Event Report

Notes on the 49th Annual Meeting of the Asian Development Bank, Frankfurt (Germany)

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As the Asian Development Bank (ADB) approaches its 50th anniversary, its relevance is challenged by the enormity and the diversity of the region it serves and, many would add, by the advent of the parallel Asia Infrastructure Investment Bank (AIIB) dominated by China.

At the 49th Annual Meeting held in Frankfurt Chancellor Angela Merkel commended the Asian community for Asia's enormous progress, and reminded that "Germany shows that growth and energy use can be decoupled".

Draghi, Kuroda and Rajan: Central bankers doing things differently. Commercial bankers not doing much at all?

ADB and AIIB focus on infrastructure projects but the limitations of their financing were laid bare. Can the private savings glut be reallocated? Can the private sector be better engaged?

The threat of climate change on Asia will not let up to press a compelling case for a new focus. Technology changes in the world of finance upset the established ways. Time indeed for Europe and Asia to work on "cooperating for sustainability".

CCC+1

China, Central banks and Commodities, these are the three C's on which the fate of the global economy seems to depend. They form an acronym that participants to the 49th annual meeting of the Asian Development Bank loved to discuss about in Frankfurt. But in an inspiring keynote speech[1] former German Bundespresident Horst Koehler impressed on the community that the one C that needs to be focused on is the C for Change. "The world is in a mess and requires new thinking." Pointing to the massive savings in the rich aging societies that are desperately looking for return, he challenged the ADB and the many bankers in the audience to develop better risk hedging mechanisms that make redirecting these savings to the south viable. "The world needs you ADB, think big, challenge the old ways, find new paths...".

Depressing Europe, still a reference...

One Asian speaker at the conference mused that "the mood flying into Europe is less upbeat than when going to Asia". The fact is that in a world economy dragged by anemic growth, Asia is still the leading driver. And yet, there were plenty of reasons for the ADB to come to Frankfurt: 16 European countries are shareholder, all represented on the board, with a combined 17% of voting power. Europe and Asia are each other's biggest trading partner but the growth momentum is stalling. European integration, its achievements and its stumbles, is a reference for budding sub-regional initiatives in Asia. Germany's Energiewende and its financing model present a useful case-study for a region that is severely affected by pollution and unfairly allotted with the effects of climate change. And indeed, there is Koehler's observation about European savings that could be usefully redeployed with a good return in Asia.

... for resilient Asia

That Asia withstands global economic headwinds relatively well is remarkable considering that weak demand in the rest of the world has dimmed exports, a traditional growth pillar. Furthermore, the prospect of higher US interest rates contributed to making 2015 the first time in decades that money flowed out of Asia. Now sentiment is improving said Marios Maratheftis, Standard Chartered's Asian economist: "the Fed may not raise, China will still grow well and we see oil and commodity prices rise". He acknowledges that the mere hint of rising US rates was a shock for Asia but "if you have a shock, something needs to absorb it. In Asia the currencies took it. If Asia had stuck to fixed exchange rates like at the time of the Asian crisis (in 1997), then the real economy would have taken the hit like in Nigeria". If flexible exchange rates make Asia's economies more resilient, so do the current account surpluses. Positive trade balances and growing remittances have made many (but not all) Asian countries less dependent on foreign investment and other capital inflows. Referring to projects that were halted in Indonesia and the Philippines, "the problem today is not the funding, it is the execution".

[1]Webcast on http://www.adb.org/news/videos/mankind-needs-new-development-path-says-former-german-president-horst-kohler

ADB significantly expands its capacity....

The ADB admits that its operational efficiency was weighed down by implementation delays which averaged almost 2 years and affected 90 percent of sovereign projects. That should not take the shine off the excellent performance of the ADB. Last year loan approvals increased 20 percent to USD 16.3 billion. In addition USD 10.7 billion co-financing projects were undertaken. The bank set up a dedicated unit to advise on public-private partnerships and helped countries launch twenty projects in PPP format. Also, ADB became the first multilateral development bank to be accredited by the Green Climate Fund, a UN initiated multi-donor vehicle for climate change. The most eye-catching development is that management under president Takehiko Nakao pulled off a transformational and huge impact bearing measure that creates ample space for the bank to expand operations. Starting 2017, the Asian Development Fund (ADF), the bank's resource base for lending to the poorest countries at below market conditions, will be merged with the mainstream resources. Bringing the ADF on the balance sheet almost triples ADB's equity to more than USD 50 billion, all of it now available to be leveraged up through borrowing, without having to appeal for a capital contribution from its member countries, invariably cash-strapped, be they Asian or European.

