

# Strategic Approach to Establishing Northeast Asian Development Bank

2006. 9

Jaimin Lee  
The Export-Import Bank of  
Korea

 Korea Eximbank  
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## Contents



### 1. Need for Development Financing in Northeast Asia

2. Financing Sources for Development Projects and their Availability

3. Strategic Approach to Establishing the Northeast Asian Development Bank

4. Summary and Conclusion

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## Need for Development Financing in Northeast Asia

### Infrastructure Building

- Lack of infrastructure is a major obstacle to economic cooperation in NE Asian Area.
  - Underdeveloped infrastructure causes a bottleneck in regional cooperation and lowers the competitiveness of the region as a whole.
- A typical example is transportation infrastructure such as ports, roads and railroads.
  - Connection between Trans-Korean Railway (TKR) and Trans-Siberian Railway (TSR) will reduce the transportation costs between Northeast Asia and Europe.

## Need for Development Financing in Northeast Asia

### Cooperation in Energy Sector

- Energy remains a critical factor in the economic development and security of Northeast Asia
- Most Northeast Asian countries need reliable energy suppliers instead of Middle East countries, e.g. Russia has extensive natural gas fields
- Gas pipelines from Siberia to Japan will not only ensure a long-term supply of natural gas but also solidify long-term economic, political, and security linkages for the region
- ① An energy development project cannot be carried out without close regional cooperation
- Gas development projects require considerable capital and a long development periods

**Need for Development Financing in Northeast Asia**

**Development Cooperation with Less Developed Economies**

- Levels of economic development varies greatly from country to country in Northeast Asia
  - Per-capita GDP of Japan is about US\$30,000 while Mongolia is about US\$400
- Some provinces are low on the central government's development list
  - Eastern parts of China (Liaoning, Heilongjiang, Jilin) and far eastern part of Russia have many infrastructure projects to jointly constructed with other countries
- They will have great potential for economic growth if economic interdependent factors are successfully integrated throughout the region.

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**5**

**Need for Development Financing in Northeast Asia**

**Support for N. Korea's Transition into a Market-oriented Economy**

- North Korea is a key variable in ensuring security and peace not only in Northeast Asia but also in the world.
- Security and peace can be achieved through North Korea's economic development by leading it towards a market-oriented economy.
- The desperate state of the North Korean economy requires huge sums of investment capital to build social infrastructure such as electricity, roads, railroads, ports, etc..
- Infrastructure development in N. Korea should be supported by multilateral financing schemes in exchange of ensuring security for all NE Asian countries.

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**6**

# Contents



1. Need for Development Financing in Northeast Asia

**2. Financing Sources of Development Projects and Their Availability**

3. Strategic Approach to Establishing the Northeast Asian Development Bank

4. Summary and Conclusion

## Financing Sources for Development Projects and their Availability

### External Sources for Development Financing

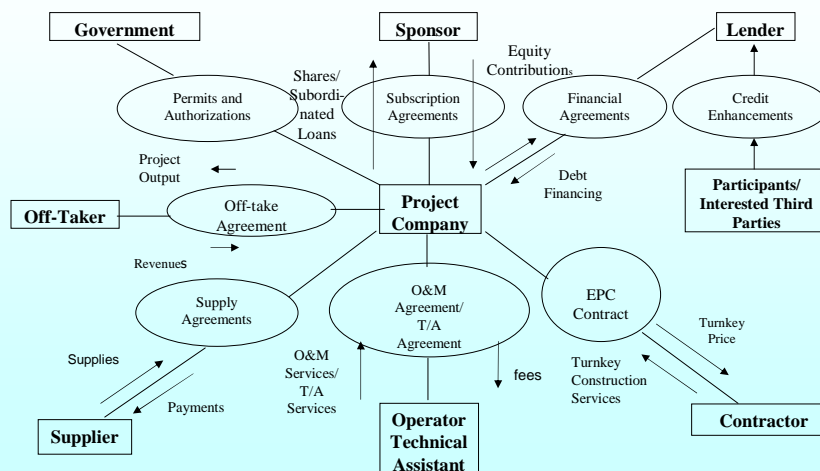
- The success of regional economic cooperation depends on smooth procedures of financing for the development projects of a country or cross borders projects.
- NE Asian economies except Japan and Korea face difficulties in raising funds from internal sources due to insufficient government budgets and immature domestic capital markets ⇒ This leads the economies to depend on external financing sources
- External financing is received from private and official sources
  - Private sources : Project Finance (P/F), Foreign Direct Investment (FDI)
  - Official sources : Bilateral Official Development Assistance (ODA),  
Official Export Credit Agency (ECA),  
Multilateral Development Banks (MDB) such as World Bank, ADB, EBRD

## Financing Sources for Development Projects and their Availability

### Project Financing

- Project financing (P/F) is a financing technique by which lenders look to the projected revenues of a project as the main source of repayment of their loans, regardless of the credit standing of the developers of the said project.
- In recent years, P/F has been booming as many countries and corporations can undertake major capital-intensive development projects without sovereign or corporate guarantees.
  - Investors and lenders must ensure that certain legal matters relating to the equity and debt investments in a project, such as taxes, foreign investment laws and foreign exchange regulations, are acceptable to all.
- However, some of NE Asian countries are not prepared to receive P/F in legal and institutional terms.

