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AGENDA ITEM 7

FOURTH MEETING OF THE APEC ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY BUILDING, KUALA LUMPUR, 3RD AUGUST 2005

ISSUES ARISING FROM THE APEC FINANCE MINISTERS' TECHNICAL WORKING GROUP MEETING, GWANGJU, KOREA, 16/18TH JUNE 2005

Background

The Coordinator ABAC FWG (and the Advisory Group) attended the TWG meeting. A report of the meeting is attached.

Issues

The report raises a number of substantive issues relating to the role and indeed the rationale for APEC and which no doubt will be considered at subsequent meetings of FWG and by Ministers. Issues of specific relevance to capacity building and to the Advisory Group are highlighted in the attachment; they occur mainly on pages 4 and 5. They are summarised below:

1. AFDC is to consider training programs on financing for SMEs – the World Bank considers that financing should involve developing a credit culture in SMEs; Indonesia is keen to develop bond issuance to promote SMEs; Vietnam is seeking technical assistance on guarantees to support SME financing
2. the APEC Finance Regulatory Training (AFRT) Initiative organised by the ADB and the US Fed Reserve will undertake training on Basel 2 and supervision and on anti-money laundering; risk focused supervision and on securities
3. the Australian Treasury will develop a capacity building initiative to promote insolvency reforms
4. the US and Australian Treasury Depts. will seek to merge a training program for insurance regulators on casualty insurance

Recommendations

The Advisory Group consider/endorse the following responses to the four initiatives:

- **Item 1.** advise AFDC of its support for the training it proposes and its willingness to encourage private sector finance inputs to support its program/s

- **Item 2.** take note of the work to be undertaken under the AFRT and to avoid duplication with other capacity building initiatives, inform the ADB of any proposed work and seek close collaboration with the Bank
- **Item 3.** through ABAC Australia, inform the Australian Treasury of private sector interest in involving in work to promote insolvency reform
- **Item 4.** through ABAC Australia, liaise with the Australian APEC Study Centre and with the US Treasury – with a view to incorporating casualty insurance as a component of training organised by the APEC Study Centre

Coordinator

19th July 2005

ATTACHMENT

SUMMARY REPORT AND RECOMMENDATIONS OF ABAC'S ATTENDANCE AT THE APEC TWG MEETING, GWANGJU, KOREA, 16TH /18TH JUNE 2005

Summary:

- ABAC was treated as a participant – as distinct from an observer – and allowed time to comment on all agenda items; generous time was provided for the ABAC presentation
- TWG recognised that there is a strong alignment between the issues that will be included on the Ministers' FMM agenda and those AB AC proposes to raise; in particular:
 - capital flows and FDI
 - the challenge of ageing and pensions and capital markets
- the APEC finance processes is wrestling with relations with APEC more broadly, as reflected in the discussion on a proposed APEC roundtable with IFIs and on how to incorporate Finance Ministers' recommendations in the Leaders' Declaration
- TWG representatives strongly support an improvement in the dialogue between APEC FMM and ABAC and moves to provide for constructive informality; however, the TWG Chair, publicly at least, was unable to commit to any particular process (privately, the Chair will consider what can usefully be done)
- Vietnam, Indonesia and China were active participants and are supporting work which focuses on financial system strengthening and reform; this augurs well for the future role of APEC
- based on comments by the SOM chair, some of the important structural reforms to APEC, as recommended by ABAC in the MTR, are unlikely to be adopted

Recommendations

- ABAC should seek to continue to be involved in the TWG processes and work to ensure that the TWG chair participates in ABAC meetings (I extended an invitation to the chair to attend the third meeting in Kuala Lumpur)
- there is generally broad support in TWG for, and recognition of, ABAC's contribution to the APEC FMM and ABAC should enhance this by regular involvement in the TWG and at economy level with senior Ministry officials
- a strong contingent of ABAC FWG members should attend the APEC FMM in September, in anticipation that there will be a more participatory dialogue/discussion
- in its presentation to APEC FMM, ABAC should:
 - make clear linkages to ageing, pensions and capital markets, infrastructure financing and bond markets
 - the benefits of FDI to financial system strengthening
 - the importance of the work undertaken on FDI in financial systems and the check-

- list and the check-list on measures to liberalise financial sectors in the WTO Doha Round
- our work on volatile capital flows
- where appropriate support APEC Finance officials in their efforts to gain more recognition in the APEC processes for financial system strengthening and economic reforms
- ABAC FWG should consider areas in which it can contribute to the TWG policy debate, over the coming year, namely, contingent liabilities as an aspect of fiscal management (perhaps as related to unfunded public pension systems), and on aspects of reforms to the financial stability framework, as well as issues that will be proposed by the incoming chair (Vietnam).

