

Event Report

2015 ADB Annual Meeting

Notes on the 48th Annual Meeting of the Asian Development Bank,

Baku, Azerbaijan

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Takehiko Nakao, the president of the Bank, said the ADB must get "stronger, better, faster". The ADB will scale up its operations in "sustainable infrastructure", an area which already accounts for 80% of the Bank's operations. Seems like nothing gets you more focused than the challenge of a young upstart. The ADB, soon in its 50th year of operation and driven by an assertive board, displays confidence that its know-how, experience, and nimble organization can keep the institution relevant to the region's needs. The bank has greatly increased its lending power by merging the resources of its donor-sponsored concessionary lending operations into its main balance sheet. On the operational side, the ADB is launching strong initiatives to assist both governments and private sector players with making a rapidly growing number of infrastructure projects more commercially viable in the form of Public-Private Partnerships.

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President Ilham Aliyev took center stage and much time to address the opening ceremony of the 48th Annual Meeting of the Asian Development Bank in Baku, Azerbaijan. Just days before, he had opened the new congress center located nearby the Heydar Aliyev Centre. The complex, named after his father and Azerbaijan's first president, is an architectural masterpiece designed by Zaha Hadid Architects. Its shiny white modernity contrasts with the history of Baku, once dubbed the "black city" for the place where oil was first welled. As a nation Azerbaijan is young; independence came when the Soviet Union broke up. The country is surrounded by the Caspian Sea, Russia, Georgia, Armenia and Iran. Remarkably, it is a member of both the Council of Europe and the Organization of Islamic Cooperation. Next month it hosts the inaugural European Games, to be followed by the Islamic Games in two years. Europe is cuddling up to Azerbaijan as it sees an alternative supplier to Russia for natural gas. China is deploying massive financing for rebuilding the Silk Road. Surely, this multi-linguistic (Russian is the second language after Azeri), multi-religious (even if mostly secular), natural resource blessed (or cursed?) country is not easy to manage. Low oil prices, the territorial conflict with Armenia, and dissent from a repressed civil society that is amplified by western criticism, are not much of a help. In a candid speech President Aliyev displayed vision and determination to steer his country on a course of economic and political independence.²

²<http://en.president.az/articles/15006>

Azerbaijan will grow and grow

Even if the thirst for energy and the better connectivity by means of new roads, rails, and pipe-lines offer new opportunities to the Central Asian countries, the prospects for their economic integration remain lacklustre. Not only do the country's products lack diversity, there seems to be a lack of political will. Will the drop in oil price be a catalyst for change? By the end of the decade, new large revenue streams will come to Azerbaijan when the Southern Gas Corridor project will start to deliver Caspian gas to Europe. President Aliyev sees bright prospects: "Azerbaijan for many decades ahead, maybe for hundred years, will be one of the important suppliers of gas to Europe, and (as) the geopolitical importance of Azerbaijan will grow, our influence will grow." Meanwhile the non-oil sector is the strongest contributor to GDP growth and the government is fixed on boosting its agricultural sector up to self-sufficiency. Subject to continued reform and political stability, there is a good chance that Azerbaijan will realise its ambitions.

Consumption will make Asia's growth more sustainable

The ADB forecasts 6.3% annual growth in the GDP of developing Asia in 2015 as well as 2016. The region has been contributing 60% to global growth since the financial crisis of 2009 and will continue to be the main driver. This message was echoed by Standard & Poor's, which presented an analysis showing that the rise in consumption in China, India and Indonesia combined, is equal to that of the U.S.³ What is particularly positive is that developing Asia's transformation to a consumption story is less dependent on credit. Comparing companies' data across sectors, S&P's found that in sectors such as industrials and energy, the increase in debt has been outpacing growth in capital expenditure and earnings since the financial crisis. The agency concludes that emerging Asia's growth in consumption is not only big in market terms, it should also be more sustainable.

Asia's growth eluded 40% of the population

The ADB continues to set poverty reduction through inclusive and sustainable growth as its core mission. That vision is not carried off by the remarkable progress made in recent years. On the contrary, last year the ADB's deputy chief economist Juzhong Zhuang presented a study arguing that the traditional poverty threshold of USD 1.25 a day led to understating Asia's poverty.⁴ Measuring a consumption basket that is specific for Asia's poor, food costs that rise faster than general price levels, and vulnerability to economic shocks and natural disasters, the ADB estimates that the number of poor people in Asia would rise from a few hundred million to 1.4 billion, or 40% of the population.

