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FINANCING STRATEGIES FOR LDCS GRADUATION IN ASIA AND THE PACIFIC: KEY SOURCES, TRENDS AND PROSPECTS

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Sudip Ranjan Basu, Steve Gui-Diby and Zheng Jian

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Abstract:

The United Nations recognizes that productivity capacity building is the key for self-sustained growth and graduation of LDCs in Asia and the Pacific. To achieve this objective, substantial financing must be mobilized to invest in infrastructure, social development and climate change challenges. Despite the significant progresses made by the Asia-Pacific LDCs in restoring macroeconomic stability, deepening the banking sector and attracting FDI and remittances, for many, fiscal spaces remain narrow and financial markets largely inefficient and undiversified. An ambitious financing strategy would be needed to close the financing gap for graduation and to promote sustainable development, which includes strengthening of fiscal space, financial intermediation and exploring innovative financing mechanisms such as blended finance, promoting new form of development partnership and climate finance. In particular, the paper shows that an estimated total of $19 billion could be raised annually by the Asia-Pacific LDCs through targeted efforts to broaden tax bases, create enabling environment for FDI and reduce transaction costs of remittances, among others. An additional USD $15 billion could further be raised if DAC members fulfil their commitment of contributing 0.15-0.20 per cent of GNI for LDCs development.

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I. INTRODUCTION

In May 2011, at the Fourth United Nations Conference on the Least Developed Countries (LDCs),[1] the Istanbul Programme of Action (IPoA) for the decade 2011-2020, called upon the global community to commit to a "renewed and strengthened partnership for development" that would allow the LDCs to progress towards closing financing gaps for the graduation, in combination of the national policies and international support measures. The IPoA has explicitly stated that during the course of this decade, the action plan will focus on the objectives with the "*aim of enabling half the number of least developed countries to meet the criteria for graduation by 2020*" (United Nations, 2011).

ESCAP (2014a) also agreed "to assist countries with special needs, especially least developed countries, landlocked developing countries and small island developing States, in taking advantage of opportunities arising from regional economic cooperation and integration, including, as appropriate, through support *to enhance their capacities and through technical assistance*". It further recognised that "there is a need to implement specific policies that focus on productive capacity-building related to infrastructure development, broadening the economic base, *access to finance* and providing assistance in overcoming the risks and shocks of entering into a regional trade block".

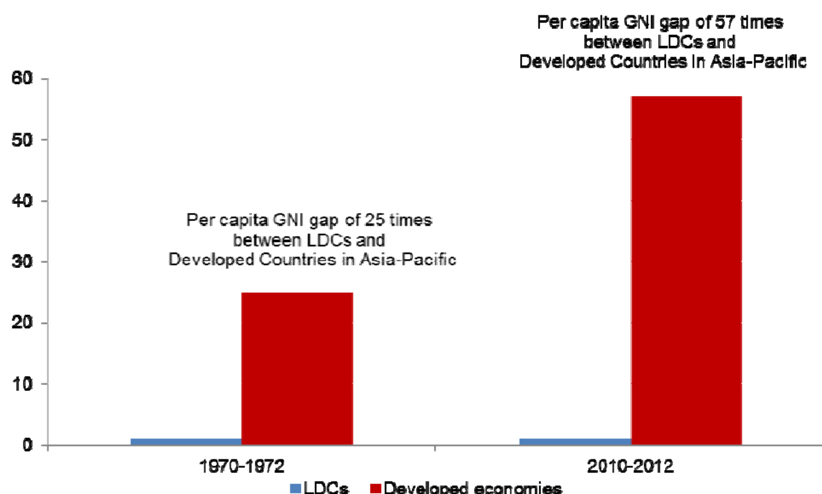
The LDCs continue to have one of the lowest per capita incomes in the Asia-Pacific region. Moreover, the income gap with developed economies has increased significantly in recent decades (figure 1), as the region has also been accompanied by one of the highest population rates.

Most importantly, LDCs lack productive capacity due to limited development in the following areas: infrastructure (such as electricity, transport, ICT, water, human and institutional capacity), energy (both production and access to energy), science and technology (for instance, to acquire technologies, skills and innovation) and private sector (e.g. one that is dynamic, broad-based, well-functioning and socially responsible). These features have considerably inhibited LDCs to meet many of the internationally agreed development goals, including the Millennium Development Goals (MDGs), such that most rank close to the bottom of the Human Development Index. Furthermore, it has also contributed to the inability of LDCs to progress towards structural transformation and to build adequate resilience against economic vulnerability.

LDCs graduation requires making progress in three criteria: per capita gross national income (GNI), human assets and economic vulnerability to external shocks. Apart from increasing GNI per capita, the other two criteria are measures of structural impediments in LDCs. For the Human Assets Index (HAI), the four indicators are based upon the following: (a) nutrition: percentage of population undernourished; (b) health: mortality rate for children aged five years or under; (c) education: the gross secondary school enrolment ratio; and (d) adult literacy rate.

[1] The current list of LDCs includes 48 countries (the newest member being South Sudan); 12 in Asia and the Pacific region. These countries are the following: Afghanistan, Bangladesh, Bhutan, Cambodia, Kiribati, Lao PDR, Myanmar, Nepal, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu.

Figure 1. Income divergence between LDCs and developed economies of Asia-Pacific



Source: ESCAP calculations based on ESCAP Statistics online. Available from www.unescap.org/stat/data/statdb/DataExplorer.aspx (accessed 20 October 2014).
Note: LDCs-Asia-Pacific consists of 12 countries, developed economies consists of Japan, Australia and New Zealand (US Dollars at current prices)

Similarly, for the Economic Vulnerability Index (EVI), the measure is based on indicators of (a) population size; (b) remoteness; (c) merchandise export concentration; (d) share of agriculture, forestry and fisheries in gross domestic product; (e) share of population living in low elevated coastal zones; (f) instability of exports of goods and services; (g) victims of natural disasters; and (h) instability of agricultural production. With the growing uncertainty in global economic and financial markets, as well as the concerns of the consequences of climate change, LDCs need to be vigilant and need to focus on mobilizing significant resources, including climate finance, to reduce their economic vulnerability.

Apart from these structural impediments (ESCAP, 2014b), LDCs lack physical infrastructure and seamless connectivity within their national borders. This is inhibiting their productive capacity and reducing their prospects of creating "enabling business environments" for crowding in more private investment for long-term investment projects.

Against this background, according to the 2012 triennial review of the Committee for Development Policy (CDP)[2], UNDESA (2014) stressed that "Financing needs also differ across countries and regions. While financing needs are disproportionately large relative to the size of their economies in many developing countries, there are specific needs in least developed countries (LDCs)". For any country to reach thresholds in three criteria would require substantial financing, especially through public investment, among others sources, as indicated in ESCAP (2013). Therefore, strategies for mobilizing resources for financing the graduation gaps remain one of the critical areas for LDCs in the Asia-Pacific region.

This paper argues that traditionally, LDCs experience lack of availability and access to financial resources, both from domestic and external sources, especially in international capital markets, to finance their graduation as well as overall development gaps. The paucity of financial resources often acts as an obstacle for them to increase their economic activity. It further reduces their potential for investing in human capital and reducing vulnerability from multiple shocks,

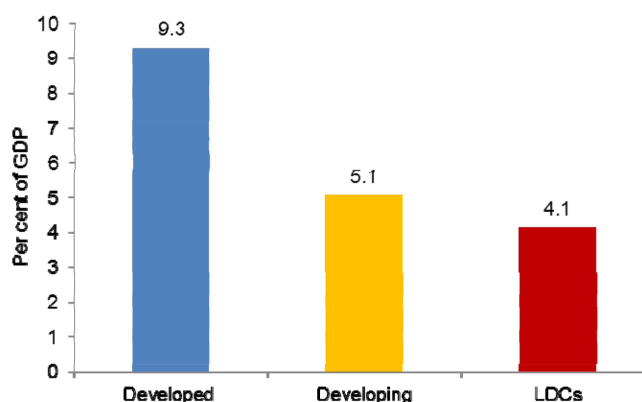
[2] The Committee for Development Policy (CDP), a subsidiary body of the UN Economic and Social Council, is – inter alia – mandated to review the category of LDCs every 3 years and monitor their progress after graduation from the category. Available from http://unohrlls.org/about-ldcs/criteria-for-ldcs/.

such as higher energy prices or climate change, as recognized in the three criteria for the graduation of LDCs.

