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Trade financing and the role of regional financial institutions in promoting South–South trade and investment

Trade Financing and Regional Financial Institutions from a South–South Perspective

Background note by the UNCTAD secretariat

Introduction

1. Developing a robust financial sector and ensuring that it contributes to strong and inclusive growth by agglomerating, protecting and reallocating savings and encouraging productive investment, including in the tradeable goods sectors, is a central policy challenge of development-centred globalization. However, as discussed extensively in UNCTAD reports, financial markets tend to operate differently from the idealized textbook account of competitive markets, and the strong push in recent years towards rapid financial liberalization has, in many developing countries, often contributed to a pattern of weak and erratic growth and rising inequality (UNCTAD, 2012a). Indeed, the potential damage from unregulated financial markets is not confined to developing countries; a growing disconnect between an expanding financial sector and the real economy has been a source of serious imbalances in advanced countries in recent years, culminating in the global crisis of 2008. Beyond the immediate and heavy economic costs to countries and communities, in terms of financial bailouts, lost output and job destruction, the crisis has thrown into question the functionality and efficiency of the international financial system, including its ability to fund long-term development and support the stable expansion of international trade (Grabel, 2012).

2. Since the early 1990s, and even against the growing talk from the start of the new millennium of a "great moderation", UNCTAD has argued that the risks stemming from the premature liberalization of trade and capital flows are significant, that the benefits are not simply there for the taking and that a more nuanced approached to development strategy is essential if countries are to benefit from the opportunities of a globalizing world. The call

for such an approach arises from the fact that the main drivers of globalization in recent years have been financial markets and a finance-friendly policy environment. While financialization has produced benefits for some countries (UNCTAD, 2012b) this shift in economic direction has been accompanied by a steady slowdown in global growth and a more volatile international environment, particularly for developing countries.

3. Global trade flows have exhibited greater volatility in recent years, with a pronounced drop and rebound following the financial crisis of 2008. Global trade declined by 12 per cent in volume in 2009, and increased by 14 per cent in the following year (World Trade Organization (WTO), 2011), suggesting a strong procyclicality of international trade and augmented, in part, by the growth of intermediates trade linked to the spread of global production chains (Ali and Dadush, 2011). There are also concerns that, insofar as they rely on markets in the advanced economies, developing country export-led growth strategies may be losing some of their relevance (UNCTAD, 2011) while, at the same time, increased attention is being given to prospects for greater South–South trade and investment. In response to trade and investment flows in recent years, regional trading arrangements among neighbouring developing countries as well as broader South–South initiatives (such as the Global System of Trade Preferences among Developing Countries, or GSTP) are now firmly back on the development agenda.

4. Capital flows to most developing countries have also exhibited strong volatility leading in many countries to episodes of feverish speculation between crises. The developing world has experienced three full cycles during the past 30 years and is currently into the fourth. Each cycle has been closely tied to policy events in the major reserve-issuing countries and have confirmed the procyclical bias of the global financial system.

5. The new millennium witnessed the beginning of the third post-war boom in capital flows to developing countries, mainly as a result of exceptionally low interest rates and the rapid expansion of liquidity in the leading advanced economies. Both net flows and net inflows peaked in 2007 before the subprime debacle. The collapse in capital flows in the early stages of the global financial crisis was followed by a renewed surge in 2010. Capital flows began to fall again in September 2011, as growing fears among portfolio investors over the sustainability of public finances in Europe gave rise to a general “flight to safety” (Department of Economic and Social Affairs (DESA), 2012).

6. These trends have fuelled the ongoing debate about how developing country strategies to manage capital inflows and protect their balance of payments can improve on the current scenario, where many countries have been focusing on hoarding large foreign currency reserves in order to protect themselves against balance of payments shocks. While understandable, these strategies are costly as well as potentially dysfunctional, in terms of economic growth and exchange rate stability. They also perpetuate leveraging and maturity mismatches that increase the financial fragility of the global financial system. Several countries, including Brazil and the Republic of Korea, have attempted to regulate capital inflows directly, albeit with limited success.