What's more, the key drivers of Asia's economic growth, technological progress, globalisation and market-oriented reforms, have led to widening inequality amongst the population both in terms of opportunity and income. Nevertheless, said the ADB's President Takehiko Nakao, growth remains an essential basis for poverty reduction. But in order to make growth inclusive, there is need for increased investment in education and healthcare, as well as job creation, in particular for women.

³Credit Week, Standard & Poor's Rating Services, April 22, 2015

⁴ <http://www.eastasiaforum.org/2014/04/14/lifting-asia-out-of-poverty-needs-to-be-done-equally/>

How to spend the benefits of lower oil wisely

Cheap credit due to worldwide low interest rates has been a tailwind for Asia's growth. So has the lower oil price. Neither may last. Governments have seized the opportunity to cut fuel subsidies. Given falling productivity and lower potential growth, Asian governments should carefully steer the windfall benefits towards productivity enhancements, ones that raise technology and innovation, said Anoop Singh of JP Morgan. However, lower subsidies disproportionately damage the poor. Governments, notably in India and Indonesia, have duly taken compensating measures.

The inevitable manufacturing sector

Debating in different panels, politicians and economists agreed on the merit of pursuing labour-intensive manufacturing strategies because, as Martin Rama, a World Bank economist, observed: "the best skills development project is not vocational training but putting everybody to work". Zaw Oo, a presidential advisor in Myanmar, said governments should find out "what value chains are available to the country, then adapt the skill formation to it". He praised the advantages of foreign direct investment for retaining and skilling the workforce at home, rather than seeing workers move offshore and send remittances which "can also have a curse effect on the economies". Vietnam was singled out as an example of good diversification in manufacturing, whereas Bangladesh suffers from overcrowding in one sector. Rajiv Mehrishi, the top official in the Indian ministry of finance, said that "manufacturing will inevitably have to lead India's growth in the next decade because of the country's high youth percentage". The Modi government launched the "skill India" and "make in India" campaigns, and various labour reforms that will start to unshackle the manufacturing sector. Yet India's vibrant democracy and the importance of small companies as a huge creator of employment, mean that the government must "hasten slowly".

Infrastructure is key

Highlighting three areas where the ADB would scale up support to eliminate poverty and promote sustainable development in Asia, the ADB president put the priority focus on "sustainable infrastructure". "Education and health" and "climate change" are the second and third priority. Said Nakao: "Infrastructure itself is also about poverty reduction: unless there is electricity and roads, people cannot access education and healthcare, and women cannot go out to do more productive work".

Both India and Indonesia are allocating part of the fiscal savings from the cut in energy subsidies to public investment in infrastructure. For India this amounts to an expenditure of 0.5% to GDP in the current year. As for the People's Republic of China, the prime example of big public infrastructure works, Lou Jiwei, the finance minister, inserted a curious carve-out: "For very remote areas we must encourage people to move out rather than build roads". China's urbanization rate is still 10% below the rest of Asia, he added. Migration and more flexibility in labour are part of the necessary reform. Driving out corruption and letting market forces play a bigger role are the basis for more equality. China will further improve education while vocational training is free.

Japan's new standard for infrastructure projects

Interestingly, Japan, not letting itself be outdone by China, introduced the notion of "Quality Infrastructure Investments" as a new international standard. Quality infrastructure investments look beyond the start-up phase to the duration of the project and its maintenance cost, not just the initial price. They pay due consideration to debt sustainability. They are more environment-friendly and more harmonious to local communities. They promote transfer of technologies and capacity building. Japan will contribute to the ADB's newly established project planning unit and strengthen the capacity of its national institutions for international cooperation (JBIC and JICA).