As underscored in the IPoA, LDCs require an urgent action plan to improve their access to finance which can support their special needs and priorities, together with enhanced policy coordination and development partnership, including in areas such as official development assistance (ODA), international trade, foreign direct investment (FDI), and debt relief.

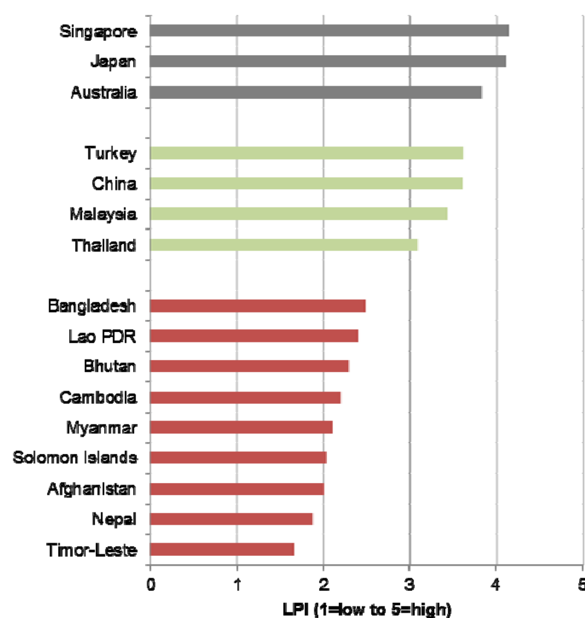
Apart from low levels of per capita income, the key challenges that LDCs face in terms of mobilization of financing resources are related to low domestic savings and investment, especially in social sectors (figure 2) and physical infrastructure which are related to transport and trade –related infrastructure (figure 3) and a small tax base.

Figure 2. Health expenditure in LDCs and other economies of Asia-Pacific, 2009-2011



Source: ESCAP calculations based on ESCAP Statistics online. Available from www.unescap.org/stat/data/statdb/DataExplorer.aspx (accessed 20 October 2014).
Note: Total health expenditure is the sum of general government and private expenditure on health, which is expressed as a percentage of GDP. The figure is based on average of the ratio for 2009 to 2011. According to ESCAP classification, the figures show Developed (Australia, Japan and New Zealand) and Developing countries.

Figure 3. Logistics performance index in LDCs and other economies of Asia-Pacific, 2011



Source: The World Bank Logistics performance index.
Available from http://data.worldbank.org/indicator/LP.LPI.INFR.XQ (accessed 20 October 2014).
Note: LPI measures the quality of trade and transport-related infrastructure (1=low to 5=high).

Over the years, due to LDCs' exposure to the global economy through trade, investment and financial markets, the global economic and financial crisis of 2008-2009 combined with food and fuel crises, have adversely impacted hard-won development outcome of LDCs (ESCAP, 2012).

Under these circumstances, many LDCs in the Asia-Pacific region, from Myanmar to Bangladesh, have undertaken several policy reforms to mobilize domestic resources, both public and private. These reforms are expected to further crowd-in international support measures, including renewed participation of the private sources. If successful, they could significantly increase resources for financing progress towards closing the graduation gaps and other development goals.

II. KEY SOURCES FOR MOBILIZING RESOURCES

In most LDCs, the low quality of social and physical infrastructure disproportionately affects poor and vulnerable communities and widens the growing rural-urban divide. Since most basic infrastructure services are driven by public sector investment, there is a growing gap between the availability and the demand for services, resulting from population growth, urbanization and climate change consequences. There is now recognition across these countries that the existing approaches, sources and governance modalities are limited in their scope to close the widening gaps for LDCs. This is reflected in the ongoing discussion of the international community on the contours of the post-2015 development agenda for sustainable development.

There are several sources for mobilizing financial resources for the LDCs in the Asia-Pacific region. Apart from traditional domestic public resource mobilization, and through existing external financing mechanisms which mostly take the form of ODA, the public discourse on financing graduation gaps and sustainable development is now aimed at exploring innovative mechanisms.

To meet the thresholds in three criteria, it is particularly important for LDCs to raise financial resources to enhance access and availability of physical infrastructure (such as roads, ICT, electricity) and to address the impacts of climate change, which are also closely linked to some indicators of the EVI criterion. To increase investment in LDCs, governments need to create appropriate institutional and regulatory frameworks for the development of domestic private sector participation as well as to increase financial intermediation by broadening and deepening capital markets. Similarly, LDCs policies to develop domestic institutional investors, for example, could help mobilize financial resources that could be invested to reduce the financing gaps.

The schematic view of financing the graduation gaps is shown in Figure 4. This paper examines both domestic and external funding sources and looks at public and private sources that will provide support to efforts of the graduation progress. There is need to reflect on how resource mobilization from these sources can be catalyzed to meet growing and emerging requirements for these economies in the region, and how public funds can leverage private funds to finance graduation which will eventually further boost government initiatives towards the sustainable development agenda.

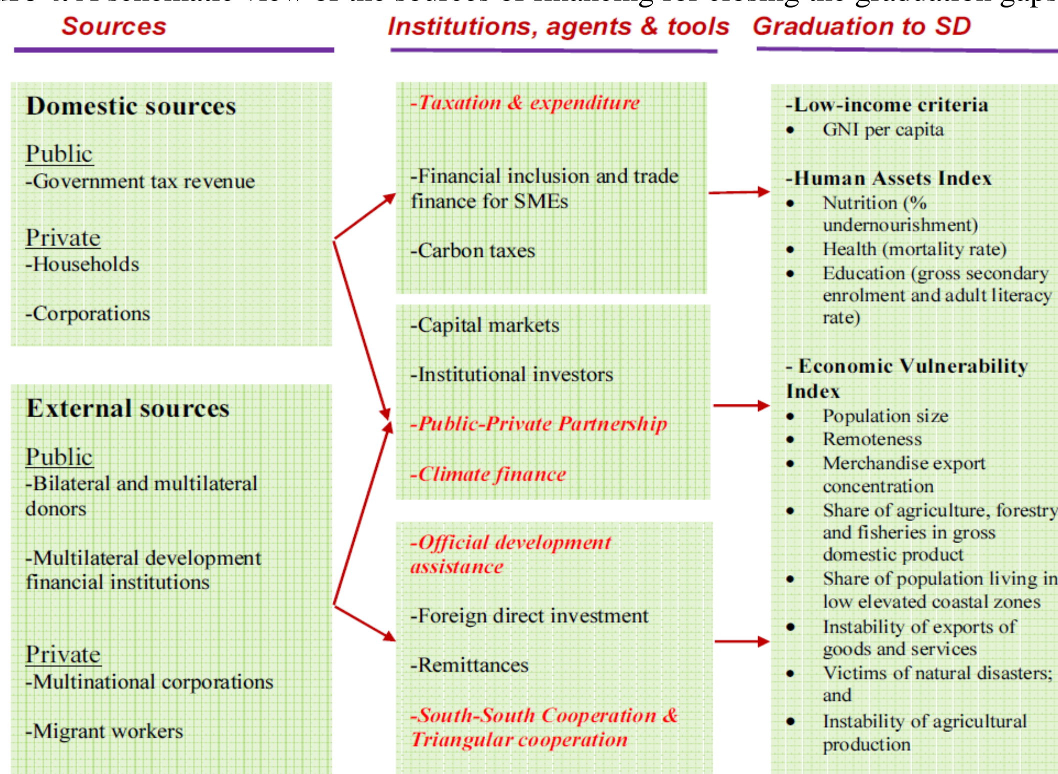
The framework also suggests that LDCs require a new and ambitious financing strategy at its core. This should be tailored to the state of their individual level of development and their progress towards the graduation thresholds. While the mobilization of resources through existing

and new sources of domestic, external and innovative financing is challenging for many of the LDCs, there is also a need to effectively use development partnerships and increase the role of the private sector in the process.

The financing strategy will also require significant investment in public goods, such as clean air, water and the continued flow of ecosystem services and other forms of environmental sustainability, upon which economies and people depend. The funding of such investments, which are characterized by high social rates of return but low private rates, is more likely to originate and be leveraged from public domestic resources. ODA should remain crucial as it acts as a complementary and mutually reinforcing element. Although LDCs in the region have been able to attract foreign private financial resources, the availability of existing resources is far from satisfactory.

