Event Report

Asian Development Outlook Update 2017: Sustaining Development through Public-Private Partnerships

EIAS Briefing Seminar

17 October 2017

Yasuyuki Sawada, Chief Economist of the Asian Development Bank, presented the Asian Development Outlook Update 2017 report, which provides growth forecast for the Asia-Pacific region. The report's theme chapter focuses on sustaining development, mainly meeting the region's large infrastructure needs, through public–private partnerships.

Yasuyuki Sawada, a professor at the University of Tokyo's Graduate School of Economics, has over 20 years of experience as an economist, researcher, and academic. He has worked at the ADB Institute in Tokyo and served as a consultant for various projects at the World Bank Group. A leading figure in development economics and applied microeconometrics, he has also served as a visiting professor at Stanford University's Stanford Center for International Development, and adjunct professor of economics at Korea University. Mr. Sawada has conducted many field studies in developing countries and has a deep insight about development issues. His research has contributed to the works of various development institutions including the Japan International Cooperation Agency, Bangladesh Institute of Development Studies, Crawford School of Public Policy's Australia-Japan Research Center at the Australian National University, and the Pakistan Institute of Development Economics.

Opening Remarks by Mr Erik Famaey, Senior Associate, EIAS

Mr. Famaey began his speech by noting that in the interest of sustaining the observed upward economic trend across Asia, the Asian Development Bank (ADB) has given considerable attention to the potential of the Public Private Partnership (PPP) mechanism in order to successfully transition middle-income countries into high-income economies.

Now on its 50th year of operations, the ADB springboarded from a two-fold mission: to foster economic growth and regional cooperation in Asia. Today, the continent has progressed well beyond the most optimistic economic forecasts – Asia is now regarded as the "motor" of global economy. As to regional cooperation, the European Union exemplifies the synergy brought about by a combination of economic motivations as well as strong political will from government leaders to actualize collective and coordinated action. In the case of Asia, it goes without saying that there is still much room for improvement. For one, certain long-standing, pervasive sentiments including (mis)perceptions of other countries slow down the realization of genuine regional cooperation and integration. Nonetheless, this can rather be seen as an incentive for an institution like ADB to evolve into a more holistic enabler – not only serving as a lender but also as a provider of policy advice and technical expertise to both the public and private sectors. In fact, a survey conducted by an Australian think tank hailed ADB as the world's most efficient multilateral development bank.

It should also be recalled that 20 years ago, Asia was plagued with an economic crisis characterized by panic among its financial markets, causing contagion all over the region. Thorough analyses, which found that Asian countries shared common structural deficiencies (weak banking regulations, cronyism, and poor governance), propelled many Asian governments to make the necessary domestic structural reforms. In the meantime, ADB was a large contributor in strengthening their external economic defense by way of a regional foreign exchange swap agreement. Overall, there was a general will to save Asia from plunging into economic collapse. Asia did not only eventually survive but a newfound resilience was maintained throughout the years; it endured even in the face of the global crisis in 2009.

Today, Asia has already undergone major changes in its political, security, and economic domains. Amid emerging trends and an ever-evolving geopolitical environment, a brighter economic future is still very much in sight for Asia. However, the continent has also had to contend with new challenges: how to get past the "middle-income trap" wherein they are no longer backward economies but are still not that technologically advanced; the graying of societies; and the looming threats of climate change, among others. Also present is the shift in the drivers of economic growth, from exports to domestic consumption. Moreover, economies must suddenly adjust to commitments made at the Paris Agreement, which would then mean an increased demand for further financing. ADB estimates that developing infrastructure in Asia until 2030 requires USD 1.7 trillion annually (an amount 1/3 of the world's GDP). In the urgent search for funding sources, ADB and other institutions such as the newly established Asian Infrastructure Investment Bank, must improve where they can and harmonize their strategies. On the part of European countries, their engagement with ADB and AIIB relies partly on a total of 20 percent voting rights in both banks. One must remember that this is a highly opportune time to recognize and carry out collective responsibility since Asia's proven, consistent track record on economic development makes it a fertile ground for growing markets, and partnering with an institution such as the ADB can only be mutually beneficial.

Presentation by Prof. Yasuyuki Sawada, Chief Economist, Asian Development Bank

Professor Sawada first introduced ADB's major annual publication "Asia Development Outlook" (ADO), which consists of a comprehensive analysis of 45 member economies across what the institution calls Developing Asia. He would be discussing an update to the report, first presented in April this year. The updated report is focused on a medium-term developing issue: how to sustain development through PPPs.

The main revision to the the April forecast is further growth acceleration expected in Developing Asia (from 5.7 percent in April to 5.9 percent in the updated forecast) excluding high-income, newly industrialized economies (NIEs).[1] On the one hand, resurgence in global trade, through electronics manufacturing for example, has worked in favor of Asia, since processes are shifting to regional manufacturing hubs outside the People's Republic of China as the country moves up the value chain. On the other hand, there remains the problem of a wide infrastructure development gap in Asia, considering that infrastructure is a backbone of economic development. In order to address financing needs for infrastructure, the implementation of PPPs is crucial. Hence, ADB's theme this year has been the contribution and potential of PPPs in sustaining Asian development, highlighting the increased role of the private sector as an effective partner in financing infrastructure development.