In Baku, President Nakao repeatedly went out of his way to emphasize the infrastructure focus. Questioned on the ADB's plans to promote trade finance in the light of the less trade friendly Basel-III regulations for commercial banks, he referred to the "ADB Trade Facilitation Programme" but added there was "now no acute need for such multilateral initiative". Similarly, on the topic of a regional bond clearing & settlement system, he replied that the Bank "can do research but we are not pushing that agenda". Even the Office of Regional Economic Integration would now report to the

research department, the IFR magazine reported. A glance at the ADB website will make clear though that the three aforementioned topics continue to be actively pursued.

ADB and AIIB set to cooperate....

Currently 80% of ADB's operations are targeted towards infrastructure, mainly in the areas of transport, energy and water. The ADB estimated that the region needs USD 8 trillion of infrastructure investments this decade, more than half of that in China. That leaves ample room for the soon to be established "Asian Infrastructure Investment Bank" to contribute its part. Co-financing with the ADB may well come about. The AIIB's Secretary General, Liqun Jin, himself an ex-ADB vice-president, was in Baku to discuss this and other forms of cooperation. Hinting that the AIIB would be lighter in physical set-up and without a resident board, ADB's Nakao gently

Japanese society's manufacturing model

Japan's revered finance minister Taro Aso, looking back much further than his lengthy political career which included prime ministership, said Japan has no intention to follow the example of onetime economic powers such as England, Holland, and later the United States, which evolved from an industrial and merchant economy into a finance-driven society. Even as Japan also changed a lot and will continue to grow, it wishes to keep manufacturing as the basis for the development of its economy. This spirit of "monozukuri" (making things) is what best suits Japan, and what made Japan successful as one of the least unequal societies among developed economies.

Chinese medicine

Discussing regional integration, Jianping Zhang, Head of Department of International Economic Cooperation, National Development and Reform Commission of the PRC, said that a process based too narrowly on economic cooperation can lead to conflict as we see with Ukraine. "Just Free Trade Agreements is not enough, it is like western medicine." China's approach to integration is much broader, with economic, physical, financial, cultural, people to people connectivity, and other elements promoting each other. The concept of the 'One Belt, One Road' initiative reflects that model. The Silk Road Fund and the AIIB will support it financially.

offered various support including the help of the ADB resident missions across the region. Nakao made it clear though that the cooperation is conditional to the AIIB's adherence to international standards of safeguard policies.

.... but compete on safeguards?

The ADB's Safeguard Policies for social and environmental aspects have evolved over five decades and have become a hallmark of the institution. If these policies, and those from the World Bank and other multilaterals, are considered to have formed a so-called best practice, China's finance minister sees it differently: "there isn't any, there is only better practice". Such remarks give rise to expectations with some, fear with others, that the AIIB will set lower standards on safeguards and eventually drag down the benchmark for other multilaterals. As far away as Ghana, the minister of trade and industry was quoted saying: "I think there is some merit in considering joining [the AIIB] which is expected not to have the same kind of conditionalities that have applied to lending from the Western world."⁵

Higher quality should attract private sector cooperation to ADB projects

Quite the opposite of lowering the standards on projects, the ADB is setting out on raising them. The Bank is coming up with two firsts for a multilateral development bank: it won accreditation from the Green Climate Fund, and it signed a co-advisory framework agreement with eight commercial banks in the area of project finance.⁶ The former will make it possible for the ADB to combine the Green Climate Fund's concessional funding with its own resources when financing climate change mitigation or adaptation projects. The latter enables the ADB to couple the market experience of global banks with its own expertise in the area of Public-Private Partnerships. The cooperation fits in the long term strategy of the Bank to make private sector development and private sector operations stronger drivers of change in Asia. The ADB wants fully private-financed projects, followed by PPP's, to be the preferred option before resorting to tax-payer funded sovereign projects.

Public-Private Partnership projects on the rise

Within the ADB a new 'Office of Public-Private Partnership' will advise governments of its developing member countries on how to structure projects to make them bankable. Its services are fee-based and cover the entire process of PPP projects from their conceptualization to contractual and financial close. The poorest countries will be able to draw on an 'Asia Pacific Project Preparation Fund', sponsored by donor countries. The ADB's enthusiasm about PPP's is underpinned by a study done by the Economist Intelligence Unit which testified of the progress made on PPP's across Asia: "Political commitment is increasing. For example in India, the new government describes itself as an enabler of PPP's. Projects there are also initiated at state-level. China embraced the concept two years ago and is training people at regional governments".⁷

⁵ <http://citifmonline.com/2015/05/12/ghana-considers-joining-asian-bank/#sthash.RSj9DNmi.ExVNGsT7.dpbs>

⁶ <http://www.adb.org/news/adb-signs-first-ever-ppp-co-advisory-agreement-global-banks>

⁷ http://www.eiu.com/public/topical_report.aspx?campaignid=AsiaInfrascopes2014

The ADB's clever capital triple-increase

The ADB's efforts to make Asia's infrastructure projects more sustainable and commercially viable are likely to attract a larger part of Asia's savings, too much of which is invested abroad with poor returns. However, Nakao is convinced that "without [the ADB's own] strong lending capacity, our relevance will be decreased". The capital increase he has successfully concluded is considered the biggest achievement of the president's first year in office. Deftly steering past budgetary barriers in many a shareholding country, the ADB merged the capital of its concessional lending, funded from the Asia Development Fund contributed by donors (Japan and the US accounting for about half), with its "ordinary" capital contributed by the 67 shareholding countries (Japan 15.7%, US 15.6%, China 6.5%, etc.) used for lending at market conditions. Unlike the Bank's "ordinary" capital, the Fund could not be leveraged. The combination of the two capital bases will triple the Bank's "ordinary" capital to \$53 billion. Together with cofinancing, ADB's annual assistance will reach as high as \$40 billion in the coming years, up from \$23 billion in 2014. A point of attention is that the Bank's combined \$100 billion loan book will be of lower credit quality (on account of bringing in the concessional loans to poorer countries). Yet the greater diversification of the loan portfolio is also a credit positive, and the Bank will further mitigate by raising the minimum equity-to-loan ratio to 37%. Ultimately, the exercise makes the Bank's triple-A credit status even stronger. Apart from the financial rationale, the Bank also observes that keeping separate loan books is outdated as the credit gap between poorer and richer countries continues to narrow. Furthermore, there has been no default. Poor countries will continue to receive concessional loans from the expanded capital base on the same terms and conditions as before.

Infrastructure XXL

At the annual meeting in Baku the Asian leaders showed little interest in what is happening in the West. Asia has learnt from its own crisis in the nineties, and the region feels rather well placed to cope with the interest rate rises that the US Fed might trigger, and it knows it should not expect the West to pull up growth significantly any time soon. What's on Asian leaders' mind is developing the home market, promoting manufacturing for jobs and creating demand. For that purpose, governments will redirect their fiscal spending to better basic infrastructure. Regional integration is again seen more as a physical than an institutional endeavour. Add the buzz around China's AIIB and the 'One Belt, One Road' project, and it is clear that 'infrastructure' was THE talk of the town in Baku.

'Stronger, better, faster' but still not enough

The ADB has read the shifting priorities well. It has strengthened its lending power, refocused the organization, and is galvanizing the private sector. Yet with huge expectations and insatiable demand for infrastructure unleashed, the ADB knows it will still have to be "stronger, better, faster". Already China and India are pushing for a further capital increase, not the ordinary type but a 'special capital increase' or "SCI". That would imply a change to the current shareholding balances, likely resulting in a reshuffle of voting power, the kind that the "Bretton Woods" multilaterals dread. Naturally, the Europeans in Baku seemed weary about the idea. President Nakao mooted the possibility of an "SCI" in his closing remarks.

Europe challenged to rethink

The possible dilution of European influence in the Asian Development Bank would crystallize the perceived waning attention as European politicians focus on the EU's own political and economic struggles, and negotiate the 'Transatlantic Trade and Investment Partnership (TTIP)' agreement with the US. The evolution is mirrored in the downward trend of participation by European companies in the ADB's project procurement.⁸ All that requires a thorough rethink because, from Baku to Beijing, the geo-political influence, as well as the business opportunities, are growing faster than in Europe.

Amidst seemingly opposite regional dynamics, the ADB is holding next year's annual meeting in Frankfurt. Europeans should be thankful for the reminder that also the New Silk Road can be a two-way flourishing exchange.

⁸ The ADB-What is in it for Europe - Clingendael Report (Feb 2014)