***Ken Waller,
Coordinator, ABAC FWG***

REPORT

I attended this meeting, along with senior representatives from Finance Ministry/Treasury and Central Banks from 20 APEC economies, and from the IMF, the World Bank, the ADB, PECC, AFDC and the APEC Secretariat. The new chair of the TWG, Mr. Tae-Kyun Kwon, Director General, International Finance Bureau of the Ministry of Finance and Economy, provided me generous time to comment on various agenda items and to make a presentation on behalf of ABAC. (A copy of my speaking notes and power point presentation is attached to this report).

The meeting covered the following main topics:

1. review of existing and new programs of policy papers and training programs under the APEC FMM processes
2. review of macro economic developments – presented by the IMF, WB and the ADB
3. discussion of policy themes for the forthcoming Finance Ministers' Annual Meeting, namely:
 - A - free and stable movement of capital
 - B - the challenge of ageing economies
4. Briefing on the SOM Process for 2005 by Amb. Jong-Hoon Kim, SOM chair
5. ABAC and PECC presentations
6. Preparations for the APEC FMM

Key points arising under the items just noted are as follows:

1. Review of existing and new policy papers

- AFDC will consider undertaking a training program on financing SMEs – possibly later

this year; the WB noted the need to look beyond traditional SME issues and consider cash flow analysis and also how to promote a global credit culture; Indonesia would wish to participate and asked that a program should also consider the issuance of bonds to support SME financing; Vietnam is looking for technical assistance on guarantees to support SME financing

- on remittances, discussion focused on savings that might be generated from moving from informal to formal systems; Australia noted that the issue should be seen not just in terms of payments systems but also in welfare and investment creating terms; the WB noted the importance of economies making structured progress and that Ministers need to maintain public pressure for reforms; the US asked that since this aspect of the work program had been completed (led by the US) a stand alone statement on remittances be made by Ministers, and which would press for continuing reform; the US proposed an attachment to the Ministerial statement; (the outcome will be determined by the drafting group on the Ministerial statement)
- the APEC Finance Regulatory Training Initiative organised by the ADB and the US Fed Reserve will undertake training on Basel 2 and supervision and on anti money laundering; training will also be provided on risk focused supervision and on securities
- the WB asked that it be involved in a proposal by Australia on insolvency reforms, noting that it could usefully undertake assessments of progress under FSAPs
- a proposal by the US to consider training on casualty insurance will be considered in conjunction with training proposed by Australia on life and general insurance matters
- two proposed studies by Australia were discussed at some length and led to revisions to the titles and scope of the studies; one will involve "a review of reform to the financial stability framework in the decade since the Asian financial crisis", and the other will be titled "fiscal management"; the latter will involve an officials' policy dialogue focusing on the extent to which fiscal risks – such as contingent liabilities arising from infrastructure financing – are reflected in government accounts, and the potential impact on the fiscal position; the former will also involve a policy dialogue based on a stock-take of measures to overcome weaknesses in financial systems:

Vietnam strongly supported the stock-take study and will co-sponsor (it relates this work to design work going on in the next 5 year national plan)

China also supported the study and will co-sponsor

(In supporting this stock-take proposal, I noted the importance ABAC had placed on financial system strengthening as central to APEC's ongoing role (in the MTR) and that ABAC could make a useful contribution to the proposed study)

Vietnam and Indonesia strongly supported the fiscal management work; the WB noted the relevance of this work to pension system reform; there was broad support for both initiatives

2. Review of macro economic developments

- the IMF noted that while the pace of growth is slowing, it is heading to a more sustainable level; the balance of risk is toward the downside with 3 major risks being the potential

for a sharp rise in interest rates, sustained higher oil prices and widening global imbalances; the US has successfully moved to a "neutral" monetary stance but long-term rates are starting to edge up; easing global imbalances would involve shared responsibilities, including by the US, Europe, Japan and China, in respect to the current exchange rate regime

- the WB noted that global imbalances could continue to exist for some time but they are not sustainable for a lengthy period; there is a need for the US to improve private savings and for Japan and Europe to improve growth and that greater exchange rate flexibility in East Asia would be helpful
- the ADB noted that East Asia needs to increase investment and to provide for more flexible exchange rate regimes; the ADB noted that due to US import and export price inelasticities, even a small reduction in the US CAD would require a major depreciation of the \$US, or, conversely, a 20% rise in the Yuen would make only a small dent in the US CAD; even so greater Yuen exchange rate flexibility should be part of world-wide package of changes to reduce current imbalances; importantly, East Asia should raise its investment rate from current subdued levels; in response to a question by Japan on how to manage in the absence of agreement on shared responsibility, I noted that economies had to keep talking to each other and that individually they had to keep reforming to improve resilience to and flexibility in dealing with external threats and to support liberalisation in the Doha Round

3A - Free and stable capital flows

- a number of country papers and a "theme" paper by Korea were presented; the author of Korean "theme" paper noted that:

- capital market liberalisation in Asia had not resulted in increased capital movement
- there are good grounds for encouraging institutional investors into APEC's emerging economies
- good data on capital flows would facilitate good policies

- the IMF noted that:

- the pick-up in investment flows in Asia may complicate policy choices but it helped to improve economic performance in the region
- expectations about a revaluation of the Yuen had prompted hedge fund activity in the region but the recent strengthening of the \$US had led to some easing of flows
- there is a trade-off between exchange rate stability (when the exchange rate is fixed) and macro economic stability
- large capital inflows do pose challenges and can feed through oil price increases
- a number of Asian economies have strong external positions but where exchange rates are fixed and capital inflows are strong, central banks are expected to sterilise flows and this can be costly; such policies are difficult to sustain over the long term
- as long-term rates are now rising, the near term risks of interest rate shocks are declining
- we confront a relatively benign outlook and this is an opportunity to develop sound

policy frameworks

- the World Bank noted:

- relatively low FDI into financial services in East Asia
- empirical evidence suggests that China is not diverting FDI away from other economies in the region
- regulations to control the flow of FDI may lead to greater volatility in inter-company lending across borders

- Chile noted:

- foreign investors play a key role in the economy
- of critical importance is the legal framework and the guaranteed rights accorded to investors

- the US noted:

- capital flows into financial services could contribute to financial system stability and that FMM should bear this point in mind in their statement on the Doha Round
- while not part of the capital account, remittances constituted an important flow of finance; (the World Bank queried, wrongly in my view, whether such flows were relevant for development purposes)

3B. The challenge of ageing economies

- a number of country papers and a theme paper by Korea were presented
- the WB noted that a number of rather sombre conclusions in the theme paper were based on predictions of future trends which did not take account of policy changes that might well come into play in the future; of course, pressure on fiscal balances arising from rising health and pension costs would, other things being equal, lead to ballooning deficits; however, predictions so developed were unlikely to be realised – non-aged related expenditures were likely to change as politicians faced choices and limited budgets; the Australian Future Fund was an example of how policy could help relieve future budget pressures
- there is a need to seek greater neutrality in retirement systems and a closer link between contributions and benefits; ensuring solid actuarial assessments; increasing the retirement aged; increasing contributions and reducing benefits; policies should aim to increase the participation rate and productivity
- most economies will have some "life-time poor" with zero pension coverage, because that group is unable to contribute to its own pension futures
- pension reform should be linked to labour market and education reforms
- Canada noted that policies since 1995 included reducing the debt burden and pension reform and that associated policies included increasing productivity growth

through investing in human and physical capital

- the US noted the importance of technology and productivity growth in improving capacity to provide for an ageing population