A chart covering progress from 2014-2018 revealed that steady growth is expected in Asia. Meanwhile, industrial economies such as the US, the Euro area, and Japan, are also gathering growth momentum, signaling a positive outlook for Developing Asia. More specifically, a speedy recovery in industrial economies means a synchronized rebound in global trade. A graph showing a year-on-year change in growth of nominal exports and imports revealed that rebound in trade was more or less synchronized from October 2016 to July 2017, compared to the previous year.

Another general observation was that out of 45 economies across Asia, the forecast for now 22 economies has been revised upwards. The overall growth rate excluding NIEs was also revised upward just two weeks ago. Remarkable progress can be seen among representative economies in East Asia, Southeast Asia, and Central Asia. In South Asia, India is expected to temporarily slide down —alongside transitory challenges such as demonetization last November and adjustment to new national goods and services tax— but forecasted to bounce back in 2018, while Bangladesh and Pakistan continue gaining growth momentum. In the Pacific, the output increase in mining and agriculture in Papua New Guinea and Fiji will continue to drive the sub-region's rebound.

The situation in the PRC —the world's second largest economy by nominal GDP— remains positive as its growth has exceeded expectations: strong consumption is visible while export growth is strengthening alongside an increase in its purchasing manager's index.

[1] NIEs include the Republic of Korea, Hong Kong, Singapore, and Taiwan

Overall, while expansion of global trade and other external factors occur, domestic demand remains to be a main economic driver (as of the first half of 2017).

ASEAN growth has also surpassed expectations: a revival in agriculture, strong FDI inflows, and ambitious infrastructure investments (especially in the Philippines and Indonesia) can be seen. However, two countries (Brunei and Vietnam) have been downgraded for their weakening resource sector, impacting their overall economies negatively.

Also noticeable is the positive movement of commodity prices across the continent. Brent crude and food prices are predicted to be moderately stabilizing this and next year, which should help ease inflationary pressures. Figures generated attest to the downward revision of inflation in Developing Asia: from 3.0 to 2.4 percent this year, and from 3.2 to 2.9 percent next year.

On risk assessment, stabilized oil price movements are a good sign, and US policy change appears to have been gradual so far; as such, overall market reactions are not likely to be created. This is good for Asian economies notwithstanding the uncertainty in US fiscal policy. Also, another possible (short-term) risk is economic disruption caused by geopolitical and weather shocks, which could affect the recent global trade rebound. However, Developing Asia should be well-equipped to handle this risk but at the same time, continue to work more on overcoming barriers to higher productivity.

The current thematic focus on PPPs resulted from short- and medium-term analyses of Developing Asia. While a short-term perspective highlights the strength of Asian economies, a medium-term vision foregrounds the question of maintaining Asia's growth momentum in the face of persistent challenges. According to a special ADB report on infrastructure needs assessment in February this year, Developing Asia currently needs USD 1.7 trillion through 2030. The fund allocation consists of 56 percent for the energy sector, 32 percent for transportation, 9 percent for ICT, and 3 percent for water. This financial goal must be reached for Asia to maintain its growth momentum and poverty reduction trends while achieving Climate Change objectives as agreed in Paris. Keeping in mind the high potential of the private sector in addressing the main challenge of infrastructure development in Asia, the current state of affairs in public investments and private ventures has been probed.

The ADO update found that private sector investment has been highest on the area of ICT, followed by energy, while the transportation sector was the least prioritized. The public sector, on the other hand, has given top priority to infrastructure, mainly due to China's proactive presence in developing economies. Investment is also high on transportation but lower on energy and the least on ICT. However, while the public sector currently bears the brunt of infrastructure development, its budget falls too short of achieving the goal. Hence, there is a need, an urgent one at that, to expand government fiscal space in order to increase infrastructure investment. This is exactly where the private sector can help. A magnified view of the situation reveals that Asia has an infrastructure gap amounting to roughly 500 billion USD per year. ADB identified 60 percent of infrastructure needs which the private sector can fulfill. While several helpful measures can be taken such as tax reforms and expenditure reorganization, tapping PPPs is still very much needed.

Professor Sawada presented the definition of PPP as "a long-term contract between a private party and a government entity for providing public assets, subsidies, and infrastructure subsidies, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance." While data shows that PPPs in Asia have increased four-fold over the last 25 years, this increase is also characterized by unequal distribution across sectors and economies. In particular, PPP transactions are concentrated in East and South Asia. However, Central Asia has started to gain ground recently. PPP investments are concentrated primarily on the energy sector, and secondarily on transportation — a reflection of the region's current development needs.

There are two major advantages in advancing PPPs across Asia: improvement of delivery and improvement of access and growth. PPPs have a general reputation for innovation, operational efficiency, while the motivation of incentivized finance naturally improves their performance. Ultimately, the private sector's strengths can be effectively marshalled towards meeting public objectives. Moreover, if PPPs can double their overall investment from 0.5 percent of GDP to 1.0 percent, ADB predicts this will provide safe drinking water to 12 million more people as well as electricity to an additional 14 million people. Furthermore, it will also increase GDP growth by 0.1 extra percentage points.