In this context, LDCs need to mobilize necessary financing to close their graduation gaps and to simultaneously invest resources to promote the objectives of the post-2015 development as highlighted by the Open Working Group (OWG) of the UN General Assembly, established on 22nd of January 2013 by decision 67/555. According to the OWG report that was submitted on 28 July 2014,[3] Goal 17 is related to "Strengthen the means of implementation and revitalize the global partnership for sustainable development". In particular, Goal 17.2 recognizes that "developed countries to implement fully their ODA commitments, including providing 0.7% of GNI in ODA to developing countries of which 0.15-0.20% to least-developed countries".

Figure 4. A schematic view of the sources of financing for closing the graduation gaps



Source: ESCAP.

Note: The conceptual framework is based on the ESCAP (2014c). The graduation objectives are based on the 2012 triennial review of the Committee for Development Policy (CDP), which is available from http://unohrlls.org/about-ldcs/criteria-for-ldcs/. The graduation efforts will further enhance LDCs capacity to move towards the sustainable development (SD) goals.

[3] The report is available from http://sustainabledevelopment.un.org/focussdgs.html.

IPoA has underscored that to "*ensure enhanced financial resources and their effective use for least developed countries' development, including through domestic resource mobilization, ODA, external debt relief, foreign direct investment and remittances*", the Asia-Pacific LDCs need to mobilize financial resources from a variety of sources.

III. MOBILIZING FINANCIAL RESOURCES FOR LDCS GRADUATION

III.1. Domestic public resources

The mobilization of domestic public resources is one of the most critical components for increasing financial resources for the graduation process of LDCs. For this purpose, different options can be considered by government to increase their domestic fiscal space: raising domestic savings, increasing tax and non-tax revenues, and reprioritizing public expenditures, improving their efficiency, and strengthening institutional capacity.

Tax revenues

In Asia-Pacific LDCs, tax revenues are relatively low compared with other developing regions. In 2011, the average tax-to-GDP ratio in LDCs was only 10.4% of GDP for central government revenues, compared with 17.1% of GDP in Latin America and the Caribbean and 16.3% in sub-Saharan Africa.

There are some notable differences across countries in the Asia-Pacific region. For example, developed countries of the region were more successful, generating 24.2% of GDP compared with 16.9% for the developing economies. Again, there are marked differences among countries in the LDCs category. In Afghanistan, Bangladesh and Myanmar and Pakistan, tax-to-GDP ratios were close to, or at, single-digit levels (figure 5). According to ESCAP estimates, Asia-Pacific LDCs raised about $22.7 billion as tax revenues in 2011.

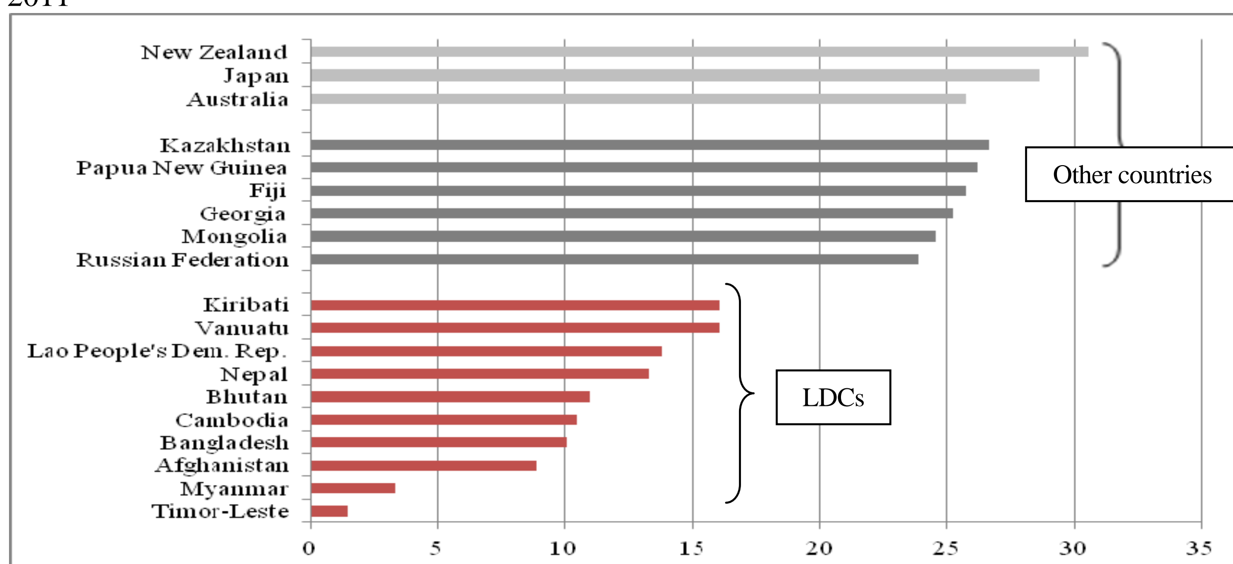
The structures of these economies present challenges for increasing tax revenues. Among these challenges, the size of the agricultural and informal sector is particularly relevant. In the agricultural sector, taxation is relatively low, while the contribution of this sector to the economy, in terms of employment or GDP, is sizeable, particularly in Afghanistan, Bangladesh, Myanmar, Lao PDR, and Nepal. Also, the taxation of personal income is difficult because many people are economically active in the informal economy. For example, the share of employment in the informal economy in total non-agricultural employment ranged between 62% in Timor-Leste and 86.4% in Nepal during the period from 2005 to 2010 (Charmes, 2012). Moreover, in the informal sector, many people hold vulnerable jobs with low wages which would be difficult to trace and tax.

Increasing tax revenue in LDCs by, for instance, broadening the base of personal income tax would be difficult in some countries, including in Afghanistan, Bangladesh, Bhutan, Cambodia, and Nepal. Yet, revenues could be raised through tax administration reforms that tackling tax evasion and fraud, and that increase collection efficiency. For example, in Bangladesh only about 1% of the population pays income tax while the income share held by highest 20% is equal to 41%. Of all least developed countries globally, illicit outflows from Bangladesh are the largest, reaching $35 billion between 1990 and 2008 (Kar, 2011).

Management of public expenditures

Resources for development could be found through rationalizing public expenditure and by making the budget more effective. In countries such as Afghanistan, Cambodia, and Myanmar, progress in health systems has been slow. Additional resources for education and health could be scaled up by curbing non-developmental expenditures, including defence expenditures. Besides the quantity of resources allocated to developmental issues, the efficiency of expenditure needs to be considered. For instance, in Nepal, Solomon Islands, and Tuvalu, more than 13% of public expenditure was on public health in 2011, yet the improvement of maternal health is still slow (ESCAP, ADB and UNDP, 2013).

Figure 5. Tax-to-GDP ratio in selected LDCs, compared with other Asia-Pacific countries, 2011



Source: ESCAP calculations based on data from International Monetary Fund, Government Finance Statistics database (accessed 20 October 2014).

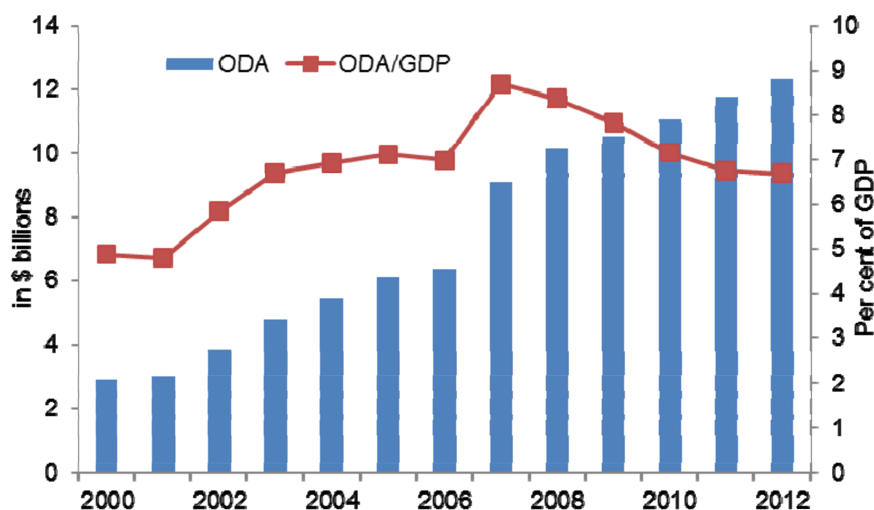
Thus, domestic public resource mobilization remains a priority area for LDCs to increase financial resources that are needed to bridge the graduation resource requirement gap. Appropriate policy measures are needed to improve the efficiency of public sector expenditure and fiscal management, including by strengthening the governance framework. Such policy measures would also contribute to supporting policy reforms that could encourage private sector participation in various infrastructure projects.

