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THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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The Kyoto Report on Growth Strategy and Finance (The APEC Finance Ministers' Growth Strategy Report to the Leaders)

APEC Finance Ministers Meeting Chair

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I. Introduction

1. We, the APEC Finance Ministers resolved in Singapore to submit a report to our Leaders on efforts to secure strong, sustainable and balanced growth in the Asia-Pacific region.

2. A large number of APEC economies have launched their own medium-to-long term growth strategies to raise growth potential and boost employment, paying due attention to ensuring that growth is sustainable and balanced. Out of these growth strategies, we have identified priorities for securing the future growth in the areas of fiscal policy and finance.

3. The global economy is recovering from the recent global financial crisis but uncertainty remains. In the APEC region, growth has been strong in developing economies, but the pace of activity continues to be modest in many advanced economies and downside risks remain. The APEC region, as the most dynamic region, has an increasing role for the future course of the world economy. The APEC economies account for 54% of world GDP, 44% of global trade, and 40% of the world's population. Given the high interdependence among our economies, our cooperation is essential.

4. Against this backdrop, we discussed and adopted "The Kyoto Report on Growth Strategy and Finance" today, which we believe will contribute to the discussion of the APEC Leaders' Growth Strategy. In this Report, we highlight the importance of strong, sustainable and balanced growth in the future, as well as the importance of fostering sound fiscal management, particularly in light of the challenge posed to public finances by aging populations. We also draw attention to the importance of securing appropriate financing as a critical component of growth, competitiveness, employment and poverty reduction, particularly: enhancement of infrastructure finance, and improvement of access to financing for micro, small and medium enterprises and households. In addition, strengthening green finance is an important instrument in promoting the uptake of low-carbon intensive technologies and in facilitating environmentally sustainable growth.

5. We would like to take this opportunity to express our appreciation for the invaluable contributions to this Report by the International Financial Institutions (IFIs), in particular, the International Monetary Fund (IMF), the World Bank (WB) and the Asian Development Bank (ADB). We also thank the APEC Business Advisory Council (ABAC) for its input on the business community's views to strengthen growth in our region.

II. Stronger, More Sustainable and More Balanced Growth

6. We recognize that our first priority is to ensure a durable recovery in private sector demand. We must take steps to build a foundation for stronger, more sustainable and more balanced growth in the future. We note the importance of strengthening multilateral cooperation to promote external sustainability and pursuing the full range of policies conducive to reducing excessive imbalances and maintaining current account imbalances at sustainable levels.

7. We will move towards more market-determined exchange rate systems that reflect underlying economic fundamentals and will refrain from competitive devaluation of currencies. Advanced economies including those with reserve currencies will be vigilant against excess volatility and disorderly movements in exchange rates. These actions will help mitigate the risk of excessive volatility in capital flows facing some emerging economies.

8. APEC members have a critical role to play in this endeavor. Progress has been made since our last meeting, while further efforts are needed. At the same time, we remain committed to narrowing the development gap between economies in order to ensure inclusive growth in the region in the long run.

9. Economies with current account deficits are taking steps to boost saving, including through fiscal consolidation. Many economies have announced fiscal consolidation plans. Some of them are reforming their pension system to reduce fiscal deficits. Some are expanding private personal pension schemes to improve public finances and raise domestic savings. In cases where fiscal consolidation plans include tax measures, measures that result in a more equitable and efficient distribution of the tax burden, as well as measures that encourage savings over consumption, are desirable. We recognize that the timing and pace of fiscal consolidation will vary across economies, depending on the robustness of the recovery of private demand and financial conditions. Deficit economies are also pursuing structural reforms including efforts to enhance export competitiveness, while maintaining the open markets.

10. Economies with current account surpluses are working to reduce their reliance on external demand and to shift towards greater reliance on domestic demand for growth. Measures to raise household income, strengthen social safety nets to reduce the need for precautionary saving, and improve financial services to households can sustainably boost domestic consumption and raise welfare. It is also important to enhance investment by promoting Public-Private-Partnerships (PPP), and to develop financial and capital markets. Advanced surplus economies should strengthen their efforts to tackle structural reforms, which will help increase domestic demand.

11. To achieve stronger, more sustainable and more balanced growth, structural reforms will play a critical role. In this regard, we conducted a survey on structural reforms. We note that priority areas for structural reforms for the next five years are infrastructure development, public health care provision, and tax structure, as revealed by the study conducted by Singapore.