7. Partly in response to these challenges and constraints, several countries in the South have turned to regional monetary and financial arrangements to secure the financial conditions for the expansion of trade. This can be justified at three levels:

(a) Regional cooperation can improve access to external finance in terms of its maturity, interest rates and currency denomination and, therefore, reduce the exposure of vulnerable economies to the international financial markets;

(b) Regional payments and clearing agreements can help developing countries trade with their neighbours, especially in times of foreign currency shortage;

(c) Regional financial institutions can have better information on local projects than their international counterparts, while also being better positioned to invest in large projects with cross-border impact than national banks. This makes regional development banks, for example, often better suited to finance regional integration (for example, through infrastructure or the provision of other regional public goods) than their national or international partners.

8. This background note contains an introduction, two substantive sections and a set of questions for discussion by the Experts. Chapter 1 reviews the role of regional cooperation in the provision of short-term finance to support trade and supply chain operations. Chapter 2 considers the medium- and long-term financing needs associated with the process of development. It describes the roles of regional development banks and regional bond markets, and the scope for long-term development finance.

1. Short-term finance

1.1 Trade finance

9. The majority of world trade – between 40 and 80 per cent – is financed on delivery by the importing firm. However, that leaves anywhere between 10 and 50 per cent of global trade being financed by banks (see Mora and Powers, 2009). Adding working-capital loans, that is, short-term loans used to buy inputs to produce goods for export then some 80–90 per cent of world trade relies on some form of trade finance, making it of enormous importance to the real economy (International Monetary Fund (IMF), 2003).

10. Trade finance (trade credit, insurance and guarantees) is at the short-term, low-risk and high-collateral end of the credit spectrum. Financing is needed not only during the import-export process itself, but also for the production of the goods and services to be exported, which often includes imports of machinery, raw material and intermediate goods. Lack of financing at any stage of the processes of production or export can stop the flow of transactions and potentially break up budding, or even long-standing commercial relationships.

11. In the advanced economies, trade financing institutions emerged during the Renaissance, when deposit banking and maritime insurance evolved to meet the growing needs of merchants and wealthy individuals. The spread of trading companies with limited liability gave rise, later, to the issue and trading of company securities, but it was not until the advent of large-scale industrialization in the second half of the nineteenth century that trade financing institutions became of key importance for the economy (World Bank, 1989). This represents a steady deepening of the links between the trade and financial systems in these economies.

12. Limitations in the availability of trade finance have traditionally placed developing country producers at a disadvantage compared with their competitors based in the advanced economies. There are several reasons for this, but two are especially significant: the lack of specialized and well-resourced financial institutions in the South, and the consequent reliance of producers based in these countries on foreign finance, which tends to be heavily procyclical and, often, destabilizing. In addition, sophisticated supply chain operations have in recent years become crucial to global trade, and their financing poses specific challenges to participating countries and the international financial system.

13. The trade financing gap is especially noticeable in the least developed countries, where the financial sector tends to be heavily transnationalized and strongly risk-averse, and where a significant share of deposits are invested in very low-risk instruments,

including short-term liquid assets and foreign government bonds. The largest banks, which have the know-how and the most customers involved in trade finance operations, tend to provide credit only to firms with high collateral and the strongest reputations. Emerging firms, particularly in new sectors, often face higher interest rates, higher fees on letters of credit and higher capital requirements than established firms (often transnational corporations). These biases can exacerbate these countries' balance of payments difficulties and create significant obstacles to building a robust investment-export nexus and promoting economic diversification.

14. The trade and finance problems of developing countries are almost invariably aggravated by financial, balance of payments and exchange rate turbulence, as these countries tend to be vulnerable to the liquidity shortages and extreme risk aversion that characterize periods of crisis. Similarly, during these periods, even the most creditworthy firms can find it difficult to access credit, demonstrating that financial markets are prone to significant failures. For example, during the Asian financial crisis of 1997–98, international banks reportedly refused to underwrite letters of credit opened by local banks in some crisis-stricken countries (Aubion and Meier-Ewert, 2003). This tightening of trade finance delayed the economic recovery, especially in the most export-oriented countries. For example, in Indonesia, the import content of exports exceeded 40 per cent, and trade finance fell drastically from almost $20 billion to $1.9 billion, significantly hampering the country's export sector.

15. In the light of these experiences, it does not come as a surprise that the financial turbulence and the worldwide liquidity contraction that followed the collapse of Lehman Brothers in 2008 severely affected the flows of trade finance (Auboin and Meier-Ewert, 2008). The flows of trade finance to developing countries fell around 6 per cent between the end of 2007 and the end 2008, and even large banks reported increasing difficulties refinancing trade credit. Spreads on short-term trade credit soared to 300–600 basis points above the London Inter-Bank Offered Rate, or LIBOR, compared with 10–20 basis points previously, leading to a virtual freeze of important trade deals. These disruptions significantly affected supply chain operations in developing countries, especially in Asia (Auboin, 2009). The situation has not improved recently; for example, Asmudson et al. (2011) report the recent drop of a $1 billion trade contract between the United States of America and China due to the lack of finance.

16. The global context of risk aversion and scarcity of finance increase the importance of resource-pooling and co-financing between the existing providers of trade finance, and the mobilization of public-sector actors in order to counteract the reduction of private-sector finance. The response of the Group of Twenty to the 2008 financial crisis was to "ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through multilateral development banks". For example, the International Finance Corporation and traditional North–South development banks have enhanced their trade facilitation programmes: the International Finance Corporation, from $1.5 billion to $3 billion; the Inter-American Development Bank, from $500 million to $1 billion; the European Bank for Reconstruction and Development, from $1 billion to $2 billion; and the Asian Development Bank from $400 million to $1 billion, while the African Development Bank has allocated $1 billion to its Trade Finance Initiative (see Hufbauer and Stephenson, 2009). The Trade Finance Facilitation Programme of the Inter-American Development Bank includes a network of 72 issuing banks in 19 Latin American and Caribbean countries, which currently has more than $1.2 billion in approved credit lines and has issued guarantees and loans for more than $800 million, supporting more than 1,100 trade transactions. In contrast, the Trade Financing Programme of the Asian Development Bank focuses on relatively challenging markets, including Bangladesh, Nepal, Pakistan, Sri Lanka and Viet Nam.

17. Several export credit agencies have also introduced programmes providing credit guarantees and short-term working capital to small and medium-sized enterprises. This includes new programmes in Chile, France, Germany, Hong Kong (China), Japan, the Nordic countries and the United States. In other cases, there is increasing cooperation to support regional trade, especially through established supply chains. To this effect, the Asia-Pacific Economic Cooperation summit in Singapore (2009) announced the establishment of an Asia-Pacific Trade Insurance Network to facilitate intra- and extra-regional trade and investment through reinsurance cooperation among export credit agencies.

18. Export credit banks (Exim banks) can also play a critical role in the current context. Like export credit agencies, Exim banks support and encourage trade and outward investment by providing loans directly to firms. The essential difference between the two types of institution is that the former take risks using another institution’s (normally a bank’s) balance sheet, while Exim banks take risks using their own balance sheet, with actual loans and liabilities. Virtually every developed country and most developing countries have an official Exim bank operating in different segments of the market, including short-term export credit, long-term credit and investment insurance. Each bank has been tailored to a country’s particular circumstances. Some provide working capital to exporters where the commercial banks are unwilling or unable to lend, because of capacity or cost. Others only offer export credit or investment insurance. Finally, some Exim banks underwrite political risks, while others focus on commercial risks; however, most banks, to some extent, do all of the above.

19. In March 2012 the Exim banks of the five emerging economies known as the BRICS – Brazil, the Russian Federation, India, China and South Africa – signed two agreements to extend credit facilities to each other in local currencies. This move is meant to reduce the demand for fully convertible currencies for transactions among the BRICS, helping to reduce transaction costs. This initiative illustrates the efforts of emerging economies to insulate themselves from the eurozone crisis and to boost trade despite the sluggish growth of developed country markets.