III.2. External public resources mobilization

Despite varying degrees of progress in mobilizing domestic public resources through taxation, available financial resources are not sufficient to cover the financing gap for graduation and to address the sustainable development agenda. The IPoA has, therefore, noted that “ODA continued to be the largest source of external financing for the development of least developed countries”. At the global level, the aggregate ratio of ODA/GNI for Development Assistance Committee (DAC) members increased from 0.05 per cent in 1997-1998 to 0.09 per cent in 2008. This is well below the 0.15-0.20 per cent target.

ODA flows to the Asia-Pacific LDCs reached $12.4 billion in 2012, representing only 28.6 per cent of global ODA flows to LDCs in 2012. ODA remains a significant source of development finance for LDCs in the Asia-Pacific region. The least developed countries in the region 44 per cent of the region's ODA in 2013, doubling their share of 21 per cent in 1990 (figure 6).

Figure 6. ODA flows in Asia-Pacific LDCs, 2000-2012



Source: ESCAP calculations based on the World Bank database. Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).

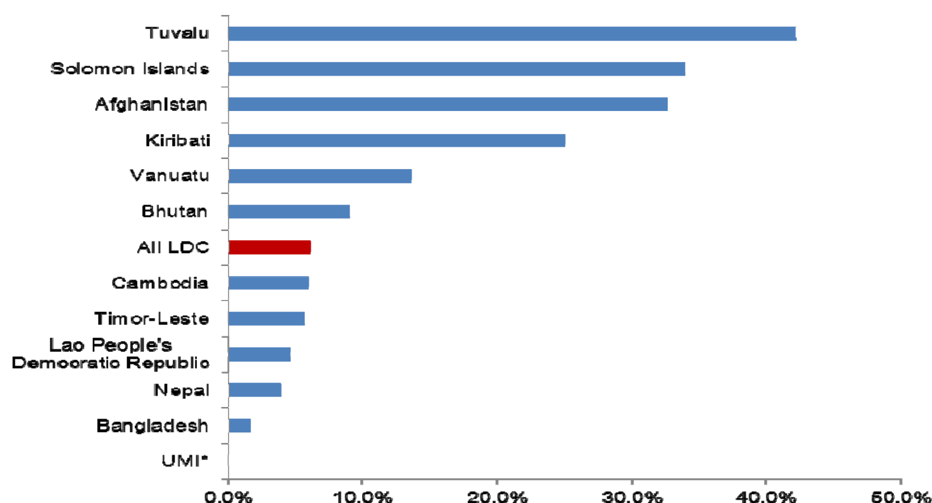
ODA inflows have played crucial roles in the recovery of Cambodia and Afghanistan from earlier conflicts and economic turmoil. They accounted for more than 100% of central government expenditure in both cases (120.8% in Cambodia in 2002, 210.2% in Afghanistan in 2007). In recent years, the relative importance of ODA has dropped substantively in many of the Asia-Pacific LDCs as they gradually strengthened their fiscal space. In Lao DPR, the share of ODA in central government expenditure decreased from 105.3% in 2006 to 36.4% in 2012. In Bangladesh, the figure more than halved from 24.6% to 11.8% between 2001 and 2011. However, ODA still remains a vital source of finance for the small island LDCs and some fragile members of the region (figure 7).

This trend reflects the greater vulnerability of LDCs when confronted with economic, social and environmental challenges. Two recent global conferences underscored the importance of aid effectiveness: the Fourth High-Level Forum on Aid Effectiveness, in Busan, the Republic of Korea (Global Partnership for Effective Development Co-operation, 2011), and the first High-Level Meeting of the Global Partnership for Effective Development Cooperation, in Mexico City (2014), to anchor effective development cooperation in the global development agenda beyond 2015 (Global Partnership for Effective Development Co-operation , 2014).

If developed countries are to follow up on their commitments, and there is a focused strategy to strengthen and recalibrate ODA flows to enhance its support for physical and social infrastructure development, the prospects and opportunities from ODA inflows can effectively provide a boost to bridge the resource gap in graduation strategies of LDCs.

Given the observed decline in ODA in recent years, especially after the 2008-2009 global economic and financial crisis, policymakers have advocated for a more predictable and robust support for productive capacity development in LDCs.

Figure 7. Comparison of country level ODA flows in Asia-Pacific LDCs, 2012



Source: ESCAP calculations based on the World Bank database. Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).
Note: * UMI refers to upper middle income countries.

III.3. Domestic private resource mobilization

The private sector is increasingly being recognized as a stakeholder and as a partner in supporting government activities in accelerating economic activities and in delivering infrastructure projects with long-term financing options. Players in the private sector span from individual entrepreneurs to multinational corporations and from direct investors to financial intermediaries, such as banks, pension funds, mutual funds, insurance companies, sovereign wealth funds, investment managers and other institutional investors.

For example, the Asia-Pacific region has a large global presence in the category of sovereign wealth funds (SWFs), accounting for $2.85 trillion, equivalent to 45% of the world's total assets under management. In addition, SWFs from developing countries represented 96% of the region's total assets under management. While China represented $1.31 trillion or 45.8% of this amount, several smaller countries, such as Timor-Leste, Azerbaijan and Brunei Darussalam, had SWFs with assets exceeding $10 billion (ESCAP, 2014c). Countries need economic reform policies to promote the development of long-term savings and institutional investors that can support their resource gaps according to specific country and institutional contexts.

To enhance the role of private resource mobilization, and taking the limited market size and the lack of liquidity in Asia-Pacific LDCs into account, governments need to develop and broaden domestic financial markets, including bond and equity markets, through appropriate regulatory frameworks that reduce volatility and market uncertainty. Different types of domestic financial institutions, including commercial banks, microfinance institutions, development financial institutions, post offices and other public networks, have a role to play to provide credit to households and firms, and to support economic activities.

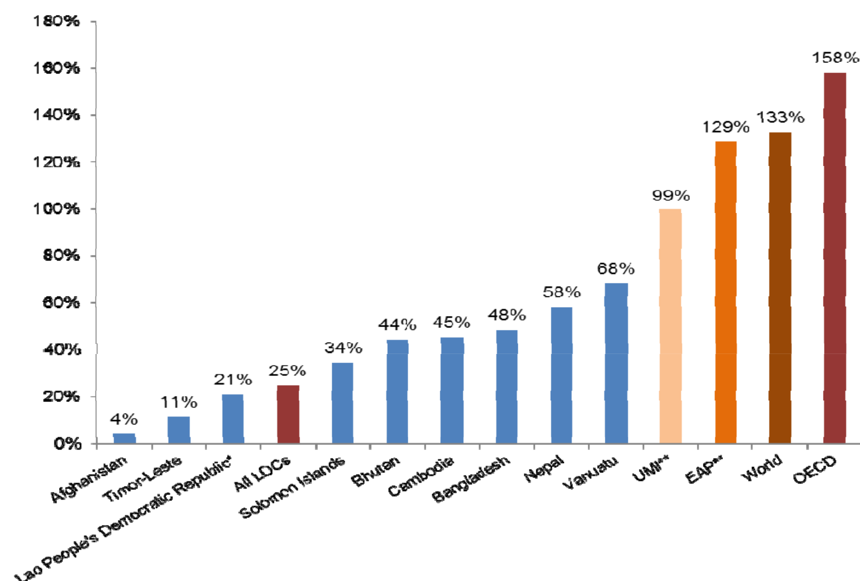
Banking sector

As primary allocators of funds which bridge savers and entrepreneurs, commercial banks are increasingly engaging in financial intermediation in LDCs. The recent experience shows that in many cases they account for more than 95% of total domestic private credit. There is no doubt that fast growth of the banking sector in the past decade has led to commendable progress in financial deepening in the Asia-Pacific LDCs. For example, domestic credit to the private sector in Timor-Leste surged from 1.5% of GDP in 2002 to 24.1% in 2006 before being hit by the global economic crisis. Cambodia also registered a 7-fold growth in domestic private credit between 2000 and 2013, and Bhutan almost 5-fold. By 2013, most LDCs of the Asia and the Pacific region had achieved better performance in financial depth compared to the overall LDC average, although still much shallower than more advanced country groups (figure 8).