### <Structure of Project Financing>



(Table 1) P/F projects propelled in China and Russia

(Unit : \$ Million)

|        | 2000 <sub>1</sub> | 2001 <sub>1</sub> | 2002 <sub>2</sub> | 2003 <sub>3</sub> | 2004 <sub>4</sub> |
|--------|-------------------|-------------------|-------------------|-------------------|-------------------|
| China  | -                 | -                 | 3,842             | 3,755             | 2,787             |
| Russia | 2,077             | 225               | 193               | 150               | 213               |
| Global | 110,885           | 108,478           | 62,172            | 69,557            | 116,439           |

Source : Project Finance International League Tables (2000 - 2004)

## Financing Sources for Development Projects and their Availability

### Bilateral ODA

- Bilateral ODA is a concessional loan that a government of developed countries provides to the government of a less developed countries for the purpose of helping the latter's economic development.
- ODA has advantages of low interest rates and long-term repayment periods - Normally, interest rates are 1 ~ 2%, and repayment maturity is more than 20 years.
- However, it cannot raise a large sum of money, or apply to revenue-generating projects, and sometimes it can cause a country's interference in the domestic affairs of another country.
- Currently, Russia and some rich provinces of China are not eligible to be ODA recipients.

(Table 2) ODA Extended by South Korea and Japan to Northeast Asian Countries

(Unit : Billion Yen & Billion Won)

|                          | China   | Mongolia | Global Total |
|--------------------------|---------|----------|--------------|
| Japan <sup>1</sup>       | 2,872.5 | 36.1     | 20,441.4     |
| South Korea <sup>2</sup> | 138.1   | 30.3     | 1,025.0      |

Note 1 : Aggregates as of the end of March 2004 (Unit : Billion Yen)

2 : Aggregates as of the end of December 2004 (Unit : Billion Won)

## Financing Sources for Development Projects and their Availability

### The Export Credit Agency (ECA)

- ECAs extend export credit for overseas projects which commercial banks avoid financing due to high risks, low profit, etc.
- The loan provided by ECAs are larger than ODA with longer repayment period than those of commercial loans.
  - ECA loan maturity is up to 15 years, and interest rates are similar to market rates
- Presently, JBIC in Japan and USEXIM in the US are providing large amounts of credits for Russia's gas projects.
- Generally, ECAs encourage commercial banks to participate in major capital-intensive projects by providing payment guarantees.
- ECAs provide loans or guarantees only for projects in which exporters or investors of their countries participate.

(Table 3) Official Export Credit to the Northeast Asian Region

(Unit : Billion Yen & Billion Won)

|                                 | China | Russia | Mongolia | North Korea | Global Total |
|---------------------------------|-------|--------|----------|-------------|--------------|
| Japan (JBIC) <sup>1</sup>       | 3,592 | 683    | 4.2      | -           | 45,836       |
| South Korea (EXIM) <sup>2</sup> | 5,106 | 1,990  | 7.4      | -           | 140,964      |

Note 1 : Aggregates as of the end of March 2004 (Unit : Billion Yen)

2 : Aggregates as of the end of December 2004 (Unit : Billion Won)

## Financing Sources for Development Projects and their Availability

### Multilateral Development Banks

- MDBs such as World Bank, ADB and EBRD provide long-term development loans for the projects undertaken in developing countries.
- They have extensive experience, information and know-how regarding financing necessary to carry out development projects in developing countries.
  - Many developing countries have received loans and T/A from MDBs.
- However, existing MDBs currently have too many countries and regions to support, compared to their limited funding resources.
  - The amount of MDB loans extended has been decreasing in recent years.



## Financing Sources for Development Projects and their Availability

### Multilateral Development Banks (cont'd)

- NE Asian economies have not received enough loans from World Bank and ADB.
  - Especially, North Korea is not an eligible recipient country for loans from the World Bank and ADB.
  - Russia is not eligible for loans from the ADB.
- Furthermore, MDBs tend to focus on social infrastructure projects such as education, health, environment sectors rather than economic infrastructure projects.