20. The central banks of countries with large foreign exchange reserves have also been supplying hard currency to local banks and to importers through repurchase agreements. For example, Brazil’s central bank has provided over $10 billion to the market since October 2008, while the Bank of Korea, the central bank of the Republic of Korea, has pledged $10 billion of its reserves to do likewise. The central banks of India, Indonesia and South Africa are engaged in similar operations. Unfortunately, developing countries with low foreign exchange reserves cannot avail themselves of similar programmes, except through costly swap operations. These gaps could be filled, in part, by South–South development banks (see below), which may be in a strong position to pool regional reserves and provide liquidity to sustain trade flows during periods of turmoil.

1.2 Financing international supply chains

21. In the last two decades, advances in information and communications technology and the reduction in trade barriers have facilitated the slicing up of vertically integrated production processes into steps separated geographically. Trade has become much more than a simple exchange of merchandise across borders. It has developed into closely related flows of investment, technologies, managers, skilled workers and goods for processing and business services, in what has been called global supply (value) chains.

22. During the 1980s and 1990s, an increasing number of countries entered into global export markets, typically producing intermediate inputs or performing assembly operations in global value chains. These chains expanded at different rates, with apparel and

automobiles leading in the 1960s and 1970s in terms of the dispersion and complexity of their supply chains, and the services sector in general, and business services specifically, being included in export credit agencies more recently. This is testified by the recent decline of the Herfindahl-Hirschman index of industrial concentration in many product categories, which reflects a decrease in concentration or, more accurately, a greater degree of spatial dispersion of export sourcing in each sector (Milberg and Winkler, 2010).

23. World network trade increased from $988 billion (about 44 per cent of total manufacturing exports) in 1990–91 to $4,557 billion (51 per cent) in 2009–10, accounting for over 60 per cent of the total increment in world manufacturing exports during this period. The share of final assembly within network trade has also increased over time, reflecting the expansion of global production networks to encompass final assembly, in particular the emergence of China as the main assembly centre. In the last decade, parts and components and final assembly have, on average, accounted for 56 and 44 per cent of total network trade, respectively (Athukorala and Nasir, 2012).

24. This new business model, where countries do not trade in final goods (wine for clothes in David Ricardo's well-known example, which helped to popularize the notion of comparative advantage) but, instead, trade in specific tasks, was described by Streeten in the 1970s, when these trends first became apparent (Streeten, 1993; UNCTAD 2002:76–77; for a recent restatement, see Grossman and Rossi-Hansberg, 2008). These shifts in production have provided new opportunities and challenges for developing countries. Some countries have been able to leapfrog stages of the traditional process of industrialization by joining these networks, while others have seen their industries dislocated from domestic production structures and international markets. At the same time, the criss-crossing of manufacturing networks has demanded huge investments in transportation, communications, infrastructure and logistics to accommodate the transit of goods in process through different countries. However, these networks are heavily concentrated in developing Asia, which accounts for an estimated 26.5 per cent of total world network exports (77 per cent of total developing country network exports), with China alone responsible for 17.3 per cent (57 per cent of the developing country total). China's share in world final assembly exports is also larger (18 per cent) than that in components (14.4 per cent).

25. The transition to production based on transnational supply chains can have significant developmental implications. For example, poor countries tend to trade much more than they did previously, while often retaining less value than before. In contrast, control of finance, technology and the composition of output along the chain tends to shift towards the transnational corporation bases usually located in the advanced economies. Production chains can also increase the vulnerability of developing countries to adverse shocks, like the current crisis. Although the root cause of the current crisis is undoubtedly financial, its impact has spread through real as well as financial channels, with global production networks often operating as amplification channels (see, for example, Escaith and Gonguet, 2009). Since goods being processed in global value chains can cross several borders (counting as "imports" and "exports" each time they do so), a given reduction in world income and in global consumption will bring about a much greater decline of global trade (Tanaka, 2009). This can be further exacerbated by the contraction of trade credit for supply chains by the large international financial institutions, which were hit especially hard by the global crisis. On some accounts, the proliferation of these chains accounts for the increased volatility of world trade during the crisis and subsequent recovery (Bems et al., 2011).

