Development Finance for Northeast Asia

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1. Infrastructure: A Basic Building Block of Economic Development

After nearly six decades of experience in promoting economic development in less-developed countries in all corners of the world, one of the key lessons that has been learned is that *adequate physical infrastructure* is an essential building block of economic growth and development. Social infrastructure— universities, schools, hospitals and clinics all play an important role in the economic development process. But it is physical infrastructure—highways and bridges; rail and air transportation; ports and harbors; petroleum and gas pipelines; communication systems; energy generation and distribution; irrigation systems; urban water and sewage facilities; environmental protection and rehabilitation—that provides the foundation needed to launch and sustain successful economic development.

The importance of infrastructure for economic progress has been recognized since the closing days of the Second World War as evidenced by the fact that it was assigned high priority in the reconstruction of the war-torn economies of Europe and Asia. Similar infrastructure requirements exist in developing countries, and for that reason the World Bank (IBRD) and the Asian Development Bank (ADB), have over the years provided substantial amounts of financial support for infrastructure development in their respective developing member countries. In addition to the provision of technical services, support for infrastructure was provided in the form of loans for large, capital-intensive, public sector infrastructure projects. The terms of such World Bank and ADB lending usually included low interest rates, long grace periods and extended repayment periods. The types of infrastructure projects that were financed included highways and bridges, irrigation systems, airports and railways, port and harbors, and power generation and distribution facilities. Most observers agree that the infrastructure projects financed by the World Bank and the Asian Development Bank have been instrumental in the economic progress achieved by developing nations in the post-WWII period.

2. How Does Northeast Asia's Infrastructure Measure Up?

Given the role and importance of infrastructure for economic development, a basic question with respect to the development of Northeast Asia is how well the region's infrastructure base—it's transportation, power, communications, energy, etc.—measures up in terms of meeting the needs of public and private investors and enterprises. Current appraisals of the region's infrastructure facilities indicate that the answer to that question is, "not very well." The region's infrastructure is in fact substantially below the standards required to attract and support private and public economic activity—commerce, financing and manufacturing—that are the key ingredients of growth and development. Most of the region's highways, bridges, dams, railways, communications, power systems, etc. are obsolete or otherwise deficient. Much of the infrastructure dates from the Second

World War and the cold war, and during the intervening years it has not been adequately maintained.

Substantial amounts of capital will have to be invested to correct these deficiencies—that is, to cover the costs of the maintenance, upgrading and expansion that will be necessary to bring the region's infrastructure up to a level that can support private and public sector economic activity. The amounts of capital required for these purposes far exceed the savings capacity of the region. Therefore, a substantial share of the financial resources needed will have to be obtained from the international capital markets and transferred to the Northeast Asian region. If this capital investment is not made in an adequate and timely manner, infrastructure will prove to be a barrier to the region's economic development.

3. How Much Capital Will Be Required & Where Will It Come From?

Based on the investment experience of other Asian nations, the Northeast Asia Economic Forum has estimated that the region's *capital absorptive capacity*—that is, its ability to transform financial resources into sound, viable infrastructure projects—amounts to approximately $7.5 billion a year.

In earlier post-War decades, a major share of the infrastructure financing needs of developing nations was covered by loans and/or investments from three main sources, for the most part using funds mobilized in the international capital markets. These three "traditional" sources were: (1) the Multilateral Development Banks, i.e., the World Bank and the Asian Development Bank; (2) the bilateral official assistance programs of Governments, including Japan, the United States, Canada, Australia, New Zealand and the nations of the European Union; and (3) private foreign direct investment.

4. Can These Sources Meet the Region's Infrastructure Financing Needs?

The first place to look for the financing required for Northeast Asia's infrastructure projects is accordingly the World Bank and Asian Development Bank, government bilateral assistance programs and private investors. However, much has changed since the time these sources were willing and able to provide the major share of the infrastructure financing required by developing countries. In the current international environment, and based on the most optimistic projections, the most that could be expected from these three traditional financing sources for this region's infrastructure would be about $2.5 billion a year—which would leave an annual financing gap of $5.0 billion.

The next question is whether these three traditional sources of infrastructure financing could increase their financing for this region's infrastructure and thereby reduced the estimated $5.0 billion annual financing gap. Unfortunately, the answer is "no"; these sources cannot be expected to increase significantly their financing for Northeast Asia's infrastructure projects. Bilateral assistance has been falling in real terms for several years and is expected to continue to follow a downward trend. The reasons include donor-country "aid-fatigue" and over-all reduced foreign assistance budgets, the end of the cold war, the shift of resources and focus from Asia to Central Europe and the Middle East, and the emergence of domestic problems and the corresponding redirection of resources to meet those needs. These factors effectively preclude any significant increase in bilateral assistance for Northeast Asian infrastructure projects.

The second possible source of added infrastructure financing are the World Bank and the Asian Development Bank. The prospects for a meaningful increase in these banks' financing for this region's infrastructure are also remote. These banks' resources are typically committed to their client-countries several years in advance. To increase their lending in Northeast Asia would require shedding or reducing financing for some existing clients or, alternatively, an agreement by major shareholding countries, i.e., the United States, Japan, Canada, EU Members and others, to substantial increases in these banks' capital resources and their authority to borrow funds in overseas capital markets. It is clear that for budgetary and other fiscal reasons the major shareholder countries would not approve a proposal to increase these institutions' capitalization and borrowing authority.