4. Briefing on SOM processes

- a key point in Amb Kim's presentation related to a proposal that SOM, in collaboration with senior officials from Finance Ministers and central banks, meet in a second roundtable dialogue with International Financial Institutions
- a number of economies queried the nature of the collaboration since it is Finance Ministers who have responsibility for relations with the IFIs and Ministers are members of the governing boards of IFIs; officials also queried the timing of a roundtable and were concerned that any agenda would reflect issues deemed as relevant by Finance Ministers; some questioned whether such a dialogue was appropriate
- the discussion led on to the question of how Finance Ministers should be brought into association with the Leaders' Declaration
- responding, Amb. Kim noted that a date for the round table had not been fixed although it could be back to back with the APEC FMM (on 10/11th Sept) and before SOM 3 on 12/13th; as to the agenda and the focus of the dialogue, these matters were still under consideration in the ESC and he was hopeful they would be settled after discussion with the IFIs
- I took the opportunity to note ABAC's views on the structural problem within APEC, namely that financial system strengthening and structural reforms were seen by business as now a key pillar of APEC and in the MTR, ABAC had proposed that this pillar be reflected in APEC's approach over the next decade or so; in response the ambassador observed that as regards reforms to APEC, IAPs could be made available ABAC a month earlier than they now are and that as regards other ABAC proposals some were perhaps too ambitious
- the TWG chair proposed that finance officials review the issue of the roundtable dialogue with their Ministers when they return to capitals and submit their comments to the chair

5. ABAC and PECC Presentations

- I spoke to the presentation attached, emphasising:

- ABAC's dissatisfaction with the processes at the meeting with APEC FMM
- the need to consider an opportunity for a dialogue when more Ministers are present – this might be achieved in an informal session (I noted the value of the dialogue between ABAC and Leaders)
- the value of participation in the TWG meetings as supporting the relevance of ABAC's work to that of Ministers
- the relevance and purpose of ABAC's presentations earlier in the week in Geneva on the check-lists on FDI in financial services and on measures for the liberalisation of major services in the WTO Doha Round

- the PECC representative (Prof. Ghon Rhee, University of Hawaii) outlined PECC's work program and noted that:
 - despite much work regional bond markets, there is, with few exceptions, little action, and the momentum seems to be fizzling out
 - if Japan is not interested in investing in Asian bonds, who else will invest?
 - a major incentive to promote regional bond markets ought to be the promotion of bonds for SME finance, with the attendant need to develop credit enhancement and special purpose vehicles; as to the latter, he noted that many small municipalities needing small scale funding – in North America, municipalities were able to access the bond market via SPV, which, because of credit enhancement, carried AAA ratings
 - two models to consider included an Asian Investment Fund and bonds issued by the European Investment Bank
- responding to my presentation, Japan noted that there is a vagueness about ABAC's discussions with APEC FMM and agreed that we should seek a real dialogue; he agreed to pursue informal discussions subject to all member economies agreeing and that this would not extend the time of the APEC FMM schedule; he proposed some streamlining of the FMM processes to allow time with ABAC and with other Ministers; these comments were endorsed by Australia and the US, with the latter noting that the high level involvement of the business community in APEC set APEC apart from other forums; the US also noted the high quality and quantity of work by ABAC and by PECC
- the US proposed that streamlining APEC FMM could be achieved in part at least by avoiding overlapping reports by the IFIs
- the US noted that APEC had not made a great success of Bogor, mainly because liberalisation occurred in the WTO; APEC should give thought as to how it might support the Doha Round; regional integration should be a more significant part of the FMM agenda
- Canada noted that the ABAC and PECC presentations raised issues which were highly relevant to the policy themes adopted by TWG and by Ministers; noting the productive developments started in the Leaders/ABAC dialogue in Bangkok, Canada strongly supported the idea of an informal session between APEC FMM and ABAC representatives, suggesting that perhaps a one hour pre-retreat discussion might be a constructive way to go; ABAC might then be in a position to propose one or two topics that Ministers could consider in the retreat
- responding to the discussion, the Chairman advised that while sympathetic to ABAC's request for an improved dialogue it may not be easy to resolve in time for the coming meeting

5. Preparations for the APEC FMM

- the Korean presentation noted the following:
 - date: 8/9th September
 - venue: Shilla Hotel, Jiju
- the APEC Finance and Deputies will meet on 6/7th Sept at the Shilla Hotel

- Korea will prepare the first draft Ministerial Joint Statement and circulate to economies for comment; there will be a main body of 3 pages and an annex of 6 pages; the main body will comprise an introduction; global and regional outlook; the APEC finance processes and other matters
 - a "retreat" subject entitled "future bioeconomy and the policy agenda"; a number of economies questioned the relevance of this theme to Finance Ministers; some suggested wider ranging topics such as technology and productivity growth
-