26. Conversely, it is also possible that supply chains increase the resilience of production against adverse shocks, for example, because they entail both sunk costs and contractual relationships with many suppliers, which are costly to establish and maintain,

and may lead firms to prefer to adjust the chain along the intensive margin (i.e. changing volumes), rather than along the extensive margin (e.g. changing suppliers). Finally, the transnational corporations at the centre of many supply chains could also help address suppliers' liquidity constraints directly, in order to protect the integrity of the chain (Bernard et al., 2009).

27. These widely different alternatives lend support to the claim that our understanding of supply chains remains too imperfect to allow us to reach definitive conclusions about the long-term impact of the crisis on international trade (Altomonte and Ottaviano, 2009). There has also been relatively little work conducted to date on the way in which supply chains have been affected by the process of financialization (Baud and Durand, 2011). However, it seems likely that a shift towards financialization is likely to have significant consequences for corporate strategy in the lead firm in these chains, with implications for the organization of production and the distribution of value along the entire chain (Newman, 2009).

28. Corporate governance has certainly changed significantly as a consequence of financialization with a focus on shareholder value, increased mergers and acquisitions and a shift in executive remuneration being its most visible features. While there are differences across countries, many financialized corporations have also diversified away from production towards finance itself (Lazonick and O'Sullivan, 2002).

29. These changes in corporate governance have certainly featured in the strategies of many international firms, including those involved in the organization of supply chains. As Milberg has noted in his analysis of the reorganization of supply chains in recent years, "Many 'manufacturing' firms now do no manufacturing at all, providing only brand design, marketing, supply chain logistics and financial management services" (Milberg, 2008:425). The offshoring of stages in supply chains to the developing countries has often been driven by cost considerations. Partly for this reason, developing country actors tend to participate in chains that are buyer-driven, that is, coordinated and controlled by leading firms that operate in sections of the chain that are closer to the consumers, which, in turn, are mainly found in the global North – and contribute relatively low-cost and low value-added activities.

30. The impact of these combined trends on suppliers lower down the value chain requires a good deal of further research. However, Palpacuer (2008) has shown that the financialization of lead firms in clothing chains has led to a deterioration of working conditions at the base of the chain, with women workers being disproportionately affected.

31. This UNCTAD Expert Group Meeting offers an opportunity to look more closely at these important problems for developing countries, in the light of the existing literature, data and other sources of information available to our Experts.

2. Development finance

2.1 Regional development banks

32. The Monterrey Consensus (para. 16) states that "investments in basic economic and social infrastructure … are vital for enabling people, especially people living in poverty, to better adapt to and benefit from changing economic conditions and opportunities". Yet uncertainty is inevitable in long-term, large-scale strategic projects and in the expansion of new industries that are essential for structural change and rapid catch-up growth.

33. National development banks can play a pivotal role in catalysing the expansion of social and economic infrastructure, building up the investment-export nexus and developing

sectors that are considered to be of strategic importance by national authorities. These can include research and development, and product innovation (where externalities are especially pervasive), as well as the internalization of strategically important production chains, support for the expansion of competitive domestic firms, national integration, regional development, import-substitution and export diversification. National development banks can also play a critical role in supporting financial sector development (banks, securities companies and the stock market) and in providing countercyclical credit. This can bring significant social gains because macroeconomic instability is one of the main causes of business failures, underinvestment and chronic unemployment.

34. These operations can all be scaled up across countries by regional development banks, which can help developing countries overcome critical limitations in credit provision and regional infrastructure. Some of these banks, including the Inter-American Development Bank, created in 1959, the African Development Bank, created in 1964, and the Asian Development Bank, created in 1966, are North–South initiatives. They allocate credit to countries in their respective regions based on contributions from regional members and developed country partners. However, the engagement of the latter gives them significant weight in the decision-making process.