While PPPs have numerous benefits in augmenting the current, limited fiscal space failing to meet infrastructure needs in Asia, Mr Sawada also pointed out that the mechanism has also had its share of shortcomings. Cross-country data show that 6.3 percent of all committed PPP investment, or a total of 41.6 billion USD in Developing Asia, has been cancelled over the last 25 years. Three factors to PPP survival were identified: the nature of the project (including solicited/unsolicited proposal through competitive bidding, the type of PPP, and risk allocation), the macroeconomic factor (pertaining to macroeconomic performance and fiscal balance), and socioeconomic stability (the law-and-order situation and the degree of corruption). There is also a need to look into new sources for funding such as institutional investors, which are plenteous in developed economies, and which are also eager to find bankable projects. Institutional investors come in the form of pension funds, mutual funds, insurance funds, and Sovereign Wealth funds, among others. A potential solution is to match these prospective resources to Asia's desperate infrastructure financing needs.

Bank financing has been the largest mode of financing for infrastructure projects not only in Asia but globally. Equity and bank loans have been the main, conventional sources. However, these are not exactly suitable for Asia because of its fiscal limits and changes in capital requirements (the economics term for this is "maturity mismatch"). What is now emerging is bond financing, a more desirable mechanism, since maturity is much shorter and therefore, fitter for long-term financing. Yet, bonds have only been used minimally for infrastructure development and PPPs in Asia, due to the high risks involved as well as the lack of bond markets in Asia. This risk gap, however, can be bridged by employing credit enhancements that can provide partial credit or revenue guarantees, bond guarantees, project completion risk guarantees, and mezzanine and subordinated debt. These will improve the bankability of the project and lower the risk on the investor's part. Local governments can provide guarantees while Multilateral Development Banks (MDBs) can facilitate credit enhancement by unlocking potential in private capital markets (which the ADB has been doing) and ensuring quality project preparation.

Finally, there are 3Ps behind the success of PPPS: suitable Projects, qualified Partners, and the right Process. Suitable projects must be carefully designed to generate net-positive social benefits. Partners should be highly qualified, meaning they have sufficient technical know-how to manage infrastructure projects and possess an innovative character with good private financial access. The bidding process must also be a transparent one to avoid potential problems from a lack thereof. These are what constitute an ecosystem of PPP—one that is supported by a proper legal and regulatory framework, not to mention conflict resolution mechanisms in place. An additional suggestion is also given to governments installing independent units focused on overseeing PPP projects.

Q & A Session

After Professor Sawada's presentation, several questions were raised by the audience. One participant asked on the extent Asians see water as a public right in comparison to Europe as well as the prospect of including water in PPPs. Professor Sawada clarified that Asian governments continue to play a big role but it is, indeed, a good idea to include it in PPPs. However, investment demand on water is not necessarily large and the main focus is given on addressing the infrastructure gap.

Another question raised the issue of how to effectively draw interest from the private sector to invest in projects when these are seen to be lacking in bankability. Professor Sawada shared that innovation and lots of experimentation is needed, and in fact, now being done to generate positive income for the private sector. For example, ADB offers a type of credit enhancement product called the credit guarantee fund. This is exactly why Multilateral Development Banks (MDBs) play an important role in reducing risk. Other examples include clean energy projects (particularly geothermal power plants) constructed by a private Philippine company. These plants are financed by a local currency-denominated bond equivalent to USD 200 million. ADB strengthened the project by providing a USD 30 million credit enhancement and this appears to be enough to attract investors.

There were also points put forward regarding the misallocation of public funds in many Asian countries and the potential role of ADB in the privatization of inefficiently managed state-owned enterprises (SOEs). Mr Sawada cited the example of the PRC, which has a debt to GDP ratio (166 percent) that is higher compared to other countries. In this case, the ADB is working with the Chinese government in stabilizing its financial sector. The relationship between ADB and the World Bank was also brought up from the audience with regard to the education sector in Asia. Mr Sawada revealed that while infrastructure is admittedly on the spotlight at present, ADB is also targeting the improvement of tertiary education in Asia. Moreover, ADB has been supporting vocational training on the continent as this is also deemed to enhance the productivity of economies and support growth momentum.

Two US-related questions were also posed. The first one was a follow up on Mr Sawada's recent comment on the potential opportunity for Asian countries to work more closely in the face of US' withdrawal from TPP. Mr Sawada explained that since the TPP appears to be on hold, stakeholders in regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP) can be inspired more to enhance its progress. At present, the process is advancing slowly due to an observed heterogeneity in commitments and approaches coming from several countries, more notably from Japan and China. Other arrangements such as ASEAN + China, ASEAN + Korea, and ASEAN + Japan, are nonetheless considered small stepping stones towards achieving a WTO-like objective. On US opinion that big MDBs should already cease to lend to China, the country remains to be a very important partner for ADB as it gains from the institution's insights and technical expertise, most especially in ensuring compliance with global climate goals.

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