Introduction

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While some Asian countries have staged a remarkable recovery from the deep 1997–98 financial crisis, growth has been uneven and the concern now is how to sustain the recovery. At the forefront of policy considerations is how to mobilise and govern financing for sustained growth.

The Sixth International Forum on Asian Perspectives, on which this book is based, thus sought to identify ways in which resources could be brought into play for development purposes from both the public and the private sectors and, indeed, from a partnership between both. The task is enormous: two–thirds of the planet's poor live in the Asian region and the accumulation of wealth in that region is not trickling down to them as fast as it should, and often hardly at all. The first question, therefore, is how can local assets — domestic resources — be drawn into supporting development; the second, complementary to the first, is how can foreign resources best be employed in the same direction; and, finally, what is an appropriate mix of public and private financing for development? The challenge has become one of rethinking the whole question of development financing in which all sectors of the financial community are involved, including official development assistance (ODA) donors.

Pro–poor sustainable growth is a necessary precondition for reducing poverty further, and that growth has to be financed. For example, an increasingly prosperous and urbanised Asia needs huge infrastructure investments, amounting to more than $100 billion per year, according to Asian Development Bank (ADB) projections, for sanitation, environmental protection and education.

The scale of the region's financing requirements calls for the mobilisation of domestic resources, particularly through public finance reform; for attracting reliable foreign flows, especially through opening further to long–term flows and through bringing corporate governance and transparency to global standards; for improving the allocation of resources, specifically through complementing Asia's bank finance with direct securities markets, and for private–public partnerships, as finance needs for infrastructure exceed public–finance possibilities by a wide margin.

Public Spending Reform

Much of Asia has long been characterised by high domestic savings, which financed the rapid capital accumulation that accompanied remarkable economic growth. One of the legacies of the Asian financial crisis, however, is the prospect that it may lead to a temporary drop in government, corporate and household savings as a result of reform efforts devoted to restoring sustained recovery. As a result of the ongoing and extremely costly resolution of the region's banking crises, bank recapitalisation has saddled many Asian governments with heavy public debt burdens, hence reducing government savings. Meanwhile, corporate savings may be affected negatively as long as growth prospects are not yet durably installed. Household savings may drop as a result of fiscal reform efforts aimed at containing public deficits and as a result of any positive income effect of financial–system reform aimed at higher capital returns. Rising old–age dependency is also set increasingly to dampen private savings. Theory and evidence have shown that only a return to sustained growth will — with a lag — stimulate savings again, as it did in the past in Asia.

One fairly reliable means of mobilising domestic resources is through public–finance reform. It can be shown that higher public savings only reduce private savings by half as much, thus resulting in a net increase in national savings. The problem here, however, is that government income has been hit by falling tax revenues, resulting from falling profit levels and private incomes, at the same time as calls on public spending rose as a result of the increased cost of debt service brought on by the devaluation of the currency. When the cost of recapitalising the banks is added, the scope for generating higher public savings is clearly reduced.

Innovative fiscal arrangements will have to be developed to deal with this new environment and permit public savings to rise. While it is obvious that Asian governments will need to improve revenue collection by broadening the tax base and reducing exemptions, a fresh look needs to be taken at streamlining and rationalising public spending. The sixth International Forum on Asian Perspectives suggested eight areas for public spending reform:

— refocusing the role of government so that spending produces public rather than private goods;

— improving transparency and accountability by adopting internationally recognised systems of public accounting and more improved disclosure procedures, and by introducing effective oversight mechanisms;

— fixing of priorities by reducing wage expenditure, rehabilitating infrastructure and raising spending on social development and poverty reduction operations;

— decentralising the management of public–sector activities according to the subsidiarity principle;

— privatising and entering into public/private partnerships for public–service delivery;

— developing a leaner and more effective civil service through appropriate incentive structures training;

— strengthening monitoring and evaluation; and

— integrating planning and budgeting into a medium–term framework.

Such measures, however, are not without their costs, specifically in the political field. What they amount to is the governance reform about which we have already made reference, and they imply reducing the power and influence of often key social, political and economic groups. By reducing discretionary powers and opportunities for patronage, such measures also diminish rent–seeking by groups which have become accustomed to using public resources for this purpose. Means will have to be found to overcome this political resistance, and among these means will certainly be reinforced democratic systems.

Attracting Foreign Resources

Alongside the central role of domestic resources for stimulating and facilitating growth, development and poverty reduction, there is an important place for foreign inflows in post–crisis Asia, provided that the right mix of these flows can be achieved. With domestic savings providing a limited pool of finance and with concessional financing in the form of aid flows on the decline, private foreign capital flows are bound to remain an important source of finance for Asian economies, despite the risks which can be associated with them and which gave rise to the Asian crisis in the first place. The primary risk associated with external flows is sudden reversal. These flows, typically bank lending and debt, tend to contribute to misallocation in the context of domestic distortions and corruption. In order to maximise the benefits of foreign flows — capital deepening, efficiency enhancement, technology transfer and consumption smoothing — the right mix of flows must be encouraged by the host countries. This is particularly true in those countries where domestic credit channels are weak. Essential to the maximisation of the benefits from foreign capital flows is the creation and maintenance of a regulatory regime with mandatory disclosure of financial information by the private corporate sector and enforcement and oversight by tightly regulated financial intermediaries. Such structures will permit foreign investors to obtain reliable information on the basis of standardised host–country data; employing modern risk–management techniques will, as a result, make global capital flows less risk–prone than in the past.

Recent research has demonstrated the degree of reversibility of different types of financial flows and the International Forum on Asian Perspectives heard evidence of the specific growth effects of the various types of flow. A clear conclusion is that Asian countries — and emerging markets generally — should favour portfolio flows and foreign direct investment (FDI) over debt–creating bank lending from abroad. Debt flows have a neutral or negative growth effect where banking systems are undercapitalised, while FDI and portfolio investment generate positive independent growth effects in emerging markets, even in conditions of bank undercapitalisation. If portfolio flows require tight regulation to avoid asset–price inflation, emerging markets can maximise the benefits from bad weather–proof and largely irreversible FDI through a number of policy measures designed, principally, to reduce long–term import substitution, raise the educational level of the population and reduce price distortions produced by subsidies.

The role of official development assistance in supporting long–term fundamental structural change is likely to be limited, especially since ODA has declined since 1990 in both absolute and proportional terms when compared with foreign private flows. However, ODA can play a catalyst role in correcting identified weaknesses and in attracting new private financing, especially where it is used in social sectors, such as education, which are important in persuading FDI to come into the economy. ODA has also been instrumental in palliating the effects of the crisis — though not all countries decided to accept the rescue packages designed by the International Monetary Fund (IMF) — and Japan was a leader in mobilising funds for this purpose. The long–term effect of this use for ODA has not been determined. Perhaps more germane to the discussion is the use of ODA for poverty–reduction programmes during and in the aftermath of the crisis. Here, in an area traditionally unattractive for private funds from either domestic or foreign sources, ODA may be virtually the only source of financing when governments are forced to cut spending and face reduced revenues. The question debated at the Forum revolved around the feasibility of maintaining ODA levels during a crisis and specifically focused on both the co–ordination of ODA policies and improving effectiveness.

A new field for overseas public funding through ODA and other official funding is support for good governance. Currently only a small proportion of development assistance is directed to this purpose and, significantly, much of that goes to small island states. The financial crisis demonstrated, among other things, that the administrative and absorptive capacity of the Asian countries most badly affected was partly to blame for the unsustainability of the high levels of private flows they were receiving. This is thus an area where ODA and other official flows could usefully be used in order to attract more stable forms of foreign financing and improve financial management, generally. At the same time, official foreign flows can be used to support local government and non–governmental organisations in an attempt to underscore the governance initiatives being taken by national authorities and reformed enterprises.

Strengthening the Financial System

The importance of a sound financial system is particularly important for growth and development, and is crucial for recovery after a crisis. In the last few years of the 1990s, it became clear that the financial system in many Asian countries was anything but sound and this weakness, especially in economies where bank lending was the major source of financing for enterprises, was fatal. Since then, valiant attempts and large amounts of money have been spent on restructuring and recapitalising surviving banks and closing terminally unviable ones, but many remain weak and vulnerable. In these conditions, banks are unable to intermediate sufficiently between private savers and corporate borrowers because they are preoccupied with trying to acquire low–risk government debt or highly liquid assets in order to pursue recapitalisation. The result for enterprises with little or no access to the securities markets or to foreign finance is a chronic shortage of funding. This is especially true for small and micro enterprises which account for up to 70 per cent of employment in low–income Asia and is thus a significant factor in maintaining or worsening poverty levels. A pro–poor strategy must, therefore, include an element of support for local banking equal to that accorded to capital markets.

Overall, the reluctance of banks to lend to private enterprises, a trend exacerbated by the crisis, is a substantial brake on recovery and future growth. Most of the crisis–hit Asian countries are unable to compensate for the banks' timidity in lending to the private sector with efficient capital markets and this implies that direct securities markets must be nurtured. Particular attention needs to be devoted to developing local bond markets in order to diversify the sources of corporate finance and to satisfy Asia's investment appetite reflected in the high levels of savings we have seen. This part of the recovery picture is relatively promising, in that government deficits and restructuring needs are stimulating the development of local bond markets through the issuing of government paper. Since the corporate bond market has a tendency to look to government paper for pricing benchmarks, this is a positive sign which will bring some dynamism to such markets. Nevertheless, obstacles remain on the supply side of local Asian bond markets. Lack of transparency in auction procedures, related to poor governance practices and the prevalence of family–owned firms, deters buyers, while market fragmentation and a small number of liquid benchmark bonds, as well as taxes and settlement obstacles in the secondary market, contribute to low levels of liquidity. Market–to–market accounting, such as that introduced in Korea, should force financial institutions to adjust their portfolios frequently and thus provide liquidity to the market. Meanwhile, the general shift which is beginning to take place in Asian countries from board–based corporate systems to market–based ones, from "insider" to "outsider" models, will strengthen corporate governance and add further transparency to corporate behaviour, thus attracting investor confidence and stimulating interest in the local bond market. This is particularly important because, as globalisation intensifies and competition between markets increases, local investors are more and more able to make investment choices outside their national boundaries.

Problems also remain on the demand side of local bond markets. The role of the small, independent investor in most Asian countries is small and bond markets have to rely on the larger, institutional investors, mutual funds and foreign investors. Local institutional investors, such as pension funds, need to be strengthened and encouraged. Deregulation can play a part in this process, but management skills also need to be reinforced. As far as foreign investors are concerned, regulation has to be made more pliable and attractive. Measures such as offering tax benefits to foreign investors are being implemented, but more needs to be done on a region–wide basis.

Finally, as part of a poverty–reduction package of strategies, small and medium–sized enterprises must be given access to the bond and financial markets. Their special needs are unlikely to be met by the private sector alone and will have to rely on government initiatives to encourage and facilitate the establishment of appropriate financial institutions through, for example, policy and tax incentives. To compensate for the lack of collateral, peculiar to small and medium–sized enterprises, loan–guarantee institutions will be necessary. In the environment thus created, commercial financial institutions with prudent supervisory systems will cater to their needs leading to their growth and the employment opportunities they are likely to create.

Private Sector Participation

The decline in public flows to emerging economies and developing countries in Asia and elsewhere has led to the transfer of some of the burden of development financing to the private sector. There has thus been a fundamental shift in the aid–for–development paradigm and the private sector's contribution has become crucially important, to such an extent that private capital has replaced public funding in what were once considered the preserves of the state: water and electricity supply; telephones and communications; transport and urban development; health, education and social security. This evolution is seen as a positive trend in countries where consumers were unable to rely on optimal choice at low cost. In addition, the sheer size of some infrastructure projects defies the capacity of public authorities' resources. The role of the public sector, therefore, has become one of creating an enabling environment for private initiatives and of supporting business opportunities in these fields. This role is emphasised by the continuing shortage of bank financing in the aftermath of the crisis and as businesses are forced to turn to domestic and foreign public financing for their projects. In Asia, the ADB has taken a leading role in facilitating the entry of the private sector into development projects.

Many of the initiatives involved are, in fact, public–private partnerships, but their scope may be limited. Financial obligations and responsibilities between the two partners must be clearly mapped out in order to avoid moral hazard problems which might culminate in expensive public bail outs. In the experience of the World Bank, for example, similar partnerships have resulted in infrastructure projects 30 to 40 per cent of which have been labelled by the World Bank as "problematic". It is essential not only to create stable macroeconomic conditions and adopt regulatory reforms which open markets to competition and private investment, but also to establish an environment conducive to mitigating project risks. The problems resemble those of the governance which we have already mentioned: improved legal frameworks for contract enforcement; improved and more transparent accounting procedures; wider use of risk management; clear definition of the layers and responsibilities of government; regulation fostering local and foreign oversight. In the absence of such reforms, the entry of the private sector will be even more timid than it has been hitherto and the effect of the partial withdrawal of the public sector will be more severe. Private participation in the development process should not, therefore, be seen as some kind of magic solution to the problems left behind by the receding crisis. It will require the same kind of attention to governance principles witnessed elsewhere in the economies of post–crisis Asia.