35. In addition to these North–South regional development banks, several financial institutions have been created at the regional level, with a membership composed almost exclusively of developing countries in Africa, Latin America and the Caribbean, West Asia and the Arab world. Significantly, debt issued by these institutions tends to obtain better risk ratings than sovereign debt issued by the individual country members of these institutions. Ocampo (2006) and Sagasti and Prada (2006) have argued that the good performance of these banks in terms of their credit ratings and exceptionally low levels of non-performing loans is due to their ownership by developing countries (which confers on them a preferred creditor status), their ability to respond to the specific needs of smaller countries and borrowers, and the greater priority they give to financing genuine regional integration projects, in contrast with the international financial institutions (World Bank, 2007).

36. A large proportion of the financing from these institutions supports infrastructure projects in energy, transport and communications, for example the Puebla-Panama Plan and the Initiative for the Integration of Regional Infrastructure in South America. Indeed, “they can provide member countries with a coordination mechanism through which to plan and finance the provision of regional transborder infrastructure and other regional public goods requiring large initial investments” (DESA, 2005:129). In contrast, the largest share of the loans for sub-Saharan Africa from the African Development Bank and from Arab and Islamic institutions is for agriculture and rural development.

37. The financing of infrastructure projects supporting regional integration represents one of the main goals of the Banco del Sur, or Bank of the South, established in 2009 by the Governments of Argentina, the Plurinational State of Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela, although it has not yet started operating (Grabel, 2012: 24–26). The Bank also aims to strengthen regional integration, reduce intraregional asymmetries and promote an equitable distribution of investments within member countries. Along the same lines, but not limited to the regional level, the BRICS have recently envisaged the creation of a bank in order to mobilize resources for infrastructure and sustainable development projects in the developing countries.

38. There is space for the further development of this project, potentially leading to payment arrangements allowing the developing countries – especially the poorest – to economize reserves and trade more easily with other countries in the South.

2.2 Long-term development finance

39. Some of the initiatives outlined in the previous section are still in their early stages, and most regional development banks remain too small to realize their full potential. At the same time, several developing countries currently hold considerable foreign currency reserves that are often invested relatively unproductively in the advanced economies. These countries could consider setting aside a certain percentage of these reserves to fund one or more regional development banks. Alternatively, as recently suggested by UNCTAD (2012c), they could use a small proportion of the assets held by their sovereign wealth funds (SWFs) to capitalize one or more regional development banks.

40. These initiatives would be especially advantageous for developing countries with large foreign exchange reserves invested in developed countries' financial markets, which currently bring extremely low returns and offer no contribution to economic development. Developing country reserves currently exceed $6 trillion, and the assets of their SWFs exceed $4 trillion. As SWFs have very long-term liabilities (since they are normally invested for future generations), they represent an ideal source of funds for development. If only 1 per cent of developing country SWF assets were allocated to South–South regional development banks, and assuming the same ratio of annual loans to paid-in capital as that in the Development Bank of Latin America – commonly known by its Spanish acronym CAF – South–South regional development banks could lend $84 billion annually. This would be higher than the loans made by the World Bank, the Asian Development Bank, the Inter-American Development Bank, the African Development Bank and the external lending of the European Investment Bank to developing economies in 2009, the peak year of their lending, when they reached only $64 billion (UNCTAD, 2011).

41. In a recent paper, Lim and Lim (2012) discuss the two crucial features that any development-oriented South–South bank should have: (a) taking a long-term view to promote stable economic growth and help local borrowers obtain cheaper funding; and (b) going beyond the simple maximization of returns to embrace the concept of "socially acceptable rate of return" for projects of that are welfare-maximizing, financially feasible and socially inclusive. This goal can be best achieved through risk pooling and policy harmonization:

(a) By pooling risks, groups of developing economies can improve the terms of their access to donors and global capital markets. This role has been traditionally played by regional development banks and subregional development banks through financial intermediation;

(b) By harmonizing financial sector policies and institutions, and creating regional monitoring and surveillance procedures to provide early warning of countries likely to experience financial or balance of payments difficulties, groups of developing economies can deepen their capital markets, attract more and better quality foreign direct investment and reduce the threat of regional contagion in case of crisis.

