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# 2007 ABAC Report to APEC Finance Ministers

The APEC Business Advisory Council (ABAC) is pleased to present its Report to APEC Finance Ministers with recommendations aimed at enhancing the creation of wealth and the stabilization of markets throughout the region. This year, the ABAC Finance and Economics Working Group's efforts were primarily focused on providing recommendations on the priorities of deepening, strengthening, and integrating capital markets, including recommendations for developing and improving policies on social security and retirement income safety. ABAC contributed to the theme, organized by Senior Finance Officials, of deepening private capital markets and looks forward to the opportunity of discussing its various recommendations with Ministers in Coolum, Australia.

*Deepening, strengthening, and integrating capital markets*

ABAC believes that high priority should be given to deepening and integrating private capital markets to sustain growth in the region and to provide the basis for regional and global financial and economic integration. As capital markets mature and grow, access to funds and capital market-related services will enhance competitiveness of all enterprises in the private sector. As markets become more efficient, costs will be reduced, new investment will take place and profits will increase. A corollary benefit would be that certain burdens traditionally assumed by governments, notably the provision of social security programs and state infrastructure investment, are abated as the responsibility to fund these programs is transferred at least in part to the private sector. Overall there would be a resulting aggregate benefit - on a "macro" level, deeper private capital markets ensure higher levels of economic stability through the diversification of savings and investment, as well as the transfer of a portion of the risk of debt default by ownership of equity.

ABAC observes that the process of normal capital formation involves the development of private market structures occurring broadly in the order outlined below. The private capital structures listed below complement, rather than compete with, traditional banking finance and should be given equal priority. The basic model described below fits developing and developed economies, but the staging and priorities may differ, though the essential ingredients do not – rule of law, contract enforcement, and transparent and supervisory rules.

Angel/Start-up equity finance. This is the riskiest part of the capital formation chain, often provided by the friends and family of the founding entrepreneur. Angel investing is essential in the financing of small enterprises and incentives should be devised to increase the health of this element of the capital market. The promotion of micro-finance would also stimulate the growth of small enterprises in developing economies during this stage.

Mezzanine Equity and Debt Finance. Larger scale institutional investors start to become interested in the enterprise once revenues and profits are flowing normally. These venture capital type investments are still risky with commensurate returns, but this is the stage where many companies make the transition to medium size enterprises. Mezzanine debt can be a private version of the public high yield debt markets.

Primary and Secondary corporate bond markets. Traded corporate bonds provide issuers access to longer term finance and offering investors a useful diversifier to cash as well as credit spread over government debt.

Primary and Secondary equity markets. Companies are able to raise equity capital from a broad and diverse range of institutional and personal investors. Secondary market trading of these securities also offers liquidity to investors. Liquid equity markets are an essential part of a balanced investment portfolio.

Derivatives markets. These markets are derived from underlying securities, and are principally comprised of financial futures, traded options and swaps of various types. Those products allow investors and issuers (writers) to create more diverse payout structures and non-symmetrical risk preferences. Use of derivatives in developing economies can be stimulated by the sharing of best practices as well as creating incentives for small companies to participate in capacity-building initiatives on derivatives.

Structured Products. By combining different derivative and cash investments in combination with non-traded derivative contracts, intermediaries can construct almost limitless payout structures allowing for a high level of customization and alignment with investment (both individual and institutional) and corporate objectives.

Major challenges currently exist that hinder the development of efficient capital markets in some economies. They often relate to inadequate infrastructure, constraints on the entry of specialist financial providers and interventions that preclude commercial pricing for risk. Immature and undeveloped capital markets in the APEC region have propagated the emergence of a dual problem, namely an accumulation of current account imbalances between major economies, and the dependence on traditional commercial banks to provide required private capital.

The default financing alternative to well-functioning and diverse capital markets in some economies primarily remains the banking sector, which may keep interest rates unnecessarily high and many enterprises isolated from needed and well-deserved long term capital. Furthermore, economies heavily reliant on banking finance remain vulnerable to over-lending and excessively risky loans. Therefore in underdeveloped capital markets, there is a distinct gulf between the savings of potential investors and companies in need of financing. Both capital market participants (issuers and investors) lack access to higher rates of return.

