1. The implications of an increasingly interconnected world on the Asian Development Bank (ADB) and other multilateral development banks are difficult to decipher with any degree of certainty. The key trends and issues in cross-border capital flows, trade, and regional cooperation are discussed below.

A. Cross-Border and Domestic Financing

2. Capital mobility across borders has linked national financial markets into a tightly connected global system. Cross-border lending, foreign direct investment, and purchases of equities and bonds that reflect the degree of integration of the global financial system, grew rapidly from about $1 trillion in 1990 to $4.9 trillion in 2000 and to a peak of $11.8 trillion in 2007. Although global cross-border capital flows still remain well below this peak, they appear to have rebounded in the world’s developing economies. Middle-income countries (MICs) of Asia and the Pacific region are now able to access finance from a number of sources. In addition to international public finance (including official development assistance on concessional and nonconcessional terms, many MICs now access finance from (i) portfolio investments, direct investment, export credit, and remittances; (ii) domestic institutional investors and domestic tax revenues; and (iii) philanthropic foundations, funds raised by civil society organizations, and the recent phenomenon of crowd-funding on online platforms.

3. Given the increased access to finance from a variety of sources since the turn of the century, the share of ADB debt in total external debt has reduced significantly for both lower middle-income countries and upper middle-income countries. During the study period, ADB loans averaged less than 1.4% of total external debt for upper middle-income countries and less than 4.1% for lower middle-income countries (Figure 1). During the same time period, average ADB lending across lower middle-income countries ranged between 7% and 9% of long-term public external debt; while average ADB lending across upper middle-income countries as a share of long-term public external debt showed a definite upward trend from less than 5% to 9% (Figure 1). Long-term public external debt is mostly used for infrastructure projects apart from some policy reform projects (policy-based loans) and emergency loans.

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2 Increased liquidity from time to time and improved credit worthiness are some of the reasons.
3 For example, ADB's emergency assistance for Wenchuan earthquake reconstruction project involved an ordinary capital resources (OCR) loan with LIBOR-based interest rate and a maturity period of 32 years. The policy-based loan for Beijing-Tianjin-Hebei air quality improvement program had a loan repayment period of 12 years.
4. ADB’s lending is attractive and competitive in the sense that the cost of borrowing from ADB is lower and the average maturity of loans longer than those of alternative sources. The average maturity of loans from official sources in recent years is more than 20 years for lower middle-income countries and upwards of 15 years in upper middle-income countries,\(^4\) compared with less than 10 years on new external debt from private creditors (Figure 2).\(^5\)

5. Implicit interest rates for public and publicly guaranteed debt from private sources have declined for most upper middle-income countries and lower middle-income countries during the study period.\(^6\) In line with this trend, implicit interest rates from official sources (including ADB) to most

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\(^4\) Official sources refer to public and public guaranteed debt cover loans from ADB and other multilateral development banks, other multilateral and intergovernmental sources, and bilateral sources.

\(^5\) Borrowing from private creditors includes bonds that are either publicly issued or privately placed; commercial bank loans from private banks; and other private financial institutions.

upper middle-income countries and lower middle-income countries have also reduced. For ADB in particular, the overall implicit interest rate for ordinary capital resources (OCR) loans reduced from 4.87% in 2006 to 1.12% in 2014. Overall, the spread between ADB’s OCR lending and lending from private creditors has shown a downward trend since 2007, and the spread is smaller for upper middle-income countries.

B. Regional Cooperation and Integration

6. Of the subregions in the Asia and the Pacific region, the Association of Southeast Asian Nations (ASEAN) has made the most progress towards economic integration. Market-driven cross-border private activity, propelled by liberalization efforts in some countries, has made this possible, together with ASEAN institutions that have helped harmonize rules and regulations. However, regional integration outcomes in different parts of the world suggest that there is considerable untapped potential for regional integration in ASEAN and elsewhere in Asia. To date, about 60% of regional integration potential has been achieved for East and Southeast Asia, and about one-third for South and Central Asia.

7. Asia’s share in world trade has increased over the years, partly due to the rapid economic growth of the People’s Republic of China (the PRC) and India. About 55% of total Asian trade is intraregional, compared with 65% for the European Union and 42% for North America. A major driver of regional integration in Asia has been the growth in intra-industry vertical trade in intermediate goods facilitated by a network of production centers spread across the region. About 60% of the region’s trade is in intermediate goods. Intra-regional trade at the subregional level is highest for East Asia (35%) and Southeast Asia (24%); and less than 10% for the other subregions.