(Table 4) Trend of Disbursements by MDBs

(Unit : \$ Million)

|                         | 1999 <sub>1</sub> | 2000 <sub>1</sub> | 2001 <sub>1</sub> | 2002 <sub>2</sub> | 2003 <sub>3</sub> |
|-------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| World Bank <sub>1</sub> | 19,391            | 17,246            | 16,889            | 15,304            | 17,512            |
| ADB <sub>3</sub>        | 4,824             | 4,019             | 3,881             | 4,235             | 3,826             |
| EBRD <sub>3</sub>       | 377               | 444               | 565               | 671               | 854               |

Note 1 : IDA included

Source : The DAC Journal, Development Co-operation, 2004 Report, OECD

(Table 5) Northeast Asian Countries' Borrowings from MDBs

(Unit : \$ Million & Billion Euro)

|                         | China    | Russia   | Mongolia | North Korea | Global Total |
|-------------------------|----------|----------|----------|-------------|--------------|
| World Bank <sup>1</sup> | 36,469.2 | 13,446.1 | 344.3    | -           | 567,447      |
| ADB <sup>2</sup>        | 9,028.1  | -        | 462.1    | -           | 73,749.5     |
| EBRD <sup>3</sup>       | -        | 5.9      | -        | -           | 25.3         |

Note 1 : IDA included, execution aggregates as of the end of June 2005 (Unit : \$ Million)

2 : Execution aggregates as of the end of 2004 (Unit : \$ Million)

3 : Execution aggregates as of the end of 2004 (Unit : Euro Billion)

Source : Annual Report of each institution

## Contents

1. Need for Development Financing in Northeast Asia

2. Financing Sources for Development Projects and their Availability

**3. Strategic Approach to Establishing the Northeast Asian  
Development Bank**

4. Summary and Conclusion

## Strategic Approach to Establishing the NEADB

### Reasons for Establishing the NEADB

- The loan amounts to be transferred to NE Asia by MDBs will fall far short of meeting the region's needs and borrowing capacity.
  - If established, the NEADB can provide development loans exclusively for the projects in the NE Asian region.
  - The establishment of a new mechanism for development financing in NEA is necessary to break the vicious circle of insufficient development financing, poor infrastructure and loose economic cooperation in this region.
    - Without MDBs playing the role as a catalyst, no real private investment can be expected to flow into the region.
- ⇒ NEADB would be the best choice to create an effective official funding source

## Strategic Approach to Establishing the NEADB

### Overview of the Past NEADB Proposals

- For more than 15 years, the necessity for establishing the NEADB has continuously been raised through many researches and conferences including the Northeast Asia Economic Forum meetings.
- Most proposals agree that 6 NE countries subscribes money for the Capitalization of NEADB.
  - 6 NE nations : South Korea, North Korea, Japan, China, Russia (Far East), and Mongolia
- The total capital and distribution of shares for 6 NE nations are stated differently in every proposal.
- They agree that the US should participate in the NEADB
- However, these proposals have not been materialized for a long time, due to diverse reasons.

## <Overview of the Proposals for the Establishment of the NEADB>

|                                    | Nam (1999)  | Kats. (2002)   | Tokyo Foundation (2002)   |
|------------------------------------|---|--|---|
| Total Capital<br>(Paid-in Capital) | US\$ 40 Bil.<br>(US\$ 20 Bil.)  | US\$ 25~50 Bil.<br>(More than 25%)   | US\$ 6 Bil.<br>(US\$ 3 Bil.)  |
| Share holding by<br>NE 6 nations   | 60%   | 40%  | 56%   |
| Distribution of<br>shares for NE 6 | Japan US\$ 0.8~1.2 Bil.<br>China US\$ 0.6~0.8 Bil.<br>Korea US\$ 0.6~0.8 Bil. | Japan 15%<br>China 10%<br>Korea 5%<br>Russia 7%<br>Mongolia 1%<br>N-Korea 2% | Japan 18%<br>China 16%<br>Korea 12%<br>Russia 8%<br>Mongolia 1%<br>N-Korea 1% |
| Share holding by<br>The U.S.       | Largest Shareholder<br>Expected   | Largest Shareholder<br>Expected  | 10%   |

## Strategic Approach to Establishing the NEADB

### Obstacles in Establishing the NEADB

- Overlapping roles with the ADB
  - As ADB can support the development of NEA, a new MDB is not necessary.
- Lack of consensus among related countries on the establishment of NEADB
  - Especially Japan which would be the largest shareholder of NEADB is not eager about its establishment.
- Political uncertainty in this region
  - Nuclear issue of North Korea has prevented regional economic cooperation.
- Lack of leadership
  - No governments in NE 6 has shown leadership for establishing the NEADB.
  - ⇒ As these problems are unlikely to be solved in the near future, it is expected to take long to set up NEADB.