.... and cuddles the competition

Coincidentally, most of ADB's member countries are committing capital to the newly established Asian Infrastructure Investment Bank. The capital trick is a win-win for both institutions, and in Frankfurt the ADB again went out of its way to give a huge platform to the AIIB by inviting Jin Liqun, the AIIB's president, to speak at several of the seminars. Jin and Nakao also signed an MOU to support each other through co-financing projects. In a sign of how deep the skepticism towards the new development bank may be, Mr. Li spoke frank words: “the world and the Asian economies have changed dramatically since 50-70 years ago, there is need for new institutions. But as a sibling, the AIIB is not able to push out the (Breton Woods) institutions. I worked in the World Bank as well as in the ADB. If you insult these institutions, you insult me. We learn from them”. Li emphasized that the AIIB does not want to exclude any country from joining and that the European countries were engaged because of their track record in good governance and the rule of law. The AIIB will define infrastructure very broadly and wants to cooperate closely with other multilateral development banks. While its focus will be on Euro-Asia connectivity, all the member countries would be eligible for AIIB financing (“Africa, Brazil, Poland...”) as long as the projects are financially sustainable, environmentally friendly, and socially acceptable. AIIB's procurement and recruitment will also be universal.

No ADB without China?

China is undoubtedly the dominant force at the AIIB with 26 percent of the voting power, compared to only 5.5 percent at the ADB. The creation of the AIIB is linked to China's One Belt One Road (OBOR) initiative that involves huge infrastructure investments particularly in Central Asia. Li said the AIIB is “duty bound to support, but for OBOR to succeed it must be embraced by all countries along the road, who would then propose good projects.” China is still one of the ADB's biggest borrowers with USD 2.8 billion worth of assistance in 2015, slightly more than 10 percent of the total. The financing is mostly targeted at environmental and climate change projects. The ADB foresees continued cooperation with China in every respect. Said president Nakao: "without China as a borrower, the ADB's relevance in Asian development would be much smaller", and "by lending to China at a spread over our funding cost, we can finance our operations and some surplus can be used for supporting poorer countries. Furthermore, by having China as a borrower our asset portfolio becomes more balanced and stronger, so it is easier to get a higher rating"[2].

China's rebalancing, everybody's job

China's economic slowdown was not deemed too much of a concern at the conference. The ADB forecasts growth of 6.5 percent in 2016, 6.3 percent next year. Some words of caution though from Paul Gruenwald, Chief Economist Asia at Standard & Poor's Rating Services: "Rebalancing will happen but, with both external demand and productivity growth remaining weak, China is still growing too fast as it is fueled by credit growth running twice as fast as GDP", and "the most overlooked issue in Asia is that China cannot rebalance unilaterally". The shift to consumption requires adaptation from its trading partners near and far. In Asia the effect is twofold: for commodity exporting countries such as Indonesia and Malaysia, the China slowdown is, as phrased by Nakao, "an opportunity to diversify their economy". Other countries, notably Korea and Taiwan, see their part in the global supply-chain shrink not just cyclically but also structurally as China on-shores and upgrades manufacturing. For foreign investors the effect also varies: retail is not benefiting as the sector is being swept by e-commerce, healthcare and pharma should get opportunities, said Gruenwald, who sees the financial flows in-and-out of China become more important than the trade flows.

Mario Draghi says that the ECB cannot....

Central Bankers are already on alert. Even while many believe that the recent volatility of the Chinese currency and shares are mere "noise" because (the stock market in particular is) not representative of the real economy, China's recent crashes shook confidence in financial markets as far as Europe and the US. Mario Draghi, the president of the European Central Bank, in his eagerly awaited speech[3] at the ADB conference, was careful to confine his hints to the critics in his own jurisdiction (none in the audience, but surely seen on the streets of Frankfurt): "those who want less assertive central banks implicitly want more fiscal activity". There is insufficient demand to absorb the world's savings. To elicit a rebalancing of savings and investment, both the short and the long term drivers of low demand should be tackled. Here is what Draghi said (and implied): "Monetary policy can only influence the short term rates (which the ECB now steers below zero in order to keep them below the extremely low long term rates). The long term answer is structural reform (that is the govenments' job) which is key to raising productivity and therefore investment returns (i.e. long-term rates)."

...do what Haruhiko Kuroda believes the BOJ can

Draghi's sober reflection on the limits of monetary policy, in particular its inability to influence long term rates, contrasts with the bullish stance of Haruhