even this registration was dispensed with in the belief that the external borrowing of private sector firms was their responsibility. The institutional capacity required for monitoring the volume and maturity structure of the external obligations of a growing private sector was not available and had to be built up.³ Furthermore, with the removal of capital controls, the public and private sectors had a choice of raising financial resources from either the domestic or international capital markets provided that the former were adequately developed. These changes eliminated the distinction between domestic and external sovereign liabilities to a large extent and made the management of the total domestic and external debt of the public sector a priority.

Lessons from the Asian financial crisis for improving public debt management

The recent financial crisis in Asia raised the importance of contingent liabilities that Governments carry, which go beyond explicit guarantees provided (mainly to State enterprises and less often to private firms). Implicit guarantees covering a range of financial activities, such as non-guaranteed borrowings of State enterprises and the private sector brought about by government policies that encouraged the borrowing, have added a further dimension to the level of contingent liabilities. The payments that could arise from deposit insurance schemes of the central Government are also a potential burden. All these need to be estimated and the magnitudes monitored for sound macroeconomic management.

¹ Ottawa, Canada.

² There is some confusion about the definition of public debt in some debt management offices. The World Bank defines total public debt as being made up of public and publicly guaranteed debt. Fuller definitions can be found in World Bank, *Global Development Finance 2001* (Washington, DC, World Bank, 2001).

³ This can be done indirectly through reporting by the financial system to the monetary authorities, direct voluntary reporting by borrowers and partial or comprehensive surveys of borrowing firms.

External changes have made it necessary for Governments to assess and manage risks in their loan portfolios through the adoption of guidelines, targets or benchmarks. The growing volume of international capital flows arising from globalization has increased the vulnerability of economies that have liberalized their capital accounts. Consequently, periodic vulnerability and debt analyses, using selected indicators, to obtain early warnings of impending financial crises should be undertaken. In some countries, short-term debt has become a large component of total external debt outstanding, introducing the possibility of a rollover risk when the payments position deteriorates. Monitoring this has become more important than the import-cover ratio, which is more relevant for countries that have liberalized only their current account transactions. Public sector external debt is only a minor component of total external debt outstanding in many developing countries and should become even smaller over time. In view of this, debt managers should focus on private non-guaranteed external debt. As stated earlier, at best this debt can only be monitored in a liberalized economy. Consequently, sound macroeconomic policies are necessary to manage this debt.

Institutional arrangements need to be reviewed for better debt management

The changes in the international economic environment and the new requirements for debt management have made it necessary for countries to review their institutional arrangements. Developing countries that are liberalizing their capital accounts need to undertake these reviews as a matter of priority, noting that public debt management covers all the activities of a loan cycle as before. Nevertheless, the newly formed organizations need to develop a capacity for more sophisticated debt management owing to the greater complexity of loan portfolios covering both domestic and foreign loans, and for the use of more advanced techniques of debt management as well.

The functional organization for debt management that is emerging, mainly through the pressure being exerted by international financial institutions, is similar to that of an investment institution. While the offices responsible for debt management are structured in this manner, the three main operational units or divisions required to perform the full range of debt management functions are named differently depending on the needs of each country. These divisions should be responsible for: resource mobilization; borrowing policy and strategy; and loan operations and debt information systems.

The division responsible for resource mobilization should make the major decisions on foreign and domestic borrowing, based on an approved borrowing plan. It should also take responsibility for on-lending and guarantee operations of the Government as well as hedging and derivative transactions. The division responsible for borrowing policy and strategy should perform the analyses that support decision-making related to all public sector borrowing. It should develop a risk management strategy, undertake portfolio analyses, develop borrowing scenarios and compare the emerging debt indicators with agreed benchmarks. The division responsible for loan operations and debt information systems should make debt service payments based on creditor invoices that are cross-checked with its own database. It should also be responsible for the preparation of accounting and other reports required by creditors and the Government for various purposes, and for the management of the loan databases. Straddling all three divisions should be a legal group to support the borrowing, on-lending and guarantee operations of the public sector.

Many of the functions that should be performed by the divisions responsible for resource mobilization and loan operations and debt information systems are

currently undertaken by the agencies of Government dealing with foreign and domestic borrowing. The same is not true of the functions of the borrowing policy and strategy division. This division requires the development of a strong analytical capability for public debt management, which is currently inadequate in many developing economies. This is a long-term process requiring a combination of appropriate staffing, relevant technical assistance and on-the-job training.

The institutional framework for debt management should include a high-level committee to oversee and approve the broad parameters of loan operations of the public sector and provide guidelines for the private sector, some of which should be approved by the cabinet. The high-level committee should include a broad-based membership to provide technical direction to the debt management office and ensure transparency in making decisions.

A suggested framework for effective public debt management

1. Objectives should be clearly stated

There is no unique organizational and governance structure that can apply to public debt management offices in different countries. Nevertheless, there are some priorities that should be given consideration when establishing a framework for debt management.

Governments should set clear objectives for public debt management. In a survey conducted in 2000, members of the Organisation for Economic Cooperation and Development identified four overall policy objectives for debt management, which were to:

- ensure the financing needs of the Government;
- minimize borrowing costs;
- keep risks at an acceptable level;
- support the development of domestic markets.

While these objectives are appropriate for a developed country accessing international capital markets and having a well-developed domestic capital market, many developing countries will initially give priority to obtaining the financing needs of the public sector at low cost. As access to international capital markets increases, the objectives should also take account of the Government's risk preferences and tolerances. The push to strengthen and deepen domestic capital markets and develop secondary markets will take place with the liberalization of the capital account of the balance of payments and when borrowers begin to exercise a choice between the domestic and international capital markets.

2. Responsibilities should be unambiguously assigned

Governments should establish a clear legal framework for public debt management setting out in unambiguous terms the responsibilities of agencies authorized to borrow, issue guarantees and undertake financial transactions, such as on-lending, on behalf of the Government. The framework should give clear responsibility for debt management to one agency, where possible. If it is necessary for more agencies to be involved, the numbers should be kept to a minimum. The legal framework should also recognize the merger of the domestic and external borrowing operations of the public sector and the need to formulate annual and multi-year borrowing plans, based on the borrowing policy of the Government.

3. *Contingent liabilities should be fully declared*

Governments should ascertain the full extent of their contingent liabilities, disclose them and make adequate provision in the budget for likely losses. Debt management will be strengthened when it is supported by a policy where financial guarantees and on-lending are only used to finance projects and programmes that, in the long run, will generate income in excess of the borrowing costs. Governments should endeavour to share some of the credit risk with other market participants. Accordingly, the credit risk should be assessed and priced and factored into the determination of the guarantee fee and the terms of on-lending. These require the adoption of an explicit and transparent policy for the issue and management of government guarantees and on-lending by Government.

4. *Information systems specific to the task need to be developed*

There is a growing demand from public debt management offices for an integrated, user-friendly management information system. This will require the specification and development of new software or the customization of off-the-shelf software to the extent necessary. The experience of other debt management offices in developing their management information systems should be studied before embarking on major software developments which would be time-consuming and expensive.

5. *Macroeconomic policies and debt management need to be coordinated but responsibilities should remain separate*

There should be effective coordination of policy formulation among staff responsible for debt management and for the fiscal and monetary policies of the Government while maintaining separate responsibility for each of the activities. It will be difficult to implement the macroeconomic policies of the Government effectively without this separation and coordination. Borrowing policies should, for example, ensure the long-term sustainability of the fiscal deficit. At the same time, debt management policy should not become subordinate to monetary policy, as this may cause tension between the relevant agencies, making it less likely that debt management decisions will be based on sound portfolio management. In view of these considerations, the institutional arrangements should clarify the objectives of the Government in these three areas and separate accountability for each of them.

6. *Risk management guidelines should be in the public domain*

Governments should establish guidelines for managing risk in the loan portfolio that embody the strategy adopted by public debt management offices for achieving their stated objectives. In the interests of transparency and accountability, these guidelines should be in the public domain. Furthermore, Governments should publish their borrowing plans well in advance and remove distortions in the market to ensure equal treatment of different types of lenders.

Appropriate models should be used to quantify the costs and risks of alternative strategies adopted by the public debt management office to manage financial risk. Furthermore, a sound risk monitoring and control environment should exist in the debt office to reduce operational risk.

Are lessons from developed country experiences helpful to developing countries?

Lessons from countries that have established public debt management offices are useful only if they can be adapted to the environment in which institutional change is due to take place. Examples from developed countries are not strictly relevant to developing countries. One difference is that developed countries established public debt management offices at a time when capital controls had been abolished. Consequently, the regulatory environment was different. Another significant difference is in the type of finance that is sought by developed countries when compared with developing countries. The former borrow in the domestic or international capital markets primarily to finance the

budget deficit of the central Government and debt service payments falling due. State enterprises in these countries borrow directly in the market, though on occasion there may be a need for a government guarantee. In addition to financing budget deficits and debt service payments, developing countries need to borrow for projects and programmes of the central Government and State enterprises from the domestic and international capital markets, international financial institutions and foreign Governments. As a consequence, project and programme finance forms a significant component of the domestic and external loan portfolio of developing countries. This has to be taken into account in establishing a framework or structure for a public debt management office.

The danger of “elitism” in autonomous debt management offices

The models from developed countries show that debt offices enjoy varying degrees of autonomy and freedom of action from government control. The greater the autonomy, the more elitist the office becomes. One justification for flexibility is the ability to hire staff on terms and conditions that can compete in the marketplace when specialized financial skills are required. This is possible only when the legal structure is clearly defined in a manner that gives debt offices flexibility without being bound by the restrictions of government regulations. Another justification is that the use of risk management techniques is possible only when debt offices are able to function outside the government financial regulations, where risk-taking is not a normal activity for an employee.

The establishment of a public debt management office in a developing country involves the merger of the domestic and external borrowing operations of the public sector. In many cases, it is the merger of two working cultures with the latter being looked upon as elitist owing to the higher profile the staff enjoys vis-à-vis public and foreign agencies. This makes the process of institutional change, already fraught with difficulty, even more time-consuming. Furthermore, domestic borrowing operations are often perceived to be, and in fact are, routine. This situation arises when the staff has engaged in these activities for a long period of time, without any involvement in the efforts that need to be made to strengthen and deepen the domestic market and develop a secondary market. Such mergers also involve overlapping functions that have to be identified and eliminated. For example, the same item of information on aspects of loan operations is entered into more than one database.

The timing of the establishment of a public debt management office should be coordinated with the liberalization of the capital account. The need for such an office is greater once capital controls are removed and steps are being taken to develop the domestic debt market. It is difficult to see any advantage in the creation of the office preceding the removal of controls by a considerable period. It is better to spend time on adequate preparatory arrangements, even though these may be lengthy, given the complex nature of the institutional changes that the creation of such an office will involve.

Status of the public debt management office

The status of a public debt management office is important for it to be able to function effectively. While the establishment of an autonomous office functioning independently of the ministry of finance is an attractive idea, the need for it in a developing country is not overwhelming. The establishment of such an autonomous office, which will tend to become elitist, is not easy given that some of the functions of a public debt management office are being performed, to varying degrees of efficiency and effectiveness, by different agencies of the Government. This makes it necessary to examine the possibility of establishing the office within the ministry of finance.

The establishment of a public debt management office at the highest departmental level within the ministry of finance would be the most effective institutional arrangement. It would involve the amalgamation of the external borrowing, domestic borrowing, debt service payment, loan accounting, debt analysis and maintenance of loan databases functions that are currently undertaken by various departments and divisions of the ministry. One choice is to leave these functions where they are located and try to establish strong links from these sites to the division responsible for borrowing policy and strategy. At the same time, the management information system should link all the offices that perform debt management functions. The second choice is to amalgamate all the functions in one office and establish it in the ministry of finance and cope with the problems such a move would result in as they arise.

Public debt management offices in the Asia and Pacific region

Most Asian countries have to consider the dynamic of the relations between their ministries of finance and central banks in determining an appropriate location for a public debt management office. A decision can be based on the logic that responsibility for public debt management should rest with the ministry of finance given the legal position that the minister of finance is authorized to borrow and issue guarantees on behalf of the Government. An extension of this argument would suggest that the central bank should take explicit responsibility for monitoring the volume and maturity structure of a growing private sector. Such an arrangement would ensure that monetary policy and debt management policy are kept separate as required in the policy framework above. However, effective public debt management requires institutional capacity for analytical work on debt management. Often, this capacity is available in the central bank and not the ministry of finance. This necessitates some departure from the logic set out above to exploit institutional capability where it exists.

Thailand leads the way

Thailand was among the first of the countries in the region to establish a Public Debt Management Office after the financial crisis of 1997. It was done in 1999 by the merger of the division in the Fiscal Policy Office responsible for foreign borrowing of the Government and State enterprises (which are Government-guaranteed) and divisions in the Controller General's Department responsible for domestic borrowing of the public sector and government debt service payments. The new office is in the Ministry of Finance as are the two departments from which the functions were transferred. The Bank of Thailand continues to perform the agency function for public sector domestic borrowing by registering and issuing debt instruments to individual holders and making debt service payments. The Government is drafting a new law that reflects this change and the new priorities for public debt management. The organizational structure that is emerging for the Public Debt Management Office is similar to what has been proposed in this paper. This will be implemented when the status of the Office within the Ministry of Finance has been decided. In addition, the domestic bond market is being developed, as domestic borrowing has become the major component of public debt in the post-crisis period.

For the Republic of Korea, public debt management is a new area

Debt management activities in the Republic of Korea were fragmented in the pre-crisis period, as the budget was generally balanced. Responsibility for resource mobilization was with the Treasury, and the Bank of Korea performed the back office functions relating to loan operations. The analytical functions relating to debt management that were not done in the pre-1997 period have since been assigned to a Government Debt Management Team pending a decision on an appropriate public debt management structure which would involve

the Ministries of the Economy, Finance, and Planning and Budget, and the Bank of Korea.

Indonesia has a long way to go

At the time of the financial crisis, Indonesia had only partial information about its debt service obligations and the risks arising from contingent liabilities.⁴ Furthermore, responsibility for debt management was divided among several directorates in the Bank of Indonesia and the Ministry of Finance. This made it difficult to undertake any comprehensive debt analyses. The situation led to the establishment of a government debt management office in the Ministry of Finance. Considerable work needs to be done on the institutional and regulatory aspects to meet the new priorities for public debt management.

The countries most seriously affected by the financial crisis had liberalized their capital accounts before 1997. They did not roll back these decisions in the aftermath of the crisis. However, the countries of South Asia had not liberalized their capital accounts; some like India had begun planning to, but had to suspend their timetables in the post-crisis period. India began considering the need for a public debt management office in 2000. Attention was focused on building up institutional capability for debt analysis for effective public debt management and an appropriate institutional structure for it in the public sector. Sri Lanka too has begun preliminary consideration of the issues.

The way forward

This paper has dealt briefly with the issues that are important for public debt management, as the intention is to sensitize readers to their importance. The way forward for each country is to begin with an assessment of its public debt management needs. Based on this assessment, a programme of action for strengthening capacity in debt management could be formulated. There may be a need for technical assistance depending on the institutional structure adopted and the availability of staff.

⁴ World Bank, *Indonesia: Managing Government Debt and its Risks* (Washington, DC, World Bank, 2000).

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IV. WTO AND DEVELOPING COUNTRIES: REGIONAL PERSPECTIVES ON FUTURE TRADE NEGOTIATIONS¹

**Addressing
poverty through
trade liberalization
and increased flows
of high-quality
investment**

A sense of harsh reality pervades preparations for the Fourth World Trade Organization (WTO) Ministerial Conference to be held at Doha, Qatar, from 9 to 13 November 2001, as the world grapples with the aftermath of the 11 September 2001 attacks. In a climate of great political uncertainty and economic slowdown, some countries may be tempted to turn defensive and erect protectionist barriers. Yet there could not be a more critical time to ensure that the openness of the world trading system is safeguarded and promoted. That international trade and open economies have played a crucial role in alleviating poverty and increasing the welfare of millions of people, there is no doubt. However, the role of trade goes beyond economic efficiency to encompass political ideals based on greater understanding and mutual trust, respect for diversity and civic freedoms. Multilateral cooperation in trade is therefore an essential building-block for both economic well-being and peaceful relations or, in the words of the European Union Trade Commissioner, "Trade is a weapon of peace". Consequently, a strong, rules-based and open world trading system is crucial to the future progress of the ESCAP region. The mistakes of Seattle must not be repeated.

All countries have a responsibility to seek ways in which poverty in developing countries can be addressed through trade liberalization and increased flows of high-quality investments. Now more than ever before, developed countries must ensure that the requests and concerns of developing countries are built into the final outcome of the Doha Conference. It should be an outcome that guarantees that each and every one of the 142 member countries of WTO can gain something. Even Solomon Islands, tiny specks in the vast Pacific Ocean, should be able to gain something from the multilateral trading system, the principles and rules of trade embodied in it and a successful outcome to the Conference.

At the end of September 2001, ESCAP brought together ministers and other senior-level trade officials from more than 30 member countries to share experiences and views in a common regional forum that was neither a negotiating nor a pre-negotiating forum. This open forum, combined with the rich and varied membership of ESCAP, proved to be a useful opportunity for Governments to engage in an open dialogue and exchange experiences on issues of concern and common interest prior to the WTO Conference. The highlights are discussed below.

**Concerns of
the developing
countries in the
run-up to Doha**

Trade negotiations in future should take into account the implementation capacity of developing countries more fully. As membership of WTO expands to over 142 countries – compared to the 23 members that participated in the first round held in 1947 – trade negotiations should be conducted in a manner that goes beyond legal aspects to encompass differences in levels of development and economic structure among the membership. For example, developing

¹ Prepared by Tiziana Bonapace, Economic Affairs Officer, Trade Policy Section, International Trade and Industry Division, ESCAP. This article was submitted for printing before the Doha Conference.

countries need substantial technical and financial capacity-building assistance in implementation, and for this assistance to be given a chance to work, flexibility in extending Uruguay Round deadlines is important.

Implementation issues require immediate action

Action on the implementation issue has become a crucial element in the run-up to Doha. A number of developing countries continue to insist that such action is a prerequisite to their agreement to enter into a new round of multilateral trade negotiations because these are unresolved obstacles that undermine the spirit of Uruguay Round disciplines and the efficient functioning of the trading system. Implementation issues thus belong to the traditional trade agenda and require immediate action in the framework of ongoing WTO negotiations. However, developed countries have adopted the position that most of the implementation proposals would involve changes in the text of WTO agreements and in their national legislation, and thus would require new negotiations within a comprehensive round.

Working towards compromise solutions

In the run-up to the Doha Conference, the Chairman of the WTO General Council together with the Director-General of WTO and a group of developed and developing countries have worked towards obtaining a compromise solution. Various types of issues have been identified, including ones on which early agreement can be reached, ones that have been solved or appear to be relatively less urgent, ones that should be referred to subsidiary bodies of WTO for consideration and action and other pending issues. The top priority for most ESCAP developing countries remains the need for changes to anti-dumping rules, trade-related aspects of intellectual property rights, trade-related investment measures (TRIMs) and removal of restrictions on textiles, including the need for tariff cuts. Since then, progress has been made on some issues, notably the extension of the transitional period for TRIMs notified under article 5:1 of the Agreement and the improved provision of food aid and technical and financial assistance for improving agricultural productivity and infrastructure in the least developed and the net food-importing developing countries.

The danger of using trade policies to achieve social and environmental objectives

Another area of deep concern to some developed countries and all developing countries is the effort by some of the former to introduce into the multilateral trading system environmental and labour standards. Trade policies are poor instruments for achieving social and environmental objectives. Furthermore, devising trade rules in these areas is likely to serve protectionist forces in a manner that would change the open-trade orientation of WTO – an orientation that has served developing countries well and that should be safeguarded at all cost. Indeed, trying to achieve environmental and social objectives through trade policy would reduce world trade and economic growth, hurting both developed and developing countries and reducing their ability to achieve social and environmental protection.

Identifying common interests

As globalization and interdependence among developed and developing countries deepen, traditional North-South antagonisms, frequently encountered in the 1960s and 1970s, are giving way to a growing diversity of common interests, in which there is scope for win-win outcomes. Manufactures and services present two examples.

Both developed and developing countries stand to gain from further tariff reductions

The share of manufactures in the exports of developing countries is now very large, having risen from around 30 per cent in the 1980s to around 70 per cent at present. Furthermore, about 40 per cent of developing countries' exports of manufactures go to other developing countries. Tariff barriers against imports of manufactures by developing countries are now, on average, much higher than those imposed by developed countries. Developing countries could gain from reducing the high tariffs they impose on imports from other developing countries, for example, on components used in the automobile sector. Likewise, developing countries could gain significantly if developed countries were to reduce tariff barriers they impose against those very products in which developing countries have a comparative advantage, and deal with the problems of tariff peaks and tariff escalation. Footwear, garments and fruit juices are a few of the most striking examples. Overall, therefore, despite the significant tariff reductions that eight rounds of tariff negotiations have brought about, there remains considerable scope for further most-favoured-nation tariff reduction concessions to be exchanged among developed countries and developing countries.

Liberalization of services is a promising area for developing countries

It is, however, in the services sector where developing countries could gain significantly from liberalization. By introducing competition in the services sector, particularly in infrastructure services, the quality and efficiency of services will improve and thus enhance domestic supply capacity and export competitiveness. Furthermore, it might be possible to achieve a reasonable balance in the exchange of concessions between developing countries and developed countries in ongoing General Agreement on Trade in Services 2000 negotiations and to rectify some of the imbalance of the Uruguay Round results. Particularly in mode 4 (movement of natural persons), developing countries should negotiate sector-specific commitments in addition to horizontal commitments on intra-corporate transferees and business visitors. This has to be supplemented by improvements in rules and regulations on visas and work permits, standards and qualifications, licensing and mutual recognition agreements. It is also in developing countries' interests to negotiate significant commitments under mode 1 (cross-border supply) as several of them have a competitive advantage in information- and knowledge-intensive sectors. Overall, therefore, developing countries could gain from increased market access in export sectors such as tourism, professional services and maritime, air transport and energy services, while bolder liberalization of their own domestic service sectors could enhance their overall export competitiveness.

Achieving results by focusing on the common interests of developing countries

To achieve results in negotiations, developing countries need to consider their negotiating strategies carefully. Developing countries now make up about three quarters of the membership of WTO. This, combined with the influential role which China is expected to play as the world's eighth largest trading country, will open up greater opportunities to identify their common interests and put forward their own WTO proposals in a proactive manner. However, if this opportunity is to be seized, common interests need to take precedence over narrowly-focused national interests, which in the past have resulted in weak and divided negotiating positions among developing countries.

Linkages between liberalization and development need to be strengthened

If entire societies of peoples living in developing countries are to be convinced of the WTO process and the benefits it can bring, it is important to strengthen the linkages between liberalization and development. One of the most difficult types of reform to implement is trade liberalization. It is particularly difficult because the adjustment costs that come with it are immediate, they are intense and they are usually localized. For example, once a tariff reduction in a particular industry takes effect, unemployment and asset depreciation are immediately experienced. However, the benefits emanating from trade reform are long-term, they are spread out across more than one sector and they are often difficult to trace back to the initial trade policy reform. For example, often it will not be realized that a country's newly acquired export competitiveness in a particular sector is the result of tariff reductions on an input sector implemented perhaps a decade back.

Educating the public is key

Education of the public at large is an important element of this process. People across a broad section of society need to be made aware of the adjustment costs that trade liberalization will bring and the lags in the supply response. There should be open discussion and consultations with different domestic interest groups of the measures that could be taken to alleviate the adjustment difficulties. Otherwise, disappointment at not seeing immediate results may cause the reforms to be abandoned. Worse, other complementary reforms, for example, in land ownership, or in infrastructure development, may not follow. A foreign investor would not want to invest in a country that has a liberal foreign investment law, but a deficient financial or transport system. Trade liberalization has to be integrated into a country's overall development strategy. Taken as part of an integrated development process, people will see the long-term benefits and support the reforms. Furthermore, WTO liberalization will be seen as a means of "locking in" economic reform packages, rather than as a venue for negotiating trade agreements and imposing trade liberalization in a top-down process.

Strength in numbers

At the regional level, there is scope for countries to band together. The ESCAP region with its richly diverse membership offers opportunities for alliances or negotiating groups to be forged across a wide diversity of countries, but centred and united around a common negotiating interest or a common export product. For small countries there may be a distinct advantage in combining with other countries. Acting individually, their limited market access offers invariably place them in a weak position to attract significant concessions from other more powerful countries. However, by combining with other countries, they are in a position to get noticed and extract more useful concessions from more powerful players. During the Uruguay Round (and the Tokyo Round) perhaps the best example of such an influential alliance was the Cairns Group, consisting of both developed countries and developing countries. In the services sector, as well, there could be untapped opportunities in certain sectors such as construction, travel and tourism or professional services, to mention but a few. Furthermore, only half of ESCAP developing members are WTO members. Thirteen countries are in the process of accession, and many of these countries have experienced significant difficulties in this process. Of even more concern is the fact that six of these countries are least developed countries, accounting for a miniscule share of world trade. WTO membership is a precondition for more meaningful participation by the least developed countries in the world economy. A number of the ESCAP secretariat's ongoing activities are therefore focused on assisting countries in their accession process, and in this area as well, an

Making WTO truly universal

ESCAP network or an alliance of member countries could be envisaged to facilitate accession to WTO.

The confluence of economic growth and political events of the past few years bring to the fore unprecedented challenges to the international trading system: how can the reach of WTO be extended geographically to make it a truly universal trading system while ensuring that it remains effective for the orderly conduct of trade and economic cooperation among all countries?

ESCAP, as the regionwide cooperative mechanism of eminence – by providing opportunities for closer communications and consultations among Governments – can promote understanding and agreements on key issues and thus facilitate a more equitable integration of developing countries into the multilateral trading system. A well-functioning multilateral trading system is crucial for the long-term prosperity of the region and peace in the world.

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V. PACIFIC ISLAND ECONOMIES: RECENT ECONOMIC GROWTH EXPERIENCE

by *Te'o I.J. Fairbairn*¹

Modest economic growth performance may reflect a poor policy milieu

As in other developing regions, the small island countries of the South Pacific generally recognize the importance of economic growth as a basis for improving living standards and achieving other valued development objectives. Yet, from the available evidence, it is apparent that, with one or two possible exceptions, Pacific island countries have not been successful in attaining high rates of growth. The actual record has been one of low to modest growth, which, in some cases, has resulted in a significant decline in per capita income and, in turn, living standards and human welfare. For these small countries, a key challenge is to improve significantly upon past performance, above all by establishing a favourable policy milieu for fostering growth and stability. In this, Pacific island countries need to give particular attention to ensuring good governance, law and order, macroeconomic stability and a commitment to structural reforms so vital for promoting efficiency and growth.

This paper is concerned with the recent record of economic growth achieved by a number of Pacific island countries, based on available data on gross domestic product (GDP) and related studies.² The growth performance of individual countries is considered, highlighting the main sources of growth along with the major constraints. The paper then attempts to draw a few lessons from this experience and offers suggestions on policy initiatives that Pacific island countries need to pursue in order to improve their economic performance.

Pacific island countries face many obstacles to sustainable growth

Developing Pacific island countries face many daunting problems in the quest for economic growth and sustainability. These include the physical disadvantages of remoteness, smallness and dispersion, factors that significantly raise transport and other development costs and limit opportunities for realizing economies of scale (and externalities). In many cases, too, rapid population growth exerts pressure on scarce resources and frustrates efforts to raise living standards. Severe shortages of professional and technical skills, paucity of domestic savings and vulnerability to external shocks pose further constraints. The development predicament of the very small coral atolls, such as Kiribati and Tuvalu, is particularly difficult.

Other problems arise from an increasingly chilly international economic environment, creating much uncertainty for the Pacific island countries. The current worldwide slow-down in growth and trade combined with a more competitive global trading environment is likely to further weaken the demand for the region's exports and undermine foreign exchange earnings. The progressive erosion of various preferential trading arrangements, including those

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² The present discussion focuses on the growth experience of the smaller Pacific island countries, including Fiji, Kiribati, Samoa, Solomon Islands and Vanuatu, which are members of the Asian Development Bank (ADB) and a number of other international development organizations. This choice has been partly dictated by the availability of reasonably up-to-date data on measured GDP. Unless otherwise indicated, values are expressed in Australian dollars (at an exchange rate of \$A 1 = US\$ 0.51).

with Australia and New Zealand, is also threatening trading opportunities, while declining aid flows are of further concern. In some cases, traditional outlets for migrants have been tightened, thereby restricting overseas migrations.

However, the development of natural resources may be the way forward

For most, if not all, Pacific island countries, the further development of their natural resource bases – both land and marine – is looked upon as providing the most promising and sustainable basis for achieving their growth objectives. In agriculture, a major potential lies in the production of a variety of commercial crops for export as well as a wide range of high-value crops geared to overseas niche markets. Fishery and tourism and, in the case of the larger Pacific island countries, forestry, offer major opportunities. In some cases, the processing of raw materials and export-oriented manufacturing can also make useful contributions to growth. For the small coral atoll countries, the main potential would appear to be a more intensive exploitation of marine resources, since agricultural development is severely limited by the paucity of arable land.

The potential for sustainable growth in the Pacific island countries has been the subject of investigation by the World Bank and other international organizations. A study by the World Bank some years ago suggests that, given the development potential of existing natural resources and provided that a favourable policy climate can be put in place, Pacific island countries can achieve annual growth rates of over 3 per cent over the medium term.³

Economic growth leaves much to be desired

In general, Pacific island countries suffer from a paucity of national income data, but from the available evidence, it is apparent that GDP growth over the recent period has been modest and, in some cases, quite poor (see table). The overall growth rate for these countries, which is heavily influenced by Fiji's 60 per cent share of national income, averaged 2.3 per cent per annum over the period, roughly equal to population growth. Samoa has been the best-performing economy, achieving consistent and healthy growth since 1995. Several other countries, including Fiji and Solomon Islands, performed well for a certain period but were unable to sustain the momentum. The sluggish performance of a number of Pacific island countries over the last few years, marked by negative growth, is also notable.

A further point concerns the record of per capita income, the assessment of which must take into account significant differences in rates of population growth among Pacific island countries (low in Tonga and Samoa but high in Solomon Islands and Kiribati). Allowing for population growth, at least two countries recorded falling per capita income, suggesting an extensive period of declining living standards and impoverishment. Over the period, per capita income grew at 2.9 per cent per annum in Samoa, the best performance of the countries under review.

Fiji has been hit by economic and political crises

As to the performance of individual countries, Fiji performed reasonably well until 1996 but indifferently thereafter. The earlier growth was underpinned by agriculture, dominated by a significant expansion in sugar production, as well as tourism and garment exports. The decline that followed (1997–1998) can largely be attributed to a slump in agriculture as a result of internal and external shocks. Both tourism and garments suffered from a loss in competitiveness arising from

³ World Bank, *Pacific Island Economies: Building a Resilient Economic Base for the Twenty-first Century* (Washington, DC, World Bank, 1995).

Table. Economic growth in selected Pacific island countries, 1992-2000

(Percentage)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Average annual growth	
											GDP	GDP per capita
Fiji	4.9	2.2	3.9	2.1	3.1	-1.8	-1.3	7.8	..	..	2.2	1.1
Kiribati	-4.6	1.0	1.7	3.2	1.9	3.0	8.3	1.5	-1.7	1.5*	2.3	0.4
Samoa	-1.2	4.1	-6.5	9.6	5.9	2.5	2.6	5.2	6.7	..	3.6	2.9
Solomon Islands	9.5	2.0	5.2	7.0	3.5	-1.0	-2.2	1.0	3.5*	..	2.1	-1.1
Tonga	0.3	3.8	5.9	2.3	-0.4	-1.6	0.1	2.2	6.1	..	2.2	1.3
Tuvalu	..	..	..	..	..	3.0	14.9	3.0	..	..	..	..
Vanuatu	-0.7	4.4	2.6	3.0	3.0	1.0	0.2	-2.0	..	..	1.7	-0.7
Region											2.3	

Source: South Pacific Forum Secretariat, "Economic vulnerability of small islands", *Trends and Developments* (Suva, South Pacific Forum Secretariat, 1998), pp. 11-17 and "Asian Development Outlook 2000 - the Pacific", *Trends and Developments*, 2000, p. 7. The figures are based on ADB and national sources.

Notes: .. = not available; * = estimate.

currency realignments in the wake of the 1997 Asian financial crisis. The continued decline in the investment rate has been a further depressive factor.

A recovery in agriculture, tourism and several other exports contributed to the sharp rise in GDP in 1999. For 2000, however, growth is expected to be negative, following a political coup that gave rise to law and order problems, overall political uncertainty and loss of investor confidence. The economic consequences have been palpable - serious macroeconomic imbalances, a sharp fall in investment, disruption to key industries including tourism and a flight of capital and skills overseas.

Provided that political stability can be restored, Fiji is in a good position to resume a pattern of healthy growth. Over time, Fiji has been markedly successful in establishing policy and institutional mechanisms for promoting macroeconomic stability, advancing the process of microstructural reforms, diversifying its economic base and coping with external shocks (including natural hazards). Other than resolving political issues, key challenges include pressing ahead with structural reforms, restoring macroeconomic stability and boosting private sector investment. Resolving the controversy over land leases is a further key issue.⁴

**Kiribati
(and Tuvalu):
coral atolls
are particularly
fragile
economically**

Economic growth was modest over the last decade in Kiribati, averaging around 2.3 per cent per annum, which amounts to a slight increase in per capita income. The generally sluggish performance is hardly surprising for, as a small coral atoll, Kiribati faces powerful constraints to economic sustainability and meeting the material and social demands of a rapidly growing population. Such constraints stem, above all, from a slender resource base and a tiny and highly fragmented domestic market.

⁴ A. Gani, "Some dimensions of Fiji's recent emigration", *Pacific Economic Bulletin*, vol. 15 (1): 19-43.

Kiribati's performance can be improved significantly by persevering with efforts to make more effective use of public sector resources and to develop marine resources (fish and seaweed) further. A policy of fiscal prudence over time has made for a generally sound macroeconomic setting, but Kiribati lags in tackling vital structural changes capable of boosting efficiency and growth. In relation to public sector reform, key challenges include downsizing the public service (including the numerous State-owned enterprises), which currently accounts for 80 per cent of total paid employment in the country, and privatization or commercialization of selected State-owned operations. Greater efforts to foster local entrepreneurship in small business and tourism are also needed.

In the face of economic fragility, Kiribati has attempted – with a fair measure of success – to develop alternative sources of income. Apart from the sale of fishing licences, other major earnings sources include remittances from migrant workers on foreign shipping and earnings from a trust fund (currently valued at over \$A 600 million). These flows, together with substantial receipts of official development assistance (ODA), have contributed to maintaining external balance and boosting the gross national product (GNP) to levels well above GDP.⁵ In relation to ODA, Kiribati, in common with many other Pacific island countries, relies on aid to fund almost the entire official capital expenditure programme.

Tuvalu is subject to similar constraints as Kiribati (and many other coral atolls), and growth over the decade as a whole was probably modest. As in Kiribati, opportunities for achieving respectable rates of growth lie mainly in the harvesting of marine resources, the fostering of small business and the promotion of a more efficient public sector.

Samoa has managed to withstand a series of shocks

Economic growth in Samoa was adversely affected by a series of exogenous shocks during the early 1990s, but the economy recovered well and recorded relatively high and consistent growth leading to a healthy increase in per capita income. The growth momentum has been sustained by an expanding tourism industry, construction and substantial public sector development activity, as well as exports of fish and garments. Although difficult to measure, the positive effects of macroeconomic and structural reforms implemented earlier, particularly those involving financial deregulation, reduction in tax and tariff rates and divestment of public sector investments in selected areas, have also contributed to the improved performance.

One can be reasonably optimistic with regard to Samoa's capacity to sustain relatively high and durable growth, at least over the medium term, barring major cyclones. Samoa remains committed to pressing ahead with further measures to strengthen the policy framework necessary to maintain a healthy rate of growth. Key areas that are being addressed are maintaining fiscal discipline, broadening the tax base, improving financial supervision, fostering private sector development and divesting public sector assets suitable for private sector operation. Progress in these and related areas will further strengthen the overall framework for future growth and stability.

⁵ In 2000, GNP per capita (\$A 1,630) was nearly double the level of GDP per capita (\$A 870) according to D. Throsby, "The Kiribati economy – performance and prospects", *Pacific Economic Bulletin*, vol. 16 (1): 1-18.

Solomon Islands' future performance hinges on political stability to implement the reform agenda

Solomon Islands' economic performance over the past decade has been both uneven and uninspiring. Rapid population growth coupled with modest GDP growth has led to the worst performance in terms of per capita income over the last few years among the countries under review. Growth was strong during the first half of the period, largely underpinned by an intensive but unsustainable exploitation of forest resources. Overall, however, growth has been constrained by a combination of external and internal shocks and the adverse impact of the Asian financial crisis, especially on the demand for logs.⁶ More recently, these problems have been compounded by the eruption of ethnic tensions in 1998 followed by armed intervention in government in 2000. Performance has also been constrained by continuing weakness in economic management, reflected in unsustainably high budget deficits, high debt levels and persistent inflation, as well as by low commodity prices for key exports such as palm oil and gold.

To its credit, Solomon Islands has made considerable headway in formulating strategies and programmes for promoting macroeconomic balance and vital structural reforms. This is apparent, for example, in a number of documents, notably the so-called Policy Structural Reform Programme (1997), the Medium-Term Plan and the Public Sector Investment Programme. Among the policy priorities are the need to restore macroeconomic stability, investor confidence and sound financial management and to pursue public sector reforms, boost private sector development and foster sustainable resource management. However, a crucial precondition for the successful implementation of these measures is to resolve ethnic tensions and restore political stability. Failure to do so will mean continued economic decline.

Reforms in Tonga still have some way to go

The overall record of the Tongan economy has been one of moderate growth, sufficient to contribute towards a slight increase in per capita income. Interestingly, a recent study indicates that over the last 20 years, the fastest-growing sectors have been government administration and community services and, to a lesser extent, activities related to tourism.⁷

Tonga's productive (and export) base could be considerably strengthened through more intensive efforts to develop agriculture, fisheries and tourism. Overall, making use of large areas of arable land which is poorly utilized at present could considerably enhance agriculture's contribution to the economy. In relation to tourism, Tonga can further capitalize on the potential to cater for niche markets, such as yachting, whale watching and sport fishing.

Although Tonga has made major advances in implementing economic reforms, much still needs to be done to create the right policy and institutional environment for accelerated growth. Key policy areas requiring attention are taxation reforms, clarification of the role of Government (possibly paving the way for the privatization of non-core activities) and improving the regulatory framework for the private sector. Enhancing the effectiveness of public expenditure is another priority.

⁶ Te'o I.J. Fairbairn, "Pacific island economies: performances, growth prospects and the impact of the Asian economic crisis", *Asian Pacific Economic Literature*, vol. 13 (2): 50.

⁷ L. Harkness, "Recent economic developments in the Kingdom of Tonga", *Pacific Economic Bulletin*, vol. 16 (1): 19-43.

Economic stagnation in Vanuatu also reflects political instability

For Vanuatu, the pattern of growth over the decade is similar to that of Solomon Islands; that is, it was marked by respectable growth up to the mid-1990s followed by a lacklustre performance, and over the period as a whole there was a slight decline in per capita income. The early growth reflected a number of factors, including increased earnings from agriculture, tourism and construction. Economic stagnation over the last few years appears to be largely related to a situation of political instability that was particularly evident during 1996-1998. Political uncertainty appears to have undermined good governance and the quality of economic management and has led, among other things, to serious macroeconomic imbalances, a financial crisis and a general lack of confidence on the part of investors.

The poor performance has reinforced the need to restore macroeconomic stability and to press on with much-needed economic restructuring. A so-called Comprehensive Reform Programme was introduced in 1998 (with ADB assistance), containing strategies and proposals for wide-ranging structural reforms in key economic areas. Among the initiatives proposed were those relating to improving the efficiency of the public sector, including the performance of State-owned enterprises, and to tackling vital reforms in the financial and taxation system. Strategies to foster greater private sector development (as well as subsidiary issues relating to equity and sustainability) were also included. However, progress in these areas depends greatly on the re-establishment of a more settled political climate and the restoration of good governance.

Some general observations

From the above discussion, a few cursory observations can be made on the growth performance of the Pacific island economies over the last decade. As noted earlier, with the exception of Samoa, overall growth performance has fallen far short of what is considered the potential growth rate for these countries and is markedly inferior to that achieved by several Caribbean countries, which share many development constraints with these economies. Some countries in the Caribbean have consistently recorded growth rates of over 4 per cent per annum, about twice the rates achieved by the Pacific island countries.

The record of economic growth is also unimpressive when related to the rate of investment that these countries have been able to maintain. For most Pacific island countries (Fiji being the main exception), gross investment expenditure has been unusually high over time, typically around 25-30 per cent of GDP (thanks mainly to ODA contributions). Such high investment levels should have led to higher growth than was actually achieved. The underlying factors in this apparent paradox need to be examined in depth, although the high capital-output ratio that is implied may have something to do with the dominance of investment in infrastructure with typically lengthy pay-off periods and a less than effective use of investment funds.⁸

Sources of growth

The recent performance by the Pacific island economies suggests that, with the possible exception of Samoa and Fiji, these countries have not yet structurally reached a point where they can sustain healthy growth on a consistent basis. Economic structures remain narrow, undiversified and highly vulnerable to external shocks. Instances of accelerated growth occur periodically and are

⁸ World Bank, *Pacific Island Economies: Building a Resilient Economic Base for the Twenty-first Century* (Washington, DC, World Bank, 1995).

typically associated with a boost in the production of one or two export crops. In some cases, growth was boosted by the emergence of an industrial product for export. Most Pacific island countries benefited, to varying degrees, from an expanding tourism industry, while some appear to have experienced growth at certain periods from expansion in public sector activities.

Economic vulnerability

The degree of exposure of these countries to exogenous shocks – both external and domestic – is unusually high and can have serious effects on growth. Over the period under review, all Pacific island countries suffered from the effects of slumps in commodity prices and market disruptions to some extent. Fiji and Tonga experienced major setbacks from the effects of natural disasters. Domestic shocks stemming from civil unrest and political instability were particularly evident in Fiji, Solomon Islands and Vanuatu. By virtue of their smallness, geographic location and dependence on external markets, Pacific island economies will remain highly vulnerable to exogenous shocks, and these will continue to restrain their capacity for accelerated economic growth.

Policy framework

Not surprisingly, as may be apparent from the above discussion, it would appear that the most successful economies have been those that have progressed most in creating a favourable environment for economic growth and stability. In this, the importance of political stability, good governance and an enabling and facilitative framework for fostering economic growth would appear to be crucial. Of the Pacific island countries considered in this paper, Samoa and, to a lesser extent, Fiji have made the most headway in establishing such an environment – an achievement that probably explains most of the recent economic gains. For Samoa in particular, a long-standing record of political stability combined with an ongoing commitment to “getting the fundamentals right” has been impressive. Here, a commitment to achieving macroeconomic and financial stability, financial sector reforms, taxation and tariff reductions, public sector reforms and revitalization of the private sector have been key policy elements. (Kiribati and Tuvalu have also been markedly successful in maintaining macroeconomic stability but have been slow in tackling microeconomic reforms.)

Other Pacific island countries, including Solomon Islands and Vanuatu, have declared a commitment to improving the overall policy framework but progress has been uneven, predominantly, it would appear, because of ongoing political uncertainty and ethnic tensions. Here, the restoration of a more ordered political situation is undoubtedly a vital prerequisite for economic growth and prosperity.

The special situation of coral atolls

Both Kiribati and Tuvalu have long been noted for their prudent economic management, but face severe resource restrictions as a basis for generating growth. Low (and erratic) growth is likely to continue unless major breakthroughs can be made in the exploitation of marine resources. The expected efficiency gains from further economic restructuring, most notably in relation to public sector operations, will also have positive effects on future growth. In the meantime, these small countries need to persist with efforts to pursue other options for boosting income. Such efforts have so far been reasonably successful (for example, rentier income from fishing licences, worker remittances and earnings from a trust fund).

A possible lesson for Pacific island countries

As the foregoing discussion has attempted to show, the recent growth performance of Pacific island countries has generally been disappointing. The reasons for success are no doubt complex (and need more rigorous research than has been possible here) but appear to be related to progress made in establishing

a favourable policy environment for economic growth and stability. Among the poorly performing Pacific island economies were those bedevilled by political and ethnic tensions as well as weak economic management.

A possible “lesson” that may be gleaned from the present discussion is the need for Pacific island countries to show a continuing commitment to the creation of a favourable and facilitative policy environment. In this, the importance of maintaining political certainty and good governance and the value of sound policy initiatives, at both the macroeconomic and microstructural levels, go without saying.

VI. THE NEW POOR¹

People becoming poor as a result of a major event, such as an economic crisis, a change in the economic system, political changes, terrorist attacks as well as natural disasters are defined as “new” poor. Preventive, mitigation and coping strategies are suggested to tackle the problem of the “new” poor. These strategies put greater emphasis on social safety nets and other short-term programmes and their effective delivery.

There is a need to differentiate between groups of the poor for policy options to alleviate poverty

Generally the poor are viewed as a homogeneous group when policy options for tackling poverty are considered. Poverty can take different forms including absolute and relative poverty. Relative poverty refers to inequality in income distribution and exists in all countries. Absolute poverty, defined as the percentage of the population with an income below a specified poverty line, is a major problem faced by many developing countries. The absolute poor can be divided into many categories such as rural, urban, female, child and elderly. In this brief note, a new category of the absolute poor, namely the “new” poor, is defined and explained with examples from countries in Asia and the Pacific. Policy options to deal with this group are also discussed.

The “new” poor created as a result of some major event of an economic, natural or political nature

Changes in the incidence of poverty in a country occur because some persons emerge from poverty while others become poor through loss of employment or livelihood. A reduction in poverty implies that more people graduated from poverty than those who became poor. Those who are near the poverty line are usually more susceptible to becoming either non-poor or poor. This is part of the dynamics of poverty. However, following a major economic crisis, a change in economic system, political change, terrorist attacks or natural disasters, some people who were not classified as poor or borderline become poor as a result of the change in their economic status. We may define such people as the “new” poor.² They would not be captured in any type of future projections on poverty levels prepared in normal times.

Millions became “new” poor owing to the recent economic crisis

Globalization, while providing benefits to the economy, is characterized by risk and instability, as evidenced by the 1997 Asian economic crisis. This increases the vulnerability of people through unemployment and loss of income and can lead to the emergence of economic and social crises and their rapid spread to many countries. For example, prior to 1997, the economic performance of most economies in East and South-East Asia was very impressive. Some of these economies achieved double-digit rates of growth of gross domestic product (GDP) during the 1980s and early 1990s. However, the financial crisis, which started in Thailand in 1997, engulfed other countries in the region including Indonesia and the Republic of Korea, which were badly affected.

In the wake of the economic crisis, the real incomes of households fell because of job losses, cuts in wages and higher inflation. A massive contraction in output as a result of the economic crisis resulted in sharp increases in unemployment. For example, in 1998, when the full effect of the crisis was felt, several millions were added to the unemployed in Indonesia, and in the Republic of Korea more

¹ Prepared by Muhammad Hussain Malik, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

² Some may prefer to call them “recent poor” or “newly created poor”.

than one million jobs were lost.³ Those fortunate enough to retain jobs suffered cuts in real wages in the face of falling labour demand. The incidence of under-employment increased, putting further downward pressure on wage rates. A rapid depreciation of currencies triggered higher inflation, eroding the real purchasing power of households. The combined effect was a sharp increase in poverty. More than 30 million people became “new” poor in countries directly affected by the crisis.⁴ The situation becomes even more depressing when it is considered that these countries had been reducing the incidence of poverty successfully prior to the crisis. A large number of people were emerging from poverty every year. For example, in Thailand poverty had been expected to decline to 10.8 per cent in 1998 (from 11.4 per cent in 1996). However, as a result of the crisis, the incidence of poverty increased to 12.9 per cent in that year.

Some transitional economies have seen half of their populations pushed into poverty

Conflicts, wars and dramatic changes in economic systems also add to the “new” poor. Conflicts and wars destroy the means of production and kill and displace people. Dramatic changes in economic system can produce winners and losers. Over the past few decades, many countries have moved away from centrally planned to more market-oriented systems. The gradual move in some countries (China and Viet Nam) helped in raising GDP growth and lowering the incidence of poverty. However, in a large number of countries, including the Russian Federation and the Central Asian republics, the rapid transition to a market economy brought hardship to millions of people. No doubt, average pre-transition incomes and living standards were low, but guaranteed employment, uniform wage distribution, social transfers and consumer subsidies kept the incidence of poverty relatively low. In fact, very few people lived in extreme poverty.⁵ In the transition, lifelong guaranteed employment and many consumer subsidies were eliminated. Those who retained jobs suffered major reductions in their real wages. At the same time, rates of inflation rose sharply in some of these countries, to over 500 per cent per year between 1990 and 1995, compared with virtually no inflation under the previous system. In addition, the elimination of most product subsidies increased the relative prices of essentials, thus putting a further squeeze on the poor. As a result, the incidence of poverty increased sharply and a very large group of “new” poor emerged in these economies. Some indicative figures on poverty before and after the transition for selected countries are depicted in the figure below. Nearly half of population in most countries became poor following their transition to a market economy.

Acts of nature can add large numbers of poor

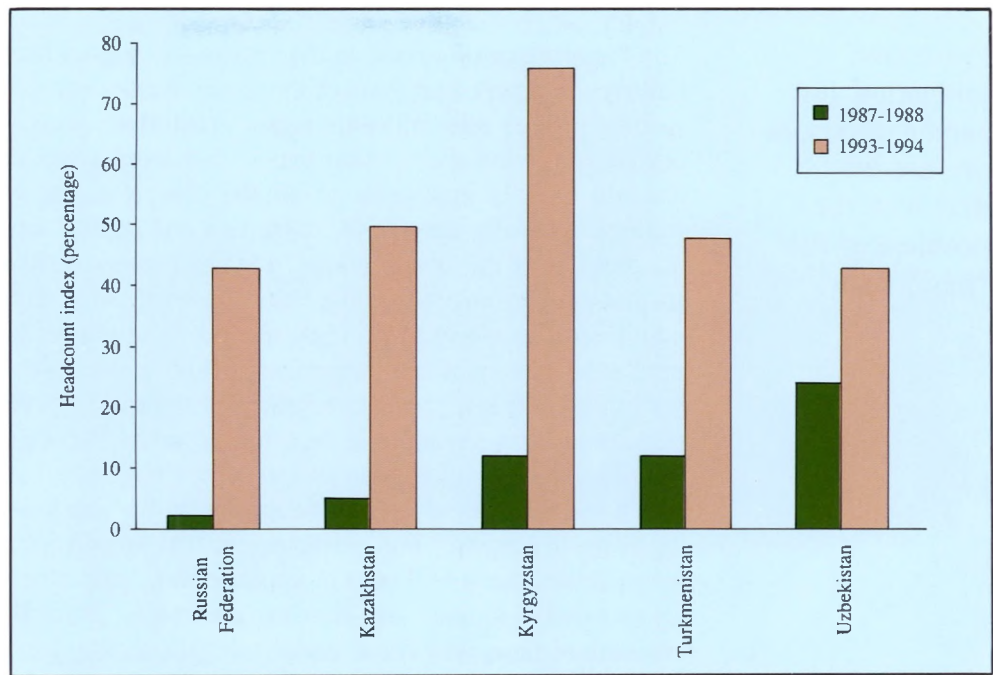
Natural disasters (such as earthquakes and volcanic eruptions), bad weather (for example, heavy rainfall and flooding) and health-related problems (including individual or epidemic illness, disability and death) are other major causes creating “new” poor since they result in loss of lives, property, assets and earning capacity. In January 2001, a severe earthquake in Gujarat State in India

³ ESCAP, *Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries* (United Nations publication, Sales No. E.00.II.F.14).

⁴ To obtain precise estimates of “new” poor poses more problems than to estimate the incidence of poverty. A rough estimate of “new” poor can be obtained by comparing the incidence of poverty prior to and after a relevant event or shock. However, observable changes in poverty estimates may partly be due to some factors other than the relevant shock. Panel survey data can help in obtaining more precise estimates of “new” poor but such data are not usually available.

⁵ United Nations Development Programme, *Poverty in Transition*, Regional Bureau for Europe and the Commonwealth of Independent States (New York, UNDP, 1998).

Figure. Incidence of poverty in selected transitional economies



Source: World Bank, "Poverty, inequality and social policy in transition economies", *Policy Research Working Paper Series No. 1530*, November 1995.

caused colossal loss to life and property. More than 20,000 people died and several thousands more were injured and more than a million houses were destroyed or damaged. Economic losses were estimated at several billion dollars. A large number of people lost sources of livelihood and the means of production and suddenly became poor.

**Terrorism
can destabilize
economies
and create
"new" poor**

Terrorist attacks can contribute to the creation of "new" poor in both direct and indirect ways. Families losing their breadwinners in such attacks can become "new" poor. Massive terrorist attacks, as occurred in New York and Washington, DC, on 11 September 2001, can destabilize the world economy. The economy of the United States of America is expected to slow down further because of these attacks and, as a result, most of the economies in Asia and the Pacific will suffer. There will be job losses (particularly in export-oriented and tourism-related industries) and "new" poor will be created. The World Bank estimates that some 10 million "new" poor will be added worldwide.⁶ Many more will become poor when other consequences of the terrorist attacks are considered. For example, labour-importing countries will become even stricter with the foreign workforce and many foreign workers will be forced to leave. Illegal migrant workers will be particularly affected. Most of these workers come from poor countries with few job opportunities and they may end up joining the ranks of the "new" poor. Terrorist activities also create refugee problems because people are forced to leave their homes to save their lives and many refugees become "new" poor. Extreme poverty in its turn leads to desperation and breeds terrorism. Therefore, the elimination of extreme poverty

⁶ World Bank, *Press Release*, 1 October 2001.

and the provision of productive employment opportunities for young people can be an effective way of fighting terrorism.

Preventive, mitigation and coping strategies are needed to deal with the problem of the “new” poor

The “new” poor discussed in the previous examples have different root causes of poverty. A detailed analysis of those root causes can only help in recommending specific poverty alleviation strategies in different cases. Such detailed analysis is beyond the scope of this short paper. However, some strategies can be proposed that are broadly applicable to all the groups of “new” poor. Three types of strategies, namely preventive, mitigation and coping, can be adopted to deal with the problem of the “new” poor.⁷ Ideally, preventive strategies should be in place so that people do not become “new” poor at all.⁸ However, this is not always possible. Therefore, to decrease the potential impact of a future downside risk, mitigation strategies are important. Both preventive and mitigation strategies are *ex ante*. While preventive strategies reduce the probability of the risk occurring, mitigation strategies reduce the potential impact if the risk occurs. Once the risk occurs, coping strategies to relieve the impact gain importance. Identification and analyses of vulnerable groups in the population can help in implementing these strategies. For example, detailed knowledge of flood-prone areas and people living there will help in implementing, under preventive strategies, appropriate forward-looking anti-flooding measures. Early flood warning systems and evacuation plans will come under mitigation strategies. Relief activities in the case of actual flooding will form part of coping strategies.

Individuals and households manage their risks and vulnerability through savings and the acquisition of assets for emergencies. However, this may not be possible for those in lower-income groups. Traditional and informal risk-sharing mechanisms through extended families and mutual gift giving are also employed but these are breaking down over time owing to urbanization and industrialization. Therefore, the role of Government becomes very important because personal and informal risk management instruments are effective, at best, only in the face of small, household-specific risks but tend to break down in the face of large adverse shocks. Market-based social risk management through insurance schemes is possible in less catastrophic situations but not everyone can afford such instruments. Moreover, Government is required to play important regulatory and supervisory roles for the smooth functioning of financial institutions providing these instruments.

Social protection and social safety nets are key components of mitigation and coping strategies to help the “new” poor

Once it is agreed that Governments have to provide appropriate social protection and social safety nets for the benefit of the “new” poor, certain measures discussed below could be of interest. First of all, good statistical capacity is important to find details of those who have suffered from a natural disaster, economic crisis or some other event quickly.⁹ This is essential for designing effective targeted programmes. In the wake of the recent economic crisis in Asia, countries implemented various programmes for the benefit of affected persons. The limited success of these programmes, in most cases, was due to the lack of reliable and timely information on the social impact of the crisis.

⁷ These strategies are discussed in a recent World Bank study in the context of social risk management. For details, see Robert Holzmann and Steen Jorgenson, “Social risk management: a new conceptual framework for social protection and beyond”, Social Protection Discussion Paper No. 0006 (Washington, DC, World Bank, February 2000).

⁸ The content and substance of preventive strategies may vary in different cases.

⁹ ESCAP, “Social impact of the economic crisis”, in *Economic and Social Survey of Asia and the Pacific 1999* (United Nations publication, Sales No. E.99.II.F.10).

Governments also need to develop the capacity to design and implement social safety nets to provide a cushion for a large number of people affected by events that create “new” poor. This capacity is also needed by local Governments, which are generally responsible for implementing the programmes. If social safety nets are already in place, it may be better to scale these up in emergencies (rather than start new programmes). Because of the involvement of various departments and agencies of Government, effective coordination mechanisms are needed to enhance the impact of the measures undertaken. All this requires putting institutional capacity in place, to be utilized in times of need.

Governments usually divert resources in times of crisis for the creation of employment through public works, cash transfers and free or subsidized provision of essential goods and services. Governments should consider setting up a “social fund”, contributing some revenues regularly to this fund in normal times and utilizing the accumulated resources only in circumstances of extreme urgency.

The social impact of the economic crisis is generally transmitted through a sharp increase in unemployment. People lose jobs, and consequently incomes, in large numbers and join the ranks of the “new” poor. In addition to public works initiatives, skill-retraining programmes are important to enhance the flexibility of workers in order to take advantage of alternative job opportunities. Greater flexibility in terms of skills is becoming necessary in the face of rapidly changing technologies.

Unemployment insurance can be an effective social protection device to keep workers from becoming poor. However, such schemes require huge financial resources and can raise costs of production as well. Moreover, most developing countries have large informal sectors where unemployment insurance schemes cannot be introduced. Despite these difficulties, feasibility studies for self-financing unemployment insurance should be undertaken in countries without such a scheme since the formulation and implementation of a scheme can take a long time.

The policy mix may need to change to deal with the “new” poor

Policy options recommended for dealing with the problem of the “new” poor are in some ways different in approach and emphasis as compared with those for structural poverty. Preventive strategies can be and should be employed so that people do not become “new” poor. There is more emphasis on social safety nets and their effective delivery under mitigation and coping strategies. However, it should be emphasized that the policy mix changes when the “new” poor are unable to emerge from poverty, despite the provision of short-term relief, and join the ranks of the permanently poor. Depending on the causes of their poverty, policies usually recommended for poverty alleviation, such as the promotion of pro-poor growth, employment generation, skills training, provision of credit and other targeted programmes can be employed.

How should the alleviation of poverty of the “new” and the permanent poor be prioritized?

A relevant and interesting question that can be raised is how to prioritize the alleviation of poverty of the “new” and the permanent poor, in the face of resource constraints. A good balance based on resource requirements is needed. Moreover, relief activities usually gain importance at times of crisis and resources should be devoted to short-term help to the “new” poor to save them from becoming permanently poor. These people were not poor prior to an exogenous shock and many of them have greater potential to emerge from poverty with short-term help; this help should be extended to contain the spread

of poverty. The group of “new” poor may include educated and skilled people. Without outside help in the form of employment opportunities or microcredit for self-employment, such people can easily turn to activities causing social tensions and instability.

Growing globalization has made the performance of many developing economies heavily dependent on their export sectors. Volatility of the external sector has caused economic uncertainty and job losses in several countries in recent years. This raises the important question of whether a strategy of export-led growth is preferable to more balanced growth of both domestic and external sectors.

In conclusion, a large number of issues and questions have been raised in this brief paper. It is hoped that this will encourage the study of this subject to derive specific policies for dealing with different groups of “new” poor.

VII. CONTEMPORARY ISSUES IN CENTRAL ASIA¹

A decade of transition

The Central Asian countries began their transition to market economic systems 10 years ago. Macroeconomic reforms initiated in the subregion have many common features with those carried out in the other economies in transition. However, there are some specific circumstances that make the transition to a market economy in Central Asia more difficult and challenging. The countries of the subregion used to be part of the former Soviet Union and were firmly integrated into the inter-State division of labour. In the immediate aftermath of the break-up of the USSR, the Central Asian countries suffered serious adjustment problems. They also faced the tough challenges of stabilizing economic growth and reducing hyperinflation and budget deficits. Independent banking and financial sectors and other market institutions had to be created and national currencies introduced. Trade and other forms of economic cooperation were permitted to develop and integration with the rest of the world was fostered by embarking on a path towards market liberalization.

Resources and reforms

Compared with other economies in transition in the ESCAP region, the countries of Central Asia are more fortunate in a number of respects. The most important of these are natural resource endowments and human resources with a high level of education and scientific and technical potential. However, each of the countries individually has a rather small domestic market. All are landlocked with a rugged topography. Primary commodities dominate exports and export revenues are highly sensitive to changes in commodity prices.

While Kazakhstan, Kyrgyzstan and Tajikistan have introduced market reforms rapidly, Uzbekistan and Turkmenistan have pursued a gradual strategy. Nevertheless, all the countries of the subregion resumed economic growth and reduced inflation rates to manageable levels in 1996-1997. By that time, the Central Asian economies had also noticeably improved economic incentives through policy and institutional adjustments and structural reforms. The policy reform measures included liberalization of prices, trade and exchange systems, decentralization and restructuring of economies and privatization of State enterprises. The combination of existing domestic resources and new economic incentives created a favourable environment for economic growth and stability in the subregion.

Lessons from experience: commitment to macroeconomic stability

The recovery process in Central Asia, which started in 1997 and strengthened in 2000, is expected to continue in 2001. The recent performance of these countries suggests that they have passed the point of no return in the transition to a market economy. Some lessons can be drawn from the 10-year experience of these countries in implementing macroeconomic reform. One of the main lessons is the decisive commitment to achieving macroeconomic stability and improving the fiscal position. These two key issues in macroeconomic policy will face most, if not all, of the countries of the Central Asian subregion in the short to medium term. Prudent fiscal and monetary policies and appreciation of the national currencies were the two main factors responsible for the considerable

¹ Prepared by Eugene Gherman, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

success in reducing rates of inflation in Central Asia between 1995 and 2000. During this period, annual inflation rates fell from 176 to 13 per cent in Kazakhstan, from 43 to 19 per cent in Kyrgyzstan, from 682 to 33 per cent in Tajikistan and from 1,105 to 7 per cent in Turkmenistan and remained flat at about 25-30 per cent in Uzbekistan. Nevertheless, further action is needed in pursuit of the stabilization process that is a precondition for sustainable growth.

Lessons from experience: institutions and governance

Another lesson is related to the necessity of creating sound institutions and building strong governance. In the last decade, structural changes could be observed in the financial and banking sectors of the Central Asian countries. In general, the financial sector undergoes the greatest changes in the course of an economic transition. Major components of financial sector reforms have been the establishment of a two-tiered banking system, with independent central banks, and the removal of interest rate controls, bringing interest rates closer to market rates. The functioning of different types of financial institutions has been improved and the supervisory, regulatory and legal frameworks strengthened. The liberalization of the external account, more flexible exchange rates and the establishment of foreign financial companies in the domestic market have accompanied the reform measures. A critical component of financial sector reform is the quality of supervision that a country can achieve in a rapidly changing environment. The recent financial and economic crisis in Asia and in the Russian Federation raised the question of how financial sector reform and liberalization can be managed so as to minimize the potentially adverse effects on the rest of the economy. It also posed the problem of which policy instruments can be used in a more liberalized financial system without excessive recourse to discretionary measures that can easily be abused.

Lessons from experience: dealing with the social consequences of reform

The third lesson deals with the social implications of the transition process. The transition process has had serious adverse social consequences for the most of the populations in Central Asia. A substantial decline in real wages and rising unemployment have resulted in declining living standards and emerging poverty in these countries that had not existed in the former Soviet Union (see chapter VI on "The new poor" in this *Bulletin*). As estimated by the Asian Development Bank, the poverty rate in Tajikistan was 83 per cent in 2000, and 7 per cent of the population in Turkmenistan lived below the poverty line in 1998. In December 2000, registered unemployment in Central Asian countries varied: it was 0.6 per cent in Uzbekistan, 3.0 per cent in Tajikistan, 3.1 per cent in Kyrgyzstan and 3.7 per cent in Kazakhstan. Therefore, social protection and alleviation of poverty appear to be among the challenges faced by the countries in Central Asia. In order to ensure that the benefits of the market economy are shared by all, the Governments of the Central Asian economies have made efforts to provide a certain minimum level of social security, health care and education.

The challenges ahead

As the transition process in Central Asia is far from complete, the lessons from the experience so far are important to complete the remaining tasks and to meet the challenges ahead. Among them are ensuring a proper role for Government in the transition process, to preserve both macroeconomic and financial stability, and revitalizing economic cooperation in the subregion.

To implement macroeconomic reforms in Central Asia more efficiently, there is a need to balance the roles of the Government and the market. Governments should play a key role in enforcing the "rules of the game" and in promoting shared social protection, improving the investment climate and creating an environment favourable to private sector development. They need to look for

opportunities to deepen economic cooperation within the subregion and with the global community. Governments also have an important role in completing all the necessary institutional and structural reforms initiated during the last decade and in developing the infrastructure needed for a market economy. All five Central Asian countries have begun implementing structural reforms. However, further privatization and restructuring of State enterprises are needed to move quickly to a market economy and create an adequate institutional framework for the newly-emerging private sector. To support the confidence of private savers and investors, government intervention should be limited to providing reliable public services, establishing a simple and transparent regulatory framework and enforcing a fair judicial system.

Further reform for continued stability

Preservation of macroeconomic and financial stability in the subregion will require further reforms to strengthen and restructure the financial sector and bring about tax structures and tax administrations in conformity with market-based economic systems. Despite the recent initiatives undertaken by the Central Asian countries in reforming tax policy and tax administration, progress in implementing tax reforms has turned out to be slow for several reasons. Among them are poor accounting systems, which make it difficult to determine the tax base accurately; inadequately equipped tax administrations for handling the significant increase in the number of taxpayers and the different types of taxpayers, particularly small- and medium-sized enterprises in the private sector, which have emerged in the course of the economic transformation; and the pervasiveness of barter trade and non-cash transactions, which complicates the task of collecting taxes. Tax adjustment measures implemented so far in the Central Asian economies constitute the initial steps of a tax reform. With a greater flow of information between the taxpayer and tax authorities it is essential to computerize the processing of data and information. Emphasis should also be put on taxpayers' education and the building up of a relationship of trust and confidence between taxpayers and authorities.

The Central Asian countries face the task of completing the creation of a strong, efficient and globally competitive financial sector, including bond markets and stock exchanges, operating in a suitable legal environment. As these economies earn significant foreign exchange from the export of natural resources, exchange rate management is important for macroeconomic stabilization. The conversion of foreign exchange into domestic currency could lead to inflation, which, in turn, could raise the cost of other factors of production and make potential exports uncompetitive in world markets. The Central Asian countries need to strengthen the management of foreign exchange reserves, notably to elaborate guidelines and reporting procedures clearly, diversify reserve asset holdings and improve risk management.

Need for intercountry cooperation

The countries of Central Asia are confronted with an environment of rapidly moving globalization, involving widespread liberalization of flows of goods, services and capital in conditions of increasingly tough competition. To meet this challenge, the countries have to revitalize intercountry economic cooperation. Economic cooperation in the subregion can be viewed as both the natural outcome of and a prerequisite for their economic and social development. It is a natural outcome partly because of their geographic proximity. In June 2000, the four countries of the Central Asian Economic Community (Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan) approved a two-year programme of measures to expedite the creation of a single economic space and a five-year strategy of economic development and integration in Central Asia. The

implementation of any programme of intercountry economic cooperation requires firm political commitment on the part of the cooperating countries. It is also important that the political commitment be concretized through the necessary administrative and policy measures. The implication is that the cooperating countries themselves have to institute a host of actions to realize the potential benefits that cooperation at the subregional level could potentially entail. However, the Central Asian countries will require considerable support from the international community in the form of both financial and technical assistance.

Increased uncertainty

The importance of this assistance has increased after the recent terrorist attacks in the United States of America and the subsequent bombing of Afghanistan. The increased uncertainty in the subregion will add to the challenges facing Central Asian countries, three of which share a common border with Afghanistan. The tragic events will have a direct negative impact on trade, airlines and tourism development in the subregion and indirect effects on public spending, business confidence and risk management. In addition, military expenditures to strengthen defence in Central Asia will reduce scarce resources available for financing social programmes. At the same time, Central Asian countries could benefit from the increased demand for oil and fuels produced in the subregion, despite the sharp falls in world prices. These economies can also expect additional financial support, including debt relief and foreign direct investment, to press ahead with prudent macroeconomic policies and structural reforms.

VIII. IMPLEMENTATION OF THE NEW BASEL CAPITAL ACCORD IN THE ASIA-PACIFIC REGION: POTENTIAL CHALLENGES AND REWARDS¹

"Implementing BIS [Bank for International Settlements] standards and guidelines will be useful to make our financial system strong but application timing must be consistent with the state of our economic development and existing limitations." Prime Minister of Thailand, Mr. Thaksin Shinawatra.

Capital adequacy in context

The Basel Capital Accord of 1988 was a milestone in attempts to secure international agreement on supervisory regulations concerning the capital adequacy of international banks. The Accord followed a period during which levels of capital held by such banks had declined, and aimed to strengthen the soundness and stability of the international banking system. A second aim was to achieve a framework that was fair and had a high degree of consistency in its application to banks in different countries. The years since the Accord have seen considerable change in the banking industry and the environment in which it operates. To take account of these changes, the Basel Committee on Banking Supervision issued a revised set of proposals for a new capital adequacy framework (the new Accord) to replace the 1988 Basel Capital Accord in January 2001. The Committee has received over 250 comments on its proposals and is due to issue a complete set of proposals in early 2002 for finalization during that year and implementation in 2005. While the focus of the framework is on internationally active banks, the underlying principles should be applicable to banks of varying levels of sophistication and the Committee expects adherence by all significant banks in due course.

Criticisms of the current Accord

Under the existing Accord, which has been implemented by over 100 countries, a minimum capital requirement of 8 per cent of risk-weighted assets is required of internationally active banks. In an attempt to capture the riskiness of banking operations, regulatory capital requirements are based on a few basic risk classifications including loan maturity, sovereign membership of the Organisation for Economic Cooperation and Development (OECD) and type of borrower (sovereign, bank or corporate). The current Accord has, however, come under increasing criticism from various quarters for being too crude to reflect actual levels of risk and lagging behind the risk management techniques of sophisticated banks. From the point of view of these banks, the existing Accord creates a bias in favour of lower-quality loans by raising capital requirements unnecessarily on prime lending.²

From the point of view of developing countries, the existing Accord is viewed as being unfair in that it raises the costs of lending to non-OECD members. It is alleged that the Republic of Korea may have accelerated the liberalization of

¹ Prepared by Vimala Aldis, Intern and Fareeda Maroof Hla, Economic Affairs Officer, Development Research and Policy Analysis Division, ESCAP.

² See the discussion in S. Griffith-Jones and S. Spratt, "Will the proposed new Basel Capital Accord have a net negative effect on developing countries?", unpublished (Institute of Development Studies, University of Sussex, 2001).

its financial markets prematurely in order to qualify for OECD membership as a result. Further, a bias has been created in favour of short-term loans to emerging market countries. The devastating consequences of the associated rollover risk were demonstrated in the 1997 Asian financial crisis.

The three pillars of the new Accord

The new Accord is to be based on three pillars: risk-based regulatory capital requirements (Pillar 1), an amended supervisory review process (Pillar 2) and disclosure requirements to promote market discipline (Pillar 3). All three pillars are viewed as being complementary and mutually reinforcing. The new Accord focuses attention on risk assessment, credit risk in particular, and institutes regulatory capital requirements based on risk weightings in an effort to encourage banks to develop more sophisticated capabilities for risk measurement and management. This is particularly important in countries affected by the Asian financial crisis, which was largely the result of poor risk assessment leading to the misallocation of capital and ultimately bank failure. It also includes explicit capital requirements for operational risk.

Questions for the region on the new Accord

Under the proposed new Accord, the determination of capital adequacy ratios is much more complex, requiring risk assessments of individual claims. In preparation for the implementation of these new regulations, numerous questions have arisen regarding problems which banks in developing countries may encounter in adhering to them. Additional concerns have been raised regarding the potential impact on bank lending to emerging market economies and economic growth. This paper attempts to address these questions with regard to countries in the Asian and Pacific region and finds that implementation of the new Accord is likely to increase bank reserve capital requirements significantly, reducing the availability of funds for domestic lending. The flow of funds to the region from international banks is also likely to be adversely affected and bank lending in general is likely to aggravate the business cycle. The greater emphasis on bank supervision and increased reliance on disclosure and market discipline will pose significant challenges to developing countries in terms of human resources and institutional capacity.

Three approaches to credit risk

Implementation will not be a simple task by any means, particularly for banks in emerging markets. Banks have the option of selecting from one of three possible approaches to the measurement of credit risk: the Standardized Approach (a modified version of the existing approach), which relies on external credit assessments; the foundation Internal Ratings Based (IRB) approach; and the advanced IRB approach. The latter two rely on the risk management systems of banks themselves. At present, the vast majority of banks do not possess the technological capacity required for the IRB approach. The Basel Committee anticipates that the majority of banks will initially follow the Standardized Approach and, owing to considerable incentives in terms of lower reserve capital requirements, will soon begin to develop IRB capabilities. In the United States of America, it is estimated that only 20 of the 9,000 existing banks will be able to adopt the foundation IRB approach by 2005.³ Many commentators have suggested that the variety of approaches available will prevent uniformity of standards being achieved for all banks in all countries, making a more level

³ Remarks made by Lawrence H. Meyer at the annual Conference of the Institute of International Bankers (Washington, DC, 5 March 2001).

playing field unlikely. A simplified Standardized Approach, applicable to all, has been suggested as an alternative.⁴

It has also been suggested that the absence of agreed basic standards on loan classification and provisioning in the new Accord will limit the usefulness of the capital adequacy framework for banks in developing countries, as it will reduce the comparability of systems internationally.⁵ The Asian financial crisis demonstrated how poorly designed frameworks can lead to bank insolvencies being hidden.⁶

**Will banks
in the region be
able to implement
the new Accord
by 2005?**

Large international banks are primarily the institutions that have begun development of risk management capabilities and it is thought that the revision of the 1988 Capital Accord occurred in response to pressure from these banks. Important obstacles facing many Asian banks in implementing the IRB approach are the lack of historical data on losses and the absence of benchmark risk weight assessments, which are essential to meet the information requirements necessary for effective risk management. Related technical issues involving data storage and data extraction from existing systems also represent serious challenges banks must face in order to meet minimum qualification standards. Banks will be required to conduct consistent internal audits, loan reviews and internal ratings. This will require extensive investment in human resources and training, as many Asian banks do not currently have the technical capacity to perform these tasks. Concerns have been raised that the high standards prescribed by these accords may increase the economic disparity between developed countries that have banks capable of implementing the IRB approach and emerging market countries. It is widely agreed that the implementation of the new Accord will result in some degree of bank consolidation as many banks may be unable to compete in this new financial environment.⁷ Thus, developing countries in Asia and the Pacific may find themselves with banking industries heavily dominated by international banks.

Compliance with even the Standardized Approach will require significant adjustments for Asian banks that may be difficult to accomplish prior to the proposed 2005 implementation date. In the new Accord, the distinction between countries that are members of OECD and those that are not is abandoned and creditworthiness is to be based on ratings of external credit assessment institutions (ECAIs) or various national export credit agencies (ECAs). This should increase the flow of lending to higher-rated non-OECD countries. The “sovereign floor” is also abandoned, so that qualifying banks and corporations can be assigned a lower risk weight than the sovereign, enabling these borrowers to obtain funds at lower cost. The range of “risk buckets” is increased so that a closer alignment may be reached between risk and capital adequacy. Additionally, the bias towards short-term lending has been reduced.

⁴ See, for example, International Monetary Fund, “IMF staff comments on the January 2001 proposals of the Basel Committee on Banking Supervision for a new capital adequacy framework for banks”, submitted to the Basel Committee on Banking Supervision, 2001 (<http://www.bis.org/bcbs/cacomments.htm>).

⁵ IMF, op. cit., p. 4.

⁶ World Bank, “Comments on the Basel Committee’s new capital framework”, submitted to the Basel Committee on Banking supervision, 2001 (<http://www.bis.org/bcbs/cacomments.htm>), p. 7.

⁷ Coley Clark, “Basel, consolidation and outsourcing”, interview published in *Finance Asia*, 3 June 2001 (<http://www.financeasia.com/articles/5F993433-53FE-11D5-81CB0090277E174B.cfm>).

External credit ratings and pro-cyclicality of lending

While it is an improvement on the old OECD membership approach, the reliance on external credit assessments raises some important concerns, in particular that market participants may overreact to ratings downgrades.⁸ The Pillar 3 disclosure requirements reinforce this concern. Although the number of ECAs is increasing, there are few ECAs in developing countries (Sri Lanka, for example, has only one) and the majority of individual claims are not rated. The number of rated firms in Group of 10 (G-10) countries is 24 times greater than in low-income countries. Foreign ratings institutions or agencies in G-10 countries will find themselves having to play a greater role. Unfortunately, the performance of ECAs has come under criticism after recent financial crises and reliance on their ratings may increase the pro-cyclical nature of bank lending.⁹ For example, the ratings of countries most seriously affected by the Asian financial crisis remained high on its vigil, only to be rapidly revised downwards once the crisis hit, leading to a mass withdrawal of capital from the region. Under the new framework, inter-bank lending for countries rated up to BBB- receives a low weight of 20 per cent. Should these ratings be revised downwards to BB+, the weights could jump to 50 per cent, and even to 150 per cent for ratings below B-. This will have a major impact on the trade finance activities of international banks, as was seen during the Asian crisis, disrupting what is essentially a low-risk activity.¹⁰ Ratings of low-rated borrowers tend to be revised more frequently and the view that ratings agencies are themselves susceptible to general market sentiment is hard to escape. ECAs are also hampered by limited access to information in an environment characterized by a lack of transparency and poor corporate governance, such as may be found in many developing countries in the Asian and Pacific region.¹¹ Whether the various national ECAs can do better is also doubtful. In addition, these agencies may be influenced more by the needs of their exporters than by objective criteria.¹²

External credit ratings and borrowing costs

Risk-based bank capital adequacy ratios could also be problematic for developing countries owing to the fact that borrowers in these countries have a shorter recorded rating history and lower Moody's and Standard and Poor's alphanumeric sovereign ratings. For example, a country like Indonesia with a sovereign rating for foreign currency loans below B- faces extremely high sovereign, corporate and inter-bank loan risk weights of 150 per cent under the new Accord while countries with ratings of AA- or higher, such as Japan and Singapore, are assigned a 0 per cent sovereign risk weight and a low 20 per cent corporate and inter-bank loan risk weight. Countries with a mid-range rating (BB+ to B-), such as India and Pakistan, have a relatively high sovereign, corporate and inter-bank loan risk weight of 100 per cent.¹³ The net effect is likely to be a reduction in the flow of capital to those countries that most need it – developing countries that tend to be lower-rated – just at a time when flows of

⁸ World Bank, *op. cit.*

⁹ S. Griffith-Jones and S. Spratt, *op. cit.*, p. 6.

¹⁰ World Bank, *op. cit.*, p. 5.

¹¹ Reserve Bank of India, "Comments of the Reserve Bank of India on the new Basel Capital Accord", submitted to the Basel Committee on Banking Supervision, 2001, p. 6 (<http://www.bis.org/bcbs/cacomment.htm>).

¹² S. Griffith-Jones and S. Spratt, *op. cit.*, annex 2.

¹³ From <http://www.standardandpoors.com/RatingsActions/RatingsLists/Sovereigns/SovereignsRatingsList.html>.

official development assistance are declining and countries are being asked to turn more to private capital flows. It could be argued, however, that improved risk assessment, strengthened supervision and greater disclosure will improve confidence and may well enhance capital flows to these countries over time.

The need for greater transparency and disclosure in external risk assessments

These considerations have led to calls for much greater transparency and disclosure on the part of ECAIs and ECAs of the criteria used in assigning ratings, because countries will need to know the criteria by which they are to be assessed. Private ratings institutions have shown themselves to be responsive to these concerns and are making more information available on their methodologies for ratings assessment reviews for individual countries.¹⁴ Further, guidance needs to be provided to supervisors on the admissibility of ratings agencies. There is some danger that, as ratings methodologies vary between agencies, capital requirements will not be consistent worldwide.¹⁵ The systematic adoption by ECAs of a methodology to measure the risk of sovereign default, consistent with best practice, is also viewed as being desirable. Such a methodology has been formulated by OECD and has been published on its web site.¹⁶

Banks in emerging market economies will need more capital

Under the new Accord's risk-based regulatory capital requirements, it is likely that banks in emerging market economies will face an increase in minimum regulatory capital, which will probably lead to tighter monetary conditions and higher interest rates initially. However, the increased capital requirement will safeguard the interests of depositors and reduce the probability of calling on public resources in the event of a crisis. Many Asian banks have relatively greater risk exposure as compared with banks in other regions. As the Bank of Thailand has pointed out, the ratings of banks and borrowers were adversely affected by the 1997 crisis and the effect of the new Accord will be to raise capital requirements and slow the pace of recovery of the banking sector. As a result, many banks may not be able to comply by the implementation date.¹⁷ Whether banks attempt to meet new capital adequacy ratios by increasing capital or shifting away from high-risk weighted assets will have important implications for the availability of investment capital, particularly for small firms and entrepreneurs.

In its most recent statement on the new Accord, the Committee has reiterated its aim that the proposals should maintain an equivalent level of regulatory capital for the average bank under the Standardized Approach and that its proposals may need revision based on the comments received.¹⁸ The Committee may be hoping to achieve this result by offsetting greater capital requirements for operational risk with reduced requirements for credit risk

¹⁴ See, for example, Moody's Investors Service, Global Credit Research, *Country Credit Statistical Handbook* (New York, Moody's Investors Service, 2001).

¹⁵ IMF, op. cit., p. 5.

¹⁶ OECD, *The Knaepen Package: guiding principles for setting premia fees under the arrangement of guidelines for officially supported export credits* (Paris, OECD, 1999) and <http://www.oecd.org/ech/act/xcred/knaepen-package-en.htm>.

¹⁷ See the comments of the Bank of Thailand submitted to the Basel Committee on Banking Supervision, 2001 (<http://www.bis.org/bcbs/cacommments.htm>).

¹⁸ Basel Committee on Banking Supervision, "Update on the new Basel Capital Accord", press release, Bank for International Settlements, 25 June 2001 (<http://www.bis.org/press/p010625.htm>).

(through better risk calibration), but banks in emerging market economies may not be able to reach this outcome. The Bank of Korea has proposed a phased introduction of the new Accord – first, the Standardized Approach by the implementation date, followed by the IRB approach when all banks are in a position to adopt it – to avoid placing banks in emerging market economies at a competitive disadvantage.¹⁹

The inadmissibility of physical capital as collateral for risk mitigation

A related problem is the fact that the new Accord does not recognize transactions secured by non-financial collateral such as commercial property, which is a common practice in many Asian banks and reflects the lack of credit assessment techniques in the region. Loans secured by non-residential land assets will be classified as being as risky as transactions that are completely unsecured (100 per cent capital charge), which will further inflate capital requirements and may be detrimental to economic growth. A number of countries in the region, including the Republic of Korea, Thailand, Malaysia and India, have written to the Basel Committee to urge that risk weights for assets secured by commercial real estate be lowered, but another lesson of the Asian financial crisis is that the value of collateral provided by commercial land is more volatile, so a greater risk weight is justifiable, although the percentage may need further discussion. However, as Bank Negara Malaysia has pointed out, many small- and medium-sized enterprises (SMEs) will find it difficult to obtain loans at reasonable rates if banks can no longer accept property as collateral.²⁰ This issue is being considered by the Basel Committee, which has said that further efforts are needed to ensure that credit exposures to SMEs receive appropriate treatment, and this is likely to result in lower capital requirements for SME lending than indicated in the proposals.

Capital charge for operational risk

Another factor contributing to increased capital requirements is the 20 per cent capital charge for operational risk, which did not exist in the 1988 Accord. It has been suggested that the operational risk charge may not be as applicable to smaller banks that engage primarily in traditional banking practices and domestic transactions and that it may therefore be unfair to subject them to the same regulations as large international banks. The Basel Committee has indicated that the 20 per cent figure will be re-examined in the light of a quantitative impact survey of banks in countries inside and outside the G-10. However, the Committee has not so far included the risk of loan concentration, which can be significant for Asian banks. While these reforms may ultimately make banks stronger, significant increases in reserve capital requirements will seriously hinder their ability to lend funds, thereby reducing lending in the short term and potentially restricting access to capital for many institutions.

Bank internal ratings may also increase pro-cyclicality of lending

The new regulations create an incentive to hold liquid, low-risk assets, which could make it difficult for emerging markets to obtain capital, resulting in a decreased flow of foreign direct investment to developing countries at least in the short run. This could have a negative impact on overall economic development and growth in these regions.²¹ The IRB approach may also exacerbate the pro-cyclicality of the business cycle, credit being more readily available during booms

¹⁹ Letter from the Governor of the Bank of Korea to the Basel Committee on Banking Supervision, 30 May 2001 (<http://www.bis.org/bcbs/cacommments.htm>).

²⁰ Bank Negara Malaysia, “New Capital Accord – second consultative paper”, comments submitted to the Basel Committee on Banking Supervision, 2001 (<http://www.bis.org/bcbs/cacommments.htm>).

²¹ S. Griffith-Jones and S. Spratt, *op. cit.*, p. 15.

and scarce during busts. This is already a problem in many Asian economies at present, particularly in Japan, where the reluctance of banks to issue loans despite high levels of liquidity has slowed the pace of economic recovery. There is the alternative that improved risk assessment capabilities may make banks more eager to hold assets, particularly those with a low probability of default, but more risky assets will face high capital charges. On the issue of pro-cyclicality, the Committee has indicated that it considers the 8 per cent capital requirement to be a minimum and that it expects banks and supervisors to strive for a higher level of reserve capital to be built up during favourable times to act as a “cushion” for downturns and so permit the “smoothing” of lending.

Pillar 2 may be of greatest importance

In the view of some commentators, the most significant aspect of the proposed new Accord is Pillar 2 and its emphasis on the supervisory review process.²² There is some concern, however, that supervisory resources may not be adequate and fees may need to be imposed on banks to fund the more complex review requirements. Supervisors will need more guidance on assessing banks' risk management systems and the quality of the ratings provided by external agencies. Cross-border coordination and cooperation between supervisors may also be required.²³ While the aim of the proposals is to encourage banks to determine their “economic capital” themselves, supervisors may have difficulty in getting banks to maintain higher capital reserves than the minimum even though the legal authority for this may be available.²⁴

Realism needed in implementation

The new Basel Capital Accord represents a step in the right direction. IRB assessments promote market confidence, and improved consistency in bank capital requirements could help to protect against the recurrence of situations like the Asian financial crisis. However, this type of reform must be done with prudence and foresight and banks in developing countries should be given the flexibility to implement new regulations at a realistic pace with technical assistance and consultation from the Basel Committee, the Financial Stability Institute, the International Monetary Fund and developed nations. To quote the Prime Minister of Thailand, Mr. Thaksin Shinawatra, “Implementing BIS standards and guidelines will be useful to make our financial system strong but application timing must be consistent with the state of our economic development and existing limitations.”²⁵ Revised capital adequacy requirements should be phased in after the establishment of a basic set of preconditions, including proper accounting standards and realistic definitions of regulatory capital. Banks operating only in domestic markets should be differentiated from large international banks. It may not be cost-effective for small domestic institutions to attempt to adhere to the requirements of the new Accord. The same rigorous standards should not be applied to all banks across the board, particularly those operating in very different economic environments. This is recognized in the new Accord by allowing banks to select from one of three approaches. However, banks that are unable to adopt the IRB approach will be at a competitive disadvantage owing to significantly higher capital requirements and banks that adopt this approach will become more adverse to assets with higher risks. The combination of these factors could have negative economic repercussions for emerging market economies.

²² World Bank, *op. cit.*, pp. 7-8.

²³ IMF, *op. cit.*, p. 7.

²⁴ World Bank, *op. cit.*, p. 6.

²⁵ Inaugural address by H.E. Mr. Thaksin Shinawatra, Prime Minister of Thailand, at the fifty-seventh session of ESCAP, Bangkok, 23 April 2001.

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