Ongoing financial market reforms have helped rationalize banking regulation, address structural problems and promote greater competition among banks and other financial institutions. Yet, bank lending-deposit spreads remain well-above the LDC norm in a few countries, including Lao PDR (e.g., 19.6% in 2010, as oppose to LDC average of 10.2 per cent). This indicates significant space for further efficiency improvement in the sector.

However, the recent global economic and financial crisis as well as subsequent irregular cross-border movements of capital and the tightening of international banking regulations poses a serious test of the robustness of the banking system in Asia-Pacific LDCs. Prudent and flexible policies which strike a delicate balance between financial liberalization for efficiency and strengthened regulation for stability would be key to answer to these challenges. Governments therefore need to step up their efforts to infuse efficiency and resources for development through financial markets. This in turn will create space and inertia for developing bond markets in Asia-Pacific LDCs.

Figure 8. Domestic credit to private sector as percentage of GDP in selected LDCs



Source: ESCAP calculations based on the World Bank database.
Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).
Notes: * 2010 figure. 2013 figure for other countries/groups.
** UMI refers to upper middle income countries; EAP refers to developing countries of East Asia and the Pacific.

Equity markets

In recent years, direct financing through capital markets has emerged in Asia-Pacific LDCs. Bangladesh and Nepal have relatively active stock exchanges. The two stock exchanges in Bangladesh, for instance, hosts 542 traded securities, with a combined market capitalization of over $80 billion. Bhutan, Lao PDR, Cambodia and Myanmar have also established own stock exchanges with technical assistance from South Korea, Japan and Thailand. Although these young stock exchanges remain rather small and inadequate to serve the financial intermediation required for big projects, they mark the beginning of a new development and may provide an alternative financing channel in the near future as they develop.

The ASEAN and South Asia sub-regions have both established sub-regional stock exchange cooperation platforms, which can also be an effective way to address the challenge of small market scale faced by LDCs. However, LDC capital markets must achieve minimum regulatory and operational standards before being integrated into sub-regional markets.

Financial inclusion

In many developing countries, large proportions of the adult population, especially from poor and vulnerable sections of society, are excluded from the financial system. Fostering financial inclusion therefore forms a critical factor in strengthening domestic demand in the region and to address rising inequality and social progress. Governments in LDCs urgently need to strengthen financial market and institutional policies to enhance the capacity of domestic financial institutions to reach out to those who have no access to banking, insurance and other financial services, which can include micro-finance, micro-insurance, and mutual funds. This would enable expanding financial services targeted to poor and low-income populations, as well as small- and medium-size enterprises (SMEs).[4]

Despite progress, billions of adults in Asia-Pacific LDCs still lack access to reliable financial services and suffer from low financial literacy and capability. Recent data show that 50% of adults worldwide have an account at a formal financial institution such as a bank, a credit union, a cooperative, a post office, or a microfinance institution, but most LDCs fall below this average (figure 9).

Most people use their account to receive wages and for business purposes. However, savings have been mostly used for emergencies while loans originated mainly from family and friends (Demirguc-Kunt and Klapper, 2012). This shows that financial institutions are still insufficiently involved in supporting productive activities carried out by low-income individuals. Different factors explain this situation, including the level of income and associated credit risks, administrative costs related to the management of many small transactions, high interest rates, financial literacy, enforcement mechanisms, and the suitability of financial services, as compared to the demand.

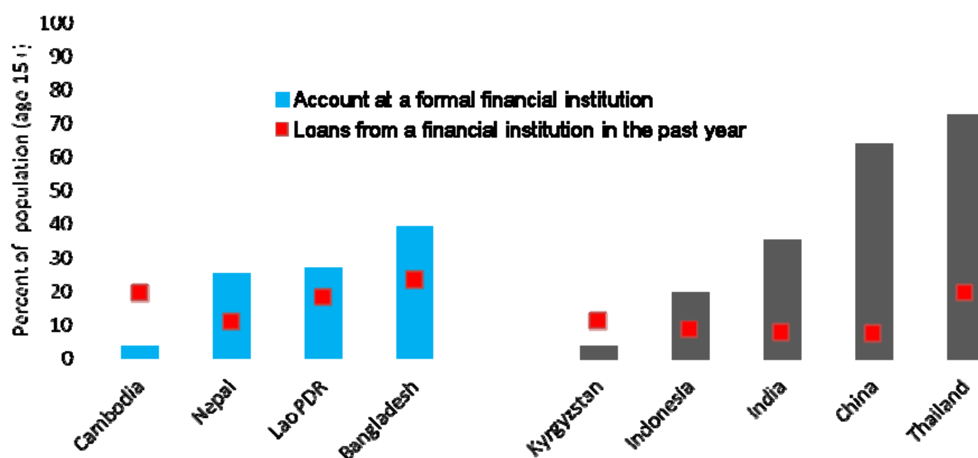
Islamic finance

Islamic finance has gained momentum as a new financing strategy that can support financing requirements for the graduations gaps in the Asia-Pacific region. Islamic financial assets have grown rapidly in the last decade in the region, including in the areas of infrastructure financing, social investments and green investments. The investment vehicles used in Islamic

[4] See the Istanbul Programme of Action (2011-2020) for further information.

finance, which are based on shared business risk, improve depth and breadth of financial markets by providing alternative sources of financing.

Figure 9. Adults (age 15+) with account at a formal institution, and had loans in the past year (%)



Source: ESCAP, based on World Bank, G20 Financial Inclusion Indicators dataset (accessed 10 March 2014).
Note: (1) Most of the data was collected in 2010-2011 period.

According to the Islamic Finance Country Index (IFCI) outlined in BMB Islamic (2013), there is potential for increasing the sector in Bangladesh and Afghanistan. For example, in Bangladesh, the market share of Islamic banks and branches as 18.9% of the deposits of the country's total banking system and 21.1% of total credit (Bangladesh Bank, 2013). According to the Islamic Financial Services Board (2014) report, if the deposits and assets of the state-owned banks are excluded from the calculation (roughly one-third of total deposits and assets), Islamic banks have achieved an even more impressive penetration of the private banking sector (Islamic Financial Services Board, 2014). Thus, in Bangladesh, Islamic financing can offer tremendous opportunities to help support the financing requirements, especially to develop a class of new long-term investment.

III.4. External private resource mobilization

As countries develop their domestic physical infrastructure and financial markets and as they promote a business-friendly 'enabling environment', foreign private investors will increase their participation, augmenting further the resources available for investment projects. In general, these private sources include foreign direct investment (FDI), remittances and other types of private flows.

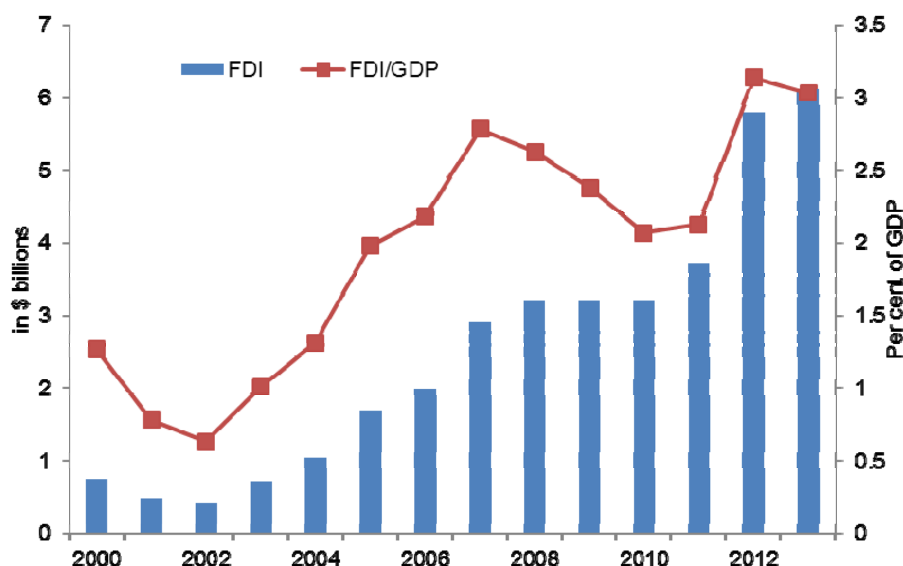
Foreign direct investment

Foreign direct investment (FDI) is a vital external private source of development financing for LDCs. FDI flows to the Asia-Pacific LDCs are almost half of the of ODA inflows in 2012. Moreover, FDI was not affected during the global financial crisis for LDCs, but remained stable at around $3.1 billion between 2008 and 2009 before increasing to $6.1 billion in 2013, which accounted for about 1.2 per cent of total FDI inflows in the developing Asia-Pacific region. In 2013, developing Asia-Pacific economies accounted for over one third of global FDI of $1.46 trillion (figure 10).