8. MICs can be both recipients of and contributors to assistance in supporting regional cooperation and integration initiatives relating to cross-border infrastructure and other regional public goods. Economic corridors that cut across national boundaries of several MICs have gained prominence. They are distinct from transport corridors and help improve competitiveness through the

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7 Most of ADB’s new lending from OCR is in the form of London interbank offered rate (LIBOR)-based loans. Libor-based loans carry a floating lending rate consisting of the 6-month LIBOR or another relevant floating rate benchmark, and an effective contractual spread and, where applicable, a maturity premium fixed over the life of the loan. However, the borrower has the option of changing the interest rate basis during the life of the loan. Maturity premium is based on the average loan maturity (ALM): it is nil for ALM <= 13 years; 0.1% p.a. for ALM 13 years up to 16 years; 0.2% for ALM greater than 16 years and up to 19 years. ALM is the weighted average time to repay a loan.

8 For sovereign loans negotiated on or after 1 January 2014, ADB’s effective contractual spread above LIBOR has been 50 basis points. For nonsovereign loans, the lending spread is determined on a case-by-case basis so as to cover ADB’s risk exposure to specific borrowers and projects. Interest rate spreads on public and publicly guaranteed debt from official sources relative to private creditors have also reduced over time.

9 The ASEAN experience is very different from the European experience. In Europe, integration came about almost as a political necessity, and there was an understanding that sovereignty had to be given up for some regional good. Nonetheless, both ASEAN and the European Union continue to pursue integration. For further details, refer to ADB. 2014. Asian Economic Integration Monitor. Manila.

10 Regional integration potential was estimated in relation to benchmark performance of other regions under similar circumstances. Data envelopment analysis methodology was used to assess the untapped potential. A multidimensional indicator—covering trade and financial integration, cross-border mobility of people, and remittances—was used to rank regions according to their current degree of regional integration, which allows for a direct comparison of Asia’s regional integration performance with that of other regions across the globe. For further details, refer to IED. 2015. Thematic Evaluation Study: Asian Development Bank Support for Regional Cooperation and Integration. Manila: ADB.


13 Economic corridor development involves building infrastructure such as transport networks, energy, communication, urban infrastructure (water, sanitation, and waste management), industrial parks, and special economic zones, and appropriate policies and institutions to attract private investments necessary for economic growth. ADB. 2014. Operationalizing Economic Corridors in Central Asia: A Case Study of the Almaty-Bishkek Corridor. Manila.
agglomeration of economic activity in specific locations interconnected with each other. Many MICs recognize the importance and potential benefits from creating economic corridors, and support their development.

9. To date, the PRC has actively supported regional cooperation and integration in various ways, through a mix of investment and knowledge sharing initiatives. Prominent infrastructure initiatives include the Silk Road Economic Belt and the 21st Century Maritime Silk Road, among others. The PRC’s regional knowledge sharing initiative aims to promote South–South cooperation through mutual learning from development experiences. Other MICs may or may not have made financial contributions to regional cooperation and integration but they appreciate the benefits of regional connectivity, joint efforts in supporting regional and global public goods, and taking measures to avoid negative spillovers. ADB recognizes that upper middle-income countries in particular can contribute in all these ways, as well as in South–South knowledge sharing.

C. Outlook

10. A comparison between MICs in Latin America and the Caribbean region and MICs who are members of ADB provides some interesting insights. Although there are historical and other differences between the two regions, MICs in both are made up of a mix of large countries with considerable economic weight and potential, medium-sized countries, and small island states. In 2014, urbanization rates and per-capita income levels of MICs in Latin America and the Caribbean were about twice those of the ADB MICs. If trends over the past decade—relatively greater dynamism exhibited by ADB MICs but similar aggregate population growth rates—continue in the foreseeable future, the Asia and the Pacific region will move closer to the per-capita income levels of the Latin America and the Caribbean.

11. Table 1 shows the net private capital inflows of the two regions during 2010–2014. Each region received about $130 billion of net private capital inflows annually, but, given the much smaller population of Latin America and the Caribbean, these flows translated into per capita availability of foreign private capital approximately 7.5 times higher than in Asia and the Pacific. This indicates the significant potential for attracting more foreign capital in Asia and the Pacific region, as it moves

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15 It is envisaged that under these initiatives, roads, railways, seaports, oil and gas pipelines, and other related infrastructure will connect East Asia through Central Asia with Europe, Russia, West Asia, South Asia, the Persian Gulf, and the Mediterranean. The maritime initiative looks at connecting the coastal eastern China through South China Sea with archipelagic Southeast Asia, Pacific, and India, Sri Lanka, Pakistan, Iran and Iraq, as well as Mombasa in Africa, and to the Mediterranean, northern Africa, and Europe through the Suez Canal.