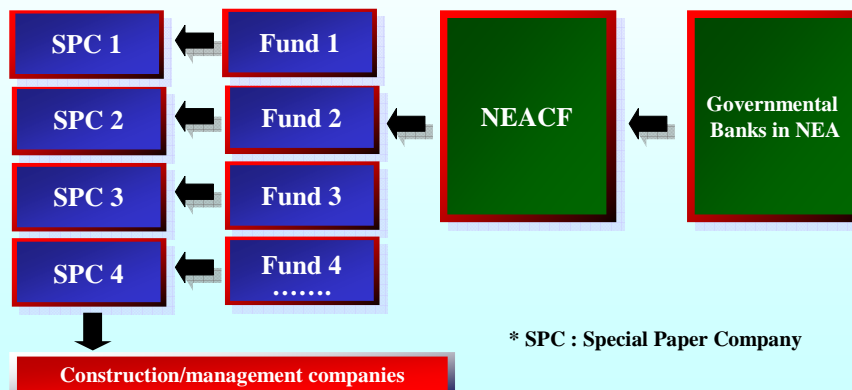
## Strategic Approach to Establishing the NEADB

### Alternatives : Creation of the NEA Cooperation Fund (NEACF)

- As a previous stage towards the NEADB, the Northeast Asia Cooperation Fund (NEACF) could be an alternative idea.
  - Step I : Governmental banks in NEA form a joint-venture company for the operation of NEACF.
    - \* Participants would be Korea Exim and KDB in Korea, China Exim and CDB in China, JBIC in Japan, and Vneshtorgbank in Russia.
  - Step II : Each of them makes certain amounts of contribution to form the NEACF. The bank that makes the most contributions would be CEO of the fund management company, and other banks would become the board of directors.
  - Step III : NEACF makes subsidiary funds (sub-funds) to supply the money for implementation of the development projects in this region. There is one sub-fund for one project.
  - Step IV : Each sub-fund establishes special purpose company (SPC) for the operation of the project.

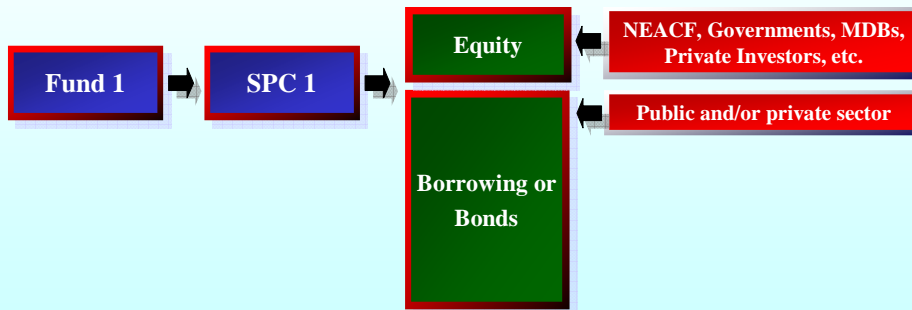
## Strategic Approach to Establishing the NEADB

### <Structure of NEADF>



## Strategic Approach to Establishing the NEADB

### <Structure of Sub-Fund>



## Strategic Approach to Establishing the NEADB

### <Merits of NEDAF>

- The SPC of a sub-fund can raise large amount of capital by utilizing the project financing (P/F) scheme.
  - It attracts investments from both public and private institutions, and borrowings in the international capital market. The NEA governments and MDBs can participate in it.
  - If the project is profitable, it can raise private capital. However, if it is not profitable but still is necessary for regional development, the sub-funds will be mostly financed from official resources.
- As a sub-fund is formed on a project basis, political obstacles will be reduced, and funding will be easy to procure.
  - Since the group to lead the NEACF is composed of banks instead of governments, mutual cooperation can be easier.


# Contents



1. Need for Development Financing in Northeast Asia

2. Financing Sources for Development Projects and their Availability

3. Strategic Approach to Establishing the Northeast Asian Development Bank

 **4. Summary and Conclusion**

## Summary and Conclusion

- Demand for development financing in the NEA region is strong due to the need for infrastructure construction, joint energy development, and North Korea's economic reform.
- After reviewing various financing facilities, the establishment of a new MDB (NEADB) would be the best choice.
- However, it will take long to set up NEADB due to many obstacles.
- As a previous stage before setting up NEADB, the NEA Cooperation Fund (NEACF) can be a feasible alternative.
- The NEACF will be created and managed by governmental banks in NEA nations such as Korea Exim in Korea, JBIC in Japan and China Exim in China.



## Summary and Conclusion (cont'd)



- NEACF subscribe to various sub-funds, which will invest in individual development projects.
- Each sub-fund could attract large amount of capital through private sector Investments or borrowings, if the project is profitable. If the project is not commercially viable in the near future, its funds would be financed by public institutions including governments.
- After the experience and know-how of financing cooperation in the NEA region, is accumulated through the NEACF, the governments of 6 NE nations can subscribe to the NEACF and officially inaugurate the NEADB.

# Thank You Very Much