FDI accounts for close to 10% of GDP in Cambodia and Solomon Island. FDI can be of great

benefits for LDCs' development as it not only channels financing, but also brings much-needed experience and technology. Yet, at the same time, FDI is volatile and many Asia-pacific LDCs have experienced sudden and significant drops in FDI in the past decade. The often pro-cyclical characteristic of FDI and the vulnerability of LDCs when facing international financial shocks requires that FDI policies in LDCs be two-pronged: in addition to fostering a business-friendly environment to attract productive FDI, LDCs need also to strengthen regulatory capacities to effectively control speculative inflows.

Figure 10. FDI inflows in Asia-Pacific LDCs, 2000-2013



Source: ESCAP calculations based on the World Bank database. Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).

Remittances

The Asia-Pacific LDCs have enjoyed a rather robust positive trend in remittances from workers employed overseas. These increased from $2.3 billion in 2000 to $23 billion in 2013. However, migrant remittances to LDCs are only about 9.4 per cent of the Asia-Pacific developing economies total inflows of remittances in 2012 (figure 11).

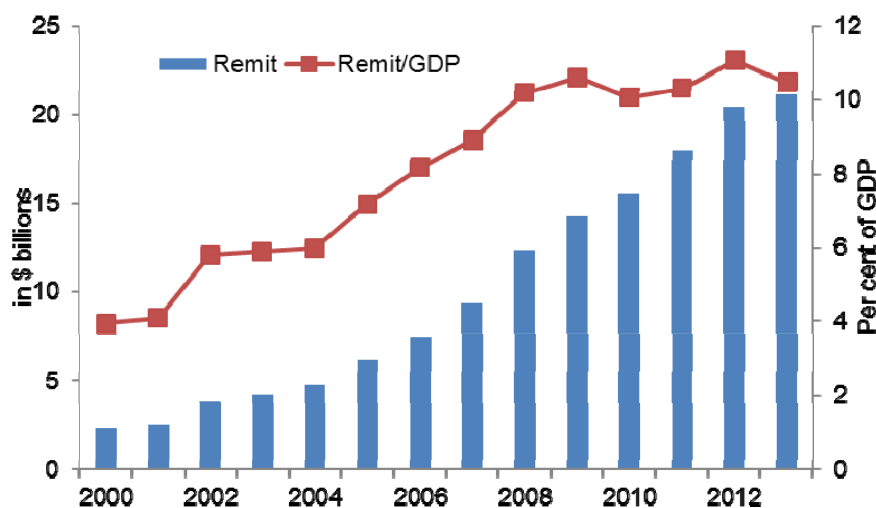
At the country level, remittances grew by 69 per cent, 57 per cent and 36 per cent respectively in Timor-Leste, Nepal and Bangladesh between 2007 and 2008 with an important counter-cyclical effect. In these three countries, remittances are also the largest external financial inflows, accounting for more than 20% of GDP in Nepal and more than 10% in Bangladesh and Timor-Leste.[5]

Although remittances are generally difficult to be mobilized for public investment, they provide a financial cushion to many households as they are used to finance expenditure in nutrition, medical care and education, and, in some cases, finance small family businesses as well. Such expenditure is crucial for the graduation of LDCs as it directly improves HAI performance and more importantly improves overall labour productivity. Therefore, government should facilitate to reduce remittance transaction costs. However, they must be cautious in trying tap remittances

[5] In Timor-Leste the figure surged from 2.75% in 2009 to 14.2% in 2010 and remained above 10% in 2011 before dropping back to 8.4%.

for public finance as remittances are a primary source of income for many of the poorest households in LDCs.

Figure 11. Remittances flows in Asia-Pacific LDCs, 2000-2013



Source: ESCAP calculations based on the World Bank database. Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).

III.5. Blended finance

UNDESA (2014) notes that policymakers need to take interest in "a class of development financing opportunities called "blended finance" that pool public and private resources and expertise. Blended finance encompasses a large portfolio of potential instruments, including instruments provided by DFIs to leverage private finance (e.g. loans, equity investments, guarantees etc.), as well as traditional public private partnerships (PPPs)".

There is an enormous opportunity for Asia-Pacific LDCs to opt for these new and innovative financing strategies that not only encompass structured public-private funds, but also create synergies and innovative 'implementing partnerships' between a wide range of stakeholders - including governments, civil society, philanthropic institutions, development banks and private for-profit institutions. This type of blended financing strategies can address the financing gaps for LDC graduation and the overarching sustainable development goals.

Public-private partnership (PPP)

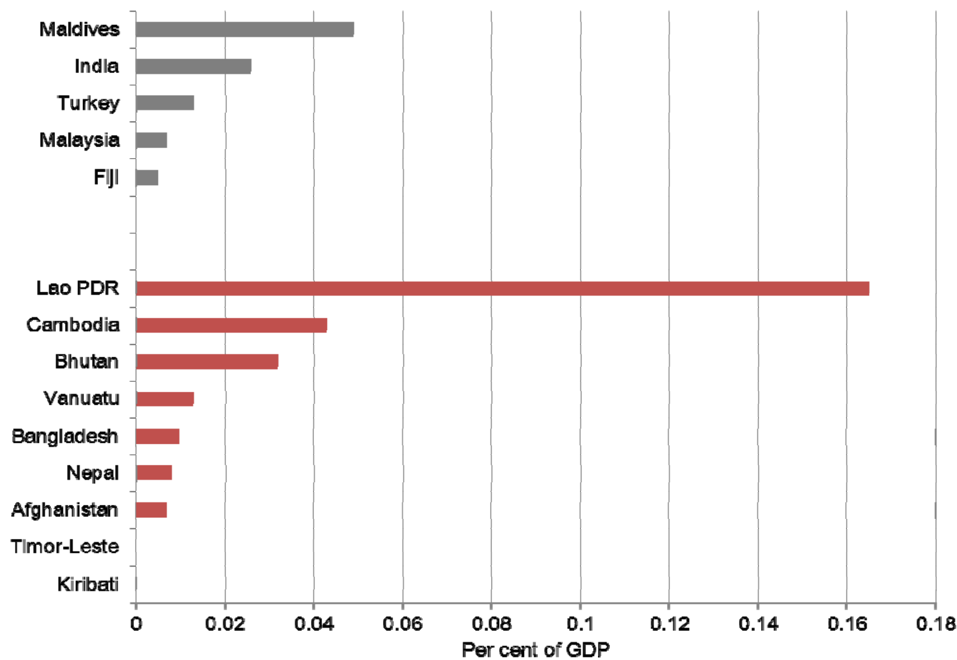
According to new evidence, PPPs are increasingly being adopted by Asia-Pacific countries as a mechanism to mobilize private resources for infrastructure investment. Thus, private investment committed to infrastructure in developing countries of the region grew almost 6-fold within a decade from $23 billion in 2001 to the historical high of $120.1 billion in 2010.[6]

Given the narrow fiscal space of LDCs, their limited access to long-term financing and weak planning and project management capacity, PPPs are an effective way to leverage private capital and technical expertise for development. PPPs often play a prominent role in addressing infrastructure bottlenecks. Between 2008 and 2015, Lao DPR, Cambodia and Bhutan registered

[6] Private Participation in Infrastructure (PPI) Project database. Available from http://ppi.worldbank.org/.

the highest private infrastructure investment-to-GDP ratios in the region, with private resources financing a bulk of their gross infrastructure investment (figure 12).