To overcome these challenges, ABAC recommends improved market infrastructure, including measures encouraging the development of an appropriate compliance, regulatory and operational infrastructure. That infrastructure should be complimented by a sound legal system that both respects and enforces contractual obligations. Adoption of these measures would inspire confidence for all market participants - domestic and foreign - as well as provide the incentives required by potential private capital investors and borrowers. Sound market infrastructure combined with a fair and effective legal system is a precondition for the development of private capital markets – providing a low cost and efficient investment "bridge" between accumulated savings and the access to capital required by private companies in the region looking to expand through investment.

ABAC also recommends that Finance Ministers take further steps to improve the overall business environment and increase economic growth, as follows:

First, ease restrictions on ownership of financial services companies, thereby enhancing competition and delivering benefits to consumers through a lower cost of capital, including access to diverse investment options to investors;

Second, promote the development of investment products targeting individual investors, including increasing the investment instruments needed to mobilize high personal savings into capital markets. Critical to this is establishing regulatory policy that distinguishes sophisticated institutional investors from individual investors, effectively protecting individual investors.

Third, remove or lower existing barriers to cross-border investment which inhibit economic growth, and endorse further work in the APEC Investment Experts Group (IEG) in promoting the use of the OECD's Policy Framework for Investment as a tool to enhance investment flows in the region.

Finally, devise new tax incentives that facilitate a shift from savings accumulation to investment**.**

ABAC encourages Finance Ministers to support the development of a sound regulatory framework for financial markets providing the prudential foundation for the protection of consumers of financial products. Three main approaches are recommended:

-Enhancing disclosure of information,

-Promoting financial consumer education

-Enhancing market efficiency and competition to increase consumers' choices.

Clearly, regulators should avoid non-market based restrictions, such as lending caps or artificially low interest rate ceilings which would dampen credit supply and constrict household demand.

*Social Security and Retirement Income Safety*

Finance Ministers should also address the increasing strain on government finances caused by the reversal of favorable demographic trends. In the developing world, the accelerating pace of urbanization will add to those pressures as traditional social support groups of family and community begin to break down, increasing individuals' reliance on retirement savings and state provided safety nets. In the developed world, "pay-as-you-go" retirement systems will place increasing pressure on budgets unless reformed to reflect the changing demographic dynamic.

ABAC recommends that Finance Ministers work with counterpart agencies within their economies to resolve those challenges, addressing social security and safety net issues. The relative cost advantage that "pay-as-you-go" plans may have had in the past was partially the result of demographic factors that no longer hold in most economies. While the transformation to new demographic realities will not be without difficulty, economies should begin now to move from "pay-as-you-go" to a fully funded social security system. Economies will also benefit from efficiency gains if private financial service providers, including foreign-owned groups, are permitted to offer pension, fund and asset management services. Gains could be expected to offset disruptions arising from the transfer of these activities from the public to the private sector. ABAC notes that work done on this issue now will pay significant dividends in the future.

*Capacity-Building*

A critical element to all of the measures mentioned herein is enhancing bilateral and multilateral communication and the sharing of best international practices between economies. Ministers should encourage better data collection on short-term capital flows as a measure to ameliorate the impact of volatile capital movements on vulnerable economies, and support efforts that encourage the IMF and other relevant agencies in disseminating data. Such measures would enhance regional financial architecture and build cooperation in dealing with external financial shocks, as well as creating a knowledge pool which would support capacity-building throughout APEC.

In this regard, ABAC endorses the recommendations on policy implementation made by the Advisory Group on APEC Financial System Capacity Building in its 2007 Report. The report contains capacity-building recommendations on strengthening and developing bond markets and in particular, corporate bond issuance, supporting banking systems as they move to implement Basel ll, promote financial stability, and small and medium enterprises' access to formal finance. In particular, as a result of the 2006 ABAC Dialogue with Finance Ministers in Hanoi, the First APEC Public-Private Sector Forum on Bond Market Development took place this year and focused on several developing economies' markets. ABAC recommends that the Forum remain an ongoing part of the Senior Finance Officials' process over the next few years.

Finally, ABAC appreciates the strengthened relationship with the Finance Ministers' process, in particular the close collaboration with the Senior Finance Officials' Meetings. ABAC also contributes to APEC through its engagement with the Economic Committee and the Investment Experts Group, and has offered many recommendations about structural reforms to strengthen and deepen financial systems and to improve investment. ABAC strongly commends the importance of the structural reform agenda as central both to the value of the FMM processes and to the longer-term aspirations of APEC.