12. We are increasing employment opportunities. As a consequence of the global financial crisis, unemployment has risen to unacceptable levels. To this end, APEC economies are taking measures, such as the provision of vocational training and the improvement of education systems, that are tailored to economy specific circumstances.

13. Sound and well functioning financial systems are critical for sustainable growth and the efficient allocation of resources. We are committed to take action at a domestic and international level to raise standards, so that our domestic authorities implement global standards consistently, in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage.

III. Fiscal Management and Aging Population

14. Ensuring sound fiscal management and instituting credible and growth-friendly fiscal consolidation plans form the indispensable parts of our growth strategy. Fiscal deficits in APEC economies have risen due to counter-cyclical fiscal policies and the loss of fiscal revenues during the recent global financial crisis. In some of the advanced economies, higher fiscal deficits also reflect underlying age-related spending increases, in particular, pension and health care expenditure.

15. APEC economies, especially those with a high level of sovereign debt, should improve the efficiency of public finance management. In addition, such economies need to improve budget formulation and execution processes along with medium-to-long term budget planning. Capacity building, sharing information and developing cooperation among the economies, particularly among the treasuries, are useful in this regard. These measures will contribute to enhancing the long-term sustainability of public finance.

16. Some of the economies have launched initiatives to promote local currency-denominated bond markets, both in Asia and Latin America. The aim of such initiatives is to mobilize domestic savings for financing investment in the region, while also reducing the currency mismatch risk posed by foreign borrowing. These initiatives have enabled those economies to issue government bonds which, along with the space created by prudential fiscal policies, helped finance their counter-cyclical packages during the crisis, which amounted to $4.5 trillion in 2009 in Asia.

17. In securing sound fiscal management, aging populations pose a serious challenge to APEC economies from a medium-to-long term perspective through significant increases in age-related spending, such as pension and health care.

18. The share of persons aged 65 and over in the total population in our region is estimated to rapidly grow from 9.3% in 2009 to 22.6% in 2050 on average. The doubling time for the share of elderly persons to increase from 7% to 14% is as short as 15-20 years for some economies.

19. Public spending on both pension and health care is projected to increase significantly over the next 20 years (2010-2030) in APEC economies. The projected increase is, on average, 0.8 percentage points of GDP for pension (from 4.4% to 5.2%), and 2.9 percentage points of GDP for health care (from 5.0% to 7.9%). For some economies where coverage is already extensive and spending levels are high, the primary objective will be to contain the increase of these expenses over the long term. In other economies, the task will be to expand the coverage of pensions and health care while ensuring that the design of these schemes would not generate large fiscal liabilities for future generations and securing fiscal sustainability in the long run. Strengthening social safety nets will also have the beneficial effect of reducing the need for precautionary saving, thus boosting consumption and contributing to the process of rebalancing.

20. With respect to containing the fiscal cost of pensions, we may consider some options, such as increasing contribution rates, reducing levels of benefit, modifying indexation of benefits from a nominal wage base to an inflation base, taxing pension benefits and raising the statutory and

voluntary retirement ages. At the same time, we should be mindful of possible impact of raising retirement age on the level and structure of employment in some economies.

21. The menu for restraining spending on health expenditures or improving its efficiency may cover: encouraging provider payment systems based on lump-sum budgets rather than fee for service; appropriate cost-sharing with beneficiaries; enhancing the cost-effectiveness of medical treatments and technologies; adopting health information technology to promote efficiency; and, promoting the use of generic medicines.

22. These options and measures to address pension and health care expenditure have already been implemented in some of the economies. These experiences can be shared by other economies, taking into account specific circumstances of each economy, which would help strenuous efforts to reach domestic consensus for adopting and implementing reforms.

IV. Infrastructure Finance

23. Enhancing infrastructure finance is critical to growth, competitiveness, poverty reduction, and contributing to the process of rebalancing. The availability of infrastructure affects the investment climate. Economies with good infrastructure are more competitive as their firms are more productive. Good infrastructure also allows better access to social service delivery systems such as hospitals and schools, thus contributing to poverty reduction.

24. Infrastructure finance is a challenge for many economies due to the tremendous amount required. For example, in Asia, while economies have made great strides in improving the coverage and quality of infrastructure, there remains a significant need for infrastructure investment, reaching an estimated amount of approximately $8 trillion over the next 10 years.