Figure 12. Private infrastructure investment in selected Asia Pacific LDCs, 2008-2012



Source: ESCAP calculations based on the World Bank database. Available from http://databank.worldbank.org/data/databases.aspx (accessed 20 October 2014).

Despite such impressive figures, PPPs in LDCs often rely on a few mega projects. To this extent, actual private resources mobilized can fluctuate significantly across years. It remains challenging for most LDCs to generate a pipeline of well-planned and bankable projects, to engage and negotiate with large private partners and to effectively monitor project implementation without external technical assistance. Thus, enhanced support from regional and international development partners in this area would be important for LDCs to sustain the vital investments required for graduation.

Meanwhile, a number of LDCs in the region, such as Bangladesh, have started to take actions to formulate a PPP strategy and establish dedicated institutions, including financing facilities, to support PPP development. This is an encouraging trend as a clear policy environment and regulatory framework is critical to attract and to govern private investment in PPPs. The knowledge and experience accumulated through such proactive support will also strengthen domestic planning, governance and institutional capacities, thereby creating a virtuous circle.

Development Finance Institutions (DFIs)

With the changing nature of development financing landscape, DFIs, both multilateral and bilateral, can play a crucial role in enhancing the scope and accessibility of blended finance for the LDCs in the region. DFIs have several instruments to use, such as concessional/blended loans, equity, guarantees as well as non-concessional financing and innovative instruments. LDCs can undertake policy measures to help promote the participation of DFIs in supporting the mobilization and use of private funds for development, including financing the graduation gaps.

The Asian Development Bank (ADB) and the World Bank are key partners in supporting LDCs in the region to mobilize additional resources and leverage public-private partnerships in support of infrastructure investments that can produce significant benefits to these economies, and linking them with bigger markets.

China has initiated to set up of a new regional development institution to help infrastructure development and promote sustainable growth. As founding members, the 21 countries from the Asia-Pacific region signed the Memorandum of Understanding (MOU) on establishing the Asian Infrastructure Investment Bank (AIIB) on 24 October 2014 in Beijing. The MOU specifies that the authorized capital of AIIB is $100 billion and the initial subscribed capital is expected to be around $50 billion.[7] The following LDCs (Bangladesh, Cambodia, Lao PDR, Myanmar and Nepal) are signatories of this MOU. A similar initiative of the BRICS (Brazil, Russia, India, China and South Africa) countries to create a new development bank is also expected to provide financing and expertise required for the development of infrastructure in the region, especially for the sizable financing gaps in LDCs.[8] These new financing institutions are important to play a catalytic role in accelerating the funding modalities and solutions for financing the LDCs to help them graduate from low-level of development status.

IV. Mobilizing resources for financing climate change

Climate change has become one of the key emerging development challenges in the Asia-Pacific region, especially for LDCs such as Bangladesh and Myanmar. Past experiences have shown that due to climate change related challenges, these economies lost many years of hard-won development gains. Furthermore, agriculture production, forestry and fisheries have been suffering from adverse impacts of environmental sustainability including climate change and related natural disasters that lead to degradation of land and soil, deforestation and reduction in access to water availability. Importantly, the risks to agricultural production vis-à-vis problems of food security are particularly critical for the poor and vulnerable in these economies.

In this context, the United Nations Framework Convention on Climate Change (UNFCCC) has recognized these constraints by stressing that developed countries need to provide support to LDCs and more vulnerable countries based on the principle of *common but differentiated responsibilities*, especially in the case of providing access to finance through international support measures.[9] The framework has established four special funds, including the Least Developed Countries Fund (LDCF).

At the recently concluded Climate Summit that was held in September 2014 in New York, the UN Secretary-General called upon the global leaders to step up their commitment to climate finance, among others, especially in LDCs to address emissions in critical sectors and support adaptation and resilience.[10]

According to the World Risk Report 2013, 9 of the 15 countries most exposed to natural hazards and climate change-related risks exposure are in the Asia-Pacific region: Vanuatu, Tonga,

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[7] The remaining 16 countries are Brunei, China, India, Kazakhstan, Kuwait, Malaysia, Mongolia, Oman, Pakistan, the Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan and Vietnam. More information is available from: http://news.xinhuanet.com/english/business/2014-10/24/c_133740149_2.htm.

[8] Please see the press release on the establishment of the New Development Bank (NDB). Available from http://brics6.itamaraty.gov.br/media2/press-releases/219-agreement-on-the-new-development-bank-fortaleza-july-15.

[9] http://unfccc.int/cooperation_and_support/financial_mechanism/items/2807.php.

[10] www.un.org/climatechange/summit/.

Philippines, Japan, Brunei Darussalam, Bangladesh, Cambodia, Solomon Islands and Fiji (Alliance Development Works, 2013). Many LDCs are vulnerable to climate-related disasters due to their exposure to earthquakes, storms, floods, droughts and sea-level rise. The total estimated losses due to natural disasters in the Asia-Pacific LDCs region during the period 2004-2013 amounted to over $11.2 billion, representing an annual average loss of over $1 billion during this period.[11]

LDCs therefore need to implement policies and strategies to minimize the economic and human costs of climate change through adoption of smart climate financing mechanisms. In particular, financing related to climate change involves two areas: financing of mitigation, which benefits both donor and recipient countries, and financing for adaptation, which provides support to recipient countries to adapt to the consequences of climate change and to make them more resilient to natural shocks

According to an overview of the Asia-Pacific climate finance landscape, the region received about 54% of the total approved spending of global climate funds, which amounted to nearly $11.5 billion since 2002.[12] The distribution of climate funds in the region has, however, been uneven, and LDCs have received only about 6.9% of the total Asia-Pacific region.[13]

An innovative area in leveraging funds to tackle climate change is the financing raised from green bonds. In 2013, $11 billion was raised globally through green bonds; this amount is expected to reach about $50 billion by 2015.[14] The Asia-Pacific region has received one fourth of all global climate finance investments. LDCs in the region have undertaken some policy reforms to create favourable conditions for investment in environmentally sustainable sectors, which in turn have stimulated the emergence of green investments, such as in Bangladesh.[15] It is now clear that LDCs need are significantly larger from other countries due to the disproportionate impact of the consequences of climate change. But these economies do not have adequate financial resources and technical expertise to develop appropriate and new technologies to address these environmental shocks and disasters.

V. Complementary role of South-South cooperation

The growing diversity of the developing world has created new opportunities for South-South cooperation (SSC) and triangular development cooperation (TDC), which can contribute significantly to enhancing financing for LDC graduation. Over the years, economic linkages among countries in the Asia-Pacific region have strengthened significantly. Development cooperation has emerged in areas such as human and productive capacity-building, technical assistance and exchange of best practices, particularly on issues relating to health, education, professional training, agriculture, environment, science and technology, trade and investment.
Several developing countries of the region have undertaken SSC activities over the past decades with varying degrees of engagement and size. For example, the two largest contributors to SSC activities in the region, China and Turkey, spend over $2.8 billion and $2.5 billion respectively,

[11] ESCAP statistics. Available from www.unescap.org/stat/data/statdb/DataExplorer.aspx (accessed 20 October 2014).
[12] For further information, the report is available from www.climatefundsupdate.org/listing.
[13] The information is available from www.climatefundsupdate.org/data.
[14] See www.economist.com/news/finance-and-economics/21599400-bonds-tied-green-investments-are-booming-spring-air.
[15] ESCAP (2014c) has noted that "the Government of Bangladesh has introduced development strategies that included directions to the banking sector in this regard, which the Central Bank took a step further by issuing green banking guidelines in 2011".

on SSC related activities in recent years. However, much of these activities have been directed towards the other regions, especially in Africa.

Other important contributors to SSC activities in the region include the Republic of Korea, India, the Russian Federation, Thailand and Indonesia. For example, Thailand provides support through several technical assistance programmes in the areas such as sustainable agriculture and food security, climate change adaptation, community health management and community empowerment towards healthy community, among others, in collaboration national partners for several LDCs in the region.