Private investors, the third potential source, could be expected to provide financing for some components of future infrastructure projects—for example, sections of pipeline or related equipment. But along side such private resources, additional financing would have to be found from other sources. A few other kinds of infrastructure, such as telecommunications or port development, where investment costs can be recovered from revenues within a reasonably short time may also be partly financed by private investors. However, given the extended period over which infrastructure investment costs can be recovered (through fees, user charges, taxes, etc.), most infrastructure is by its nature a public, rather than a private sector, investment activity. Consequently, the amount of private financing for infrastructure projects in developing countries has been, and is likely to remain, modest.

Based on these constraints, it must be concluded that it is unlikely that the World Bank or the ADB, donor governments or private investors will be able to increase their financing to more nearly meet the region's projected infrastructure investment requirements. Therefore, the projected infrastructure financing gap of $5.0 billion remains to be covered.

5. Are There Other Ways to Meet the Region's Infrastructure Financing Needs?

One possibility for meeting the region's needs that has been suggested is a "Special Fund" in the World Bank or the Asian Development Bank for the purpose of financing Northeast Asian infrastructure requirements. Special funds have been used in the World Bank and the ADB for concessional lending (i.e., "soft-window" loans to least-developed nations) and for some other ear-marked purposes. While such special fund arrangements are satisfactory for specific, delimited programs or projects, they have not proved satisfactory for financing on-going activities such as infrastructure development. Therefore, creating a special fund would not be a suitable means of meeting the region's long-term infrastructure financing needs.

A special fund is in any case merely a *conduit* for monies that have been contributed by donor countries and other entities for a one-time, special purpose. When these donors' contributions have been fully committed, the special fund goes out of business. In order to continue a special fund's operations, donors must agree to contribute additional resources to replenish its coffers. Past replenishment efforts have usually involved lengthy negotiations. It has proven difficult to secure agreement by all donors on the needs and amount of the replenishment as well as its duration and the shares of the financing to be provided by each donor. Replenishment exercises for the World Bank and ADB special funds have proven to be increasingly difficult in recent years and have not always ended successfully.

Moreover, a special fund does not generate any additional funds and therefore has no multiplier benefits. One euro, dollar or yen contributed to a special fund would provide only one unit of currency for financing infrastructure. The absence of a multiplier is a major shortcoming of a special fund arrangement as compared with a banking-type institution that can use its callable capital as collateral for bond issues. That facility makes it possible for such institutions to borrow a multiple amount of capital in foreign capital markets for use in financing infrastructure projects.

For these reasons, a special fund for Northeast Asia would not provide a satisfactory long-term arrangement for meeting the region's infrastructure financing needs. In fact, it would not even provide a useful interim arrangement. Rather, a special fund proposal would be an unfortunate detour from the real task of providing a mechanism that will meet this region's infrastructure financing needs over the longer term.

6. The Northeast Asian Development Bank (NEADB) Alternative

The above discussion leads to these conclusions:

(1) A more adequate infrastructure base is essential for the future economic development of Northeast Asia;

(2) The multilateral, bilateral and private institutions and arrangements that in the past financed a major part of developing countries' infrastructure needs will not be able to meet more than a fraction of the corresponding needs of this region;

(3) A "special fund" for financing Northeast Asia's infrastructure needs would be at best be a detour and a dead-end;

(4) What is in fact needed is a sub-regional development bank-type institution that can bring a multiple amount of capital to the region's for financing infrastructure.

The need for a sub-regional development bank for Northeast Asia was recognized and the establishment of a Northeast Asian Development Bank, (NEADB) was proposed more than a decade and a half ago. In the intervening years the NEADB proposal has been subjected to detailed analysis and lengthy reviews by a variety experts' groups including the Northeast Asia Economic Forum. As a consequence, over the course of the past decade and one-half, it has received the endorsement and support of a large number of banking, financial and development officials and experts from Asia, Europe, North America and other regions.

The mechanism for establishing a NEADB is relatively straight-forward. As a first step its initial capitalization (i.e., size of its capital base) would be decided by its founding member nations. The Bank's capital would be evidenced by shares of stock which would be made available for subscription by regional and non-regional shareholders. Most subscribers would be governments or government-related entities. A specified share of the Bank's capital could be reserved for subscribers from the Asia-Pacific region, with the balance to be made available for subscription by non-regional nations and entities.

As is the case of the now-existing developing banks, only a fraction of the cost of each subscriber's shares would be paid for in hard currency—the "paid-in" portion. The unpaid balance of the cost of the subscribed shares would be carried on the books of the Bank as a contingent asset (and would be reported as a contingent liability by the subscriber)—this share would be considered the "callable" portion. The paid-in portion is typically paid over to the Bank over a period four or five years. The callable portion would never be called by the Bank. It would be used instead as collateral for the Bank's bonds that are sold from time to time in overseas capital markets. The proceeds of these Bank borrowings would then be used to fund loans for infrastructure projects in the region.

This is the very same borrowing-financing arrangement that has been employed by the World Bank, the Asian Development Bank and the other regional development Banks for the past several decades. By using callable capital as collateral, this funding arrangement yields a large multiplier in terms of the amount of cash paid by shareholders to the Bank compared with the volume of capital the Bank can borrow in the world's capital markets and transfer to the region. Moreover, because of the high quality of the collateral (the credit-standing of the subscribing countries), the NEADB would be able to secure capital abroad with lower interest rates and longer maturities than would otherwise be available for infrastructure projects in the region. It is projected that once it became fully operational, the NEADB would be able to bring $1-2 billion each year of additional financing to the region for infrastructure projects.