25. In enhancing infrastructure finance, governments continue to play a major role, while the role of the private sector is increasingly important. Governments can provide long-term financing that is not readily available or not feasible in the market. They also have the central responsibility for putting in place a facilitative environment for private investment and innovation, such as reviewing cost recovery policy, protecting investors from arbitrary interventions, and strengthening law enforcement against non-payment for services, with a view to further promoting PPPs. As such, a holistic approach towards infrastructure financing is required.

26. To help such efforts by governments, MDBs can provide long-term financing and credit enhancement products, as well as capacity building and technical cooperation. They also have an important role in financing cross-border infrastructure. Export Credit Agencies (ECAs) can collaborate with MDBs and the private sector. We welcome the Infrastructure Forum to be held timely in Yokohama in November this year by the ABAC, the ADB and the Japan Bank for International Cooperation (JBIC).

27. Regarding private financing, we welcome the APEC Infrastructure Pathfinder Initiative which highlighted significant movement among APEC member economies toward commonality of best practice processes in private infrastructure provision, and the challenges of managing the complex issues around risk transfer and the lack of expertise. Noting that PPPs are often difficult to implement, we recognize the efforts to support this area through the APEC PPP mentoring

scheme. We welcome the 4th APEC Public Private Sector Forum on Bond Market Development held in Sapporo this May. We acknowledge the importance of creating more open and integrated financial markets in the region. In this regard, we take note of the first dialogue that took place in Malaysia this October with a view to facilitating greater cross-border flow of funds and financial services.

28. In the APEC region, there are many on-going initiatives regarding infrastructure. One of the recent examples is the establishment of an Infrastructure Fund and a Guarantee Fund to attract investments to help meet its infrastructure requirements to support strong economic growth.

29. Regarding cross-border infrastructure financing, MDBs are playing a pivotal role. For example, the ADB is implementing the Greater Mekong Subregion (GMS) Program that covers China, Thailand, Vietnam, and other economies. Other regional projects, such as BIMP-EAGA (Brunei Darussalam, Indonesia, Malaysia and the Philippines - East ASEAN Growth Area) and IMT-GT (Indonesia, Malaysia and Thailand Growth Triangle), are also receiving support from the ADB. The Inter-American Development Bank (IDB) is facilitating the Initiative for the Integration of Regional Infrastructure in South America (IIRISA) that covers South American economies including Chile and Peru, and the Plan Puebla-Panama that covers Central American economies including Mexico.

30. As infrastructure finance has a significant impact on the macroeconomic environment and on budgetary frameworks, its coherence with growth strategies or development plans, such as Poverty Reduction Strategy Papers (PRSPs), and medium-term expenditure frameworks or fiscal consolidation plans is important. We will work together with the MDBs and call on them to continue providing assistance to developing economies in elaborating holistic development plans.

31. Environmental dimensions of infrastructure finance should be addressed appropriately. While infrastructure finance is indispensable in ensuring growth, we should minimize its environmental impacts, including ecosystem destruction and biodiversity loss. Government, together with the MDBs, need to further strengthen the environmental due diligence and mitigation measures for infrastructure development, incorporating new knowledge and methodologies. MDBs should make sure that developing economies take the driver’s seat.

V. SME (Small and Medium Enterprise) Finance

32. Enhancing financing for SMEs is a critical component of the growth strategy, as SMEs play the role of engine for economic growth and employment. In APEC economies, SMEs occupy significant shares: more than 90% of the number of companies; 20% to 50% of GDP; and 25% or more of total employment, reaching more than 90% in Indonesia. SMEs enhance competition, entrepreneurship and innovations in APEC economies, as they have more flexibility in adapting to new economic environments than large enterprises.

33. To alleviate the current difficulties of SMEs, both in terms of the shortage of financing and lower demand due to the global financial crisis, most economies have extended public support for SME finance through such measures as expansion of credit-guarantee programs, provision of policy-based lending by public financial institutions including the provision of trade finance, and the introduction of tax breaks. While these measures have proven to be effective in supporting

SMEs during the crisis, we need to review them as the recovery is taking place and to focus more on strengthening the growth potential for SMEs in the long run, including by improving those existing measures and creating an enabling environment for private sector provision of financing to SMEs.