16 For example: (i) the Pan-Beibu Gulf Economic Initiative, which targets maritime connectivity with the archipelagic Southeast Asia, and (ii) the Greater Mekong Initiative, which focuses on Northeast Asia bordering Democratic People’s Republic of Korea, Republic of Korea and the Russian Federation. The PRC is also supporting the development of a road and economic corridor from the newly opened land port of Karasu in western Xinjiang Province, through Tajikistan and Pakistan to the southern Pakistan port city of Gwadar. IED. 2015. Thematic Evaluation Study: Effectiveness of Asian Development Bank’s Partnerships. Manila: ADB.


18 The urbanization rate in Latin America and the Caribbean is 78% compared with 42% in Asia and the Pacific. Gross national income per capita (in current US dollars) was $9,095 in Latin America and the Caribbean compared with $4,012 in Asia and the Pacific. World Bank: World Development Indicators database.
towards higher income levels, stronger financial systems, and improved institutions and conditions for mobilizing foreign private capital.

Table 1. Selected Private Capital Flow Indicators for Latin America and Asia

<table>
<thead>
<tr>
<th>Item</th>
<th>Latin America and Caribbean</th>
<th>Asia and the Pacific Region</th>
<th>2010–2014 (Annual average)</th>
<th>2010–2014 (Annual average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net private capital inflows ($ million)</td>
<td>Whole region</td>
<td>Whole region</td>
<td>135,176</td>
<td>128,343</td>
</tr>
<tr>
<td>Per capita net inflows ($)</td>
<td>Whole region</td>
<td>Whole region</td>
<td>257</td>
<td>34</td>
</tr>
<tr>
<td>Share received by key countries (%)</td>
<td>Brazil</td>
<td>People’s Republic of China</td>
<td>30%</td>
<td>35%</td>
</tr>
<tr>
<td></td>
<td>Mexico</td>
<td>India</td>
<td>14%</td>
<td>11%</td>
</tr>
<tr>
<td></td>
<td>Next 5 countries a</td>
<td>Next 5 countries b</td>
<td>11%</td>
<td>25%</td>
</tr>
<tr>
<td>Share by type of flows (%)</td>
<td>Whole region</td>
<td>Whole region</td>
<td>65%</td>
<td>73%</td>
</tr>
<tr>
<td>Foreign direct investment</td>
<td></td>
<td></td>
<td>32%</td>
<td>23%</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td></td>
<td></td>
<td>3%</td>
<td>5%</td>
</tr>
<tr>
<td>Export credits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a Argentina, Chile, Colombia, Peru, and Venezuela.
b Indonesia, Malaysia, Philippines, Thailand, and Viet Nam.

Note: Data for the share of flows do not include 2014, which saw unusually high flows of portfolio investment to developing countries.

12. Table 1 also shows the significant comparative strength of Asia and the Pacific region. For in Latin America and the Caribbean, Brazil, and Mexico together absorb approximately half of the net inflows, in a similar way to the PRC and India in the Asia and the Pacific region. But the next five countries combined only account for 11% of total inflows in Latin America and the Caribbean compared with 25% for the next five countries in Asia. In spite of being members of several regional integration mechanisms and various trade agreements, these Latin America and the Caribbean countries do not have significant economic links among themselves, their trade relations are focused outside the region, and are largely based on exports of minerals and agricultural commodities. By contrast, in Asia, the next five recipient countries (all MICs)—Indonesia, Malaysia, Philippines, Thailand, and Viet Nam—are all ASEAN members and, in addition to enjoying practically unrestricted trade within ASEAN, they are linked by a web of production chain linkages among themselves and with other countries in the region, thus offering an attractive platform for incoming foreign investment.

13. The better integration of value chains among ASEAN members, and the poor trade and financial integration in South Asia and Central Asia results overall in: (i) a higher share of foreign direct investment in Asia’s capital flows (73% for Asia and 65% in Latin America) and (ii) a lower share of portfolio flows in Asia (23% for Asia and 32% in Latin America).

19 The five countries (Argentina, Chile, Colombia, Peru, and Venezuela) belong to the Community of Latin American and Caribbean States and the Latin American Integration Association. There are various trade agreements as well; for example Mercosur for Argentina and Venezuela; and Pacific Alliance for Chile, Colombia, and Peru.