Many of these activities have focused on knowledge building, capacity-assistance and sharing development experiences, which are of direct benefit to the LDCs. In particular, many SSC activities provide support and enhance cooperation in areas such as trade, investment and technology transfer, especially for least developed countries. Other key areas include poverty alleviation, gender, agriculture and rural development, food security, infrastructure projects, ICT, environment, disaster relief and reconstruction, debt relief, banking, training of civil servants, governance, capacity-building and advisory services, and humanitarian aid. South-South and triangular development cooperation can provide additional instruments for funding development programmes including that of the financing for closing graduation gaps in LDCs.

VI. Prospects of raising resources for financing graduation

Undoubtedly, even if ODA commitments to LDCs rise, most of the growth impetus in LDCs will need to come from the private sector. This calls for LDCs to create an enabling policy environment for private sector investment, and to implement broad-based structural reforms to address their wide-ranging structural impediments. Use of alternate sources of finances is, however, critical to leverage private investment, given risk perceptions. As many LDCs have initiated robust policy reforms towards implementation of the IPoA programme for the decade, ESCAP estimates that for LDCs in the region:

- *Broadening tax bases, removing exemptions and enhancing administrative efficiency in tax collection alone, could raise an additional $11 billion.* [16]

ESCAP (2014) analysis shows that some LDCs in the region could potentially raise significant tax revenues. For example, in Afghanistan, the untapped tax potential is over 6.2% of GDP, while Bangladesh it is about 7.5% of GDP.

The potential is however is contingent upon the fact that LDCs would continue to undertake necessary fiscal reforms to build effective, transparent, fair and accountable national tax institutional frameworks. Countries would also need to broaden their tax bases and rationalize tax rates to minimize welfare losses by, for instance, introducing new policy reforms.

- *Creating enabling policy environments, and strengthening legal and regulatory frameworks would increase FDI inflows for greenfield projects. This could raise an additional $4 billion.* [17]

LDCs can promote policies to ensure that FDI projects can be directed towards investing more

[16] See Chapter 3 of the ESCAP (2014b) for further details of the methodology and estimates.
[17] The FDI data is based on the World Bank.

in greenfield FDI, which can create employment and increase the technological capacity of national economic sectors. Additionally, FDI policies should be articulated to advance the graduation-related policies at the country level. With further enhancement of policy reform measures, LDCs could improve their business environment to attract further momentum in encouraging FDI inflows in line with the growth in the East Asia and the Pacific (developing only) economies.

Under such assumption, if FDI to GDP ratio (average of 2010-2013) of LDCs can be increased at the East Asia and the Pacific (developing only) level which averaged 3.87% of GDP, then potential FDI inflows could be raised additionally by $4 billion for the Asia-Pacific LDCs. So, if LDCs could perform as good as their developing peers in the region, it would be possible to raise these additional FDI annually. Importantly, to achieve this level over a medium to long-term, LDCs are required to initiate necessary investment policy interventions, along with additional supportive macroeconomic policies and institutional measures.

- *Reducing transaction costs of remittances could increase remittance flows by more than $4 billion.* [18]

Remittances provide a financial cushion to many households and communities in LDCs. Given the very high cost of sending money, there is a clear case for strengthening regional cooperation, especially between LDCs and developed and emerging countries. For example, in some cases, transaction fees for sending money home can exceed 17% of the remitted amount for Bangladeshi migrant workers (World Bank, 2014).[19] Such cooperation can reduce the burden on the migrant workers by facilitating transaction costs, and providing mechanisms that would enable governments to tap these resources through, for instance, diaspora bonds or other remittance-backed bonds (World Bank, 2013).

Some preliminary estimates across LDCs in the region indicate that a reduction in transaction cost would significantly contribute to potentially generate about $4 billion. More importantly, by reducing the transaction cost, it could further encourage migrants workers for increase in cross-border movements. Also, with significant reduction is transaction fees, there would be more remittances coming through formal channels, as in the case of Bangladesh and other LDCs.

Therefore, reforms policies and cooperation across countries in the region and with outside, could create spill-over effects and given that there are lot of migration taking place from LDCs in the region, including high-skill workers, the potential for generating additional remittances is significant.

- *If the DAC members were to commit 0.15-0.20 per cent of GNI to least developed countries, Asia-Pacific LDCs would receive an additional $15 billion.* [20]

[18] An analysis of the transaction costs data indicates that in numerous cases, each of these transactions costs in many countries vary in the range between 15% to 20% of the transaction amount. By using the World Bank database on *Remittances Prices Worldwide*, the estimates show that if appropriate policies can be put in place to reduce significantly these transaction costs, region's LDCs can additionally raise about $4 billion.

[19] Database is available from http://remittanceprices.worldbank.org.

[20] The estimates are based on the assumption that DAC members would fully commit investing 0.20% of GNI to LDCs. By using the data of 2012 global ODA delivery of DAC members to LDCs, a simple extrapolation suggests that the Asia-Pacific LDCs could receive additionally about $15 billion.

There is a need for a restructuring, reallocating and refocusing ODA inflows to the Asia-Pacific LDCs. Sector specific ODA is critical for enhancing productive capacity that can substantially improve development gains. To make ODA more effective, LDCs also need to address gaps in existing institutions and governance structures, whereas donors need to increase the predictability of their support, reduce fragmentation, and invest keeping long term national goals in view. Importantly, donors should follow their commitment of investing 0.15-0.20 per cent of GNI to LDCs.

LDCs in the region have large financing requirements, but there is scope for identifying and tapping resources from a variety of traditional and innovative instruments with appropriate policy reforms and subregional and regional cooperation mechanisms. ESCAP estimates show that LDCs in the region could raise additional financing of about $34 billion per year.

Through various knowledge and technical capacity development activities, ESCAP is forging the spirit of innovative regional partnerships, especially for the LDCs and other vulnerable countries that would aim at spreading prosperity and development for all. These new form of development partnerships can support scaling up their size and depth of markets as well as can help them to receive support on enhancing skills, knowledge and technology, which are essential ingredients of raising additional financial resources.

VII. Concluding remarks

This paper illustrates that Asia-Pacific LDCs need additional resources for financing graduation, and that policy reforms must be put in place to increase their economic activity (GNI per capita) and to build their social infrastructure (HAI), especially by investing in basic services as well as by enhancing their resilience for reducing economic vulnerability (EVI). In view of their current economic vulnerability and their link to developed markets through trade and financial markets, ODA can continue to play a critical role in reducing financing gaps to help LDCs progress for the graduation.

To conclude, a pre-requisite for raising the required financing for LDC graduation will be structural reforms. The menu card for policy reforms could include, among others, and with due emphasis on country specific situations, the following:

- *raising tax-to-GDP ratios* by broadening tax bases, removing exemptions – be they for individuals, corporations or indirect taxes – and improving collection and administrative efficiency;

- *strengthening the banking sector*, including public sector institutions, as well as increasing focus on broadening and deepening capital markets and strengthening regulatory frameworks to encourage investor confidence and increase the scope of financial inclusion and Islamic finance;

- *strengthening the legal and regulatory framework* to promote FDI inflows for greenfield projects, as well as to expand the usability of remittances for productive activities;

- *advocating and positioning blended finance for graduation*, especially to promote PPPs, leveraged through well-designed incentive frameworks, to encourage financial

systems and institutions to finance infrastructure projects which can effectively enhance productive capacity of LDCs;

- *emphasizing the need to create a pool of resources to address the growing concerns of climate change consequences*, and to facilitate the availability of adequate financial resources and technical expertise to develop appropriate and new technologies to address climate change shocks;

- *promoting the complimentary role of South-South and triangular development cooperation* to share knowledge more widely and increase the availability of funding for capacity building; and

- *strengthening the role of ODA flows* to enhance capacity to access other forms of financing, for instance to fund infrastructure, basic health services and education. ODA can also support the creation of a positive development and investment environment through policy reforms in areas such as investment and trade. This is critical to raise additional resources.

The Asia-Pacific LDCs seeking to graduate would be best served to exploit alternate avenues of financing. ESCAP is positioning itself to continue facilitating intergovernmental debates on mobilizing resources, both from traditional ODAs as well as from new and innovative sources, to close the graduation gaps and to move towards the sustainable development agenda, by engaging and partnering with DFIs, the private sector and other stakeholders.

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