42. Furthermore, as mentioned previously, North–South banks and global institutions such as the World Bank and IMF tend to be responsive to the demands of their major contributors or shareholders, which may not always correspond to those of the world's smaller and poorer nations (Ocampo, 2002; Teniussen, 2002).

43. Regional arrangements may, therefore, offer something which the international financial system currently lacks:

(a) An institutional space in which the voice of smaller and poorer countries is greater than in the currently existing global institutions, and a greater sense of regional ownership;

(b) A more constructive and efficient approach to policy conditionality. Global institutions generally impose conditionality; in contrast, regional organizations can rely on dialogue and exchanges of experiences, which can better protect the policy space of their member countries;

(c) A greater emphasis on subsidiarity, providing international public goods that are regional rather than global in nature, and responding more rapidly and appropriately to the demands of their country members.

2.3 Regional bond markets

44. Regional bond markets can help meet the long-term financial needs of developing economies, secure greater diversification of sources of finance and improve the allocation of resources.

45. The most sophisticated endeavour to develop regional bond markets has been undertaken by ASEAN+3 (the five founding members of the Association of Southeast Asian Nations, plus China, Japan and the Republic of Korea), which launched the Asian Bond Markets Initiative in 2003. The main goals of the Initiative are to address issues of market infrastructure in order to increase the liquidity of primary and secondary bond markets in the region and help countries recycle their foreign currency surpluses into sources of finance for investment within Asia.

46. Partly through the activities of the Initiative, local currency-denominated bond markets in the region expanded around 30 per cent per year from 1997 to 2008 (and from $5.4 trillion in 2000 to $16 trillion in 2010), while the diversity of issuers also increased significantly. Large issues of local currency-denominated bonds have been made by governments, central banks and monetary authorities, locally based corporations, international financial institutions and transnational corporations. In 2010, around 84 per cent of these bonds had been issued by governments, and 16 per cent by corporations. ASEAN+3 countries have also made progress unifying government bond-issuing authorities and simplifying corporate bond issuance procedures.

47. On the fifth anniversary of the Initiative, in May 2008, ASEAN+3 finance ministers agreed on plans to encourage individual countries to further develop their own local currency-denominated bond markets both individually and together with other ASEAN+3 nations, and to seek to increase the accessibility of regional bond markets to issuers and investors.

48. Despite these regional initiatives, in the pre-crisis period, most cross-border financial flows – which includes portfolio investment – involving ASEAN+3 banks have been directed to other regions, especially Europe and North America (Cowen et al., 2006).

49. Progress in the regional integration of financial markets has been more limited elsewhere. Only preliminary attempts have been made in Latin America, the most prominent of which has been the Venezuelan decision to buy Argentina’s external debt bonds in 2005, and the issuing of Brazilian depositary receipts at the São Paulo stock exchange by South American firms. In Africa, bond markets remain undeveloped even at the national level; in most countries, corporate bond markets are either non-existent or remain in their infancy. However, African governments, the private sector and donors have recently taken initiatives to develop African bond markets and reduce cross-country transaction costs under the umbrella of the Southern African Development Community, the Eastern African Community and the West African Economic and Monetary Union.

Questions for the Experts

1. Can regional institutions help build more sustainable links between trade, finance and development?

2. What financial arrangements can support regional integration?

3. How might South–South trade and investment be affected by the shortage of trade finance? What are the likely effects of these shortages on international value chains?

4. What innovative modalities of trade finance and resource-pooling are available to developing countries?

5. Can South–South integration and cooperation help developing countries scale up their participation in international value chains? How can this be made compatible with developmental objectives and policy space?

6. How can the emergence of South–South regional development banks be supported?

7. How do South–South regional development banks differ from traditional North–South financial institutions? Which lending policies should be pursued by South–South institutions?

8. What role can be envisaged for regional bond markets in the developing world?

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