34. Private financing continues to play an important role as the main source of financing for SMEs. Governments, in collaboration with the private sector, could consider initiatives to remove structural bottlenecks for SME finance through such measures as: (i) capacity building of SMEs to improve their financial reporting; (ii) establishment of credit information sharing systems, including credit registries to provide financial institutions with reliable credit information of SMEs, both positive and negative; (iii) expansion of eligible assets for collateral to intellectual property and receivables, and improvement of legal frameworks and enforcement to facilitate secured lending to SMEs; (iv) streamlining of existing credit programs provided by public financial institutions; and, (v) listing of promising and fast-growing SMEs on stock markets or local currency bond markets.

35. Sharing best practices and enhancing institutional capacities among our economies through technical assistance are invaluable. In this connection, we take note of the "Memorandum of Understanding on Cooperation among the APEC Financial Institutions Dealing with SMEs", signed in Phuket, Thailand in 2003, and welcome the 7^{th} Annual Meeting of this initiative, which was held in Malaysia in July 2010. APEC should ensure that such efforts are complementary with the G20 initiative on SME Finance Challenge.

VI. Recent Innovations in Extending Financial Services to the Underserved

36. Household and individual access to appropriate financial services is critical to achieving inclusive growth. Yet nearly 2.5 billion people, more than half the world's adult population, lack access to formal financial services.

37. Recent innovations in technology and service delivery, including the use of mobile phone banking and the expansion of the use of agent banking networks (for example, the use of retail shops as an extension of bank branch networks), have made it possible to lower the cost of providing services in small quantities and remote places. In Peru, the number of agent bank has increased from 1,900 in 2007 to 7,219 in 2010. In the Philippines, the two mobile banking operations have an estimated 71.2 million customers against a population of 90.5 million.

38. While micro-financial service provision can be commercially viable, leadership by the public sector can help catalyze the efforts of private sectors for the provision of financial services to poor households and micro-businesses. We also welcome efforts made by member economies in addressing financial identity issues to help those who do not have a relationship with formal banking institutions.

39. Today, we have launched APEC's Financial Inclusion Initiative. The primary goal of this initiative is to identify those public sector interventions that can best contribute to the development of financially viable models for the provision of financial services to the underserved, including through improving financial literacy and protection measures to enable them make informed choices. Several APEC economies are world-renowned leaders on financial inclusion efforts, and

this initiative positions APEC to play a value added role, building on the principles for financial inclusion agreed by the G20, and exchanging information on best practice among emerging and advanced economies in our region, with the input of the private sector and those groups and organizations active in this field. We will ensure that our activities are coordinated with those of the G20 financial inclusion initiative.

40. We also welcome the ABAC's initiative to set up regular meetings of the ABAC Financial Inclusion Forum. The first Forum was successfully held in Sapporo this May and focused on the recent development of microfinance.

VII. Green Finance

41. Green Finance can play a strong and effective role in facilitating growth, while addressing global warming. Green Finance encompasses the provision of financing to projects and programs that address climate change.

42. The threat of global climate change is an urgent issue for APEC economies to address. We look forward to progress at COP16 (16^{th} Session of the Conference of Parties to the Framework Convention on Climate Change) to be held in Cancun, Mexico.

43. The transition to a low carbon intensive society hinges on green technologies, such as smart grid, renewable energy, highly efficient power generation plants, and mass transit systems in urban areas. Korea, for example, is providing support for green industries in the research and development stage as well as in the commercialization stage, through such measures as the establishment of a SME fund for Green SMEs and green financial products, which help catalyze private financing.

44. MDBs and public financial institutions can play a role in catalyzing private financing, through the provision of medium-to-long term finance and by facilitating appropriate risk allocation among parties. We take note that MDBs, with different expertise and capacity, can share experiences and produce recommendations as well as play a role in the financial arrangements for climate change.

45. We also take note of the on-going work of the APEC Green Growth Initiative. It seeks to share best practices in the region and to produce recommendations to strengthen green growth.

46. We will further consider ways to promote Green Finance, including: (i) investments in green industries, using such innovative financing tools as green growth funds, green industry stock indexes or green bonds; (ii) the use of market mechanisms in pricing green house gas emissions, including the use of carbon markets, according to domestic circumstances; and, (iii) complementary policy and regulatory measures, such as the introduction of a feed-in electricity tariff for solar energy, and regulations on carbon intensive facilities and equipments.

VIII. Future Step

47. We will review our progress of "The Kyoto Report on Growth Strategy and Finance" at our meeting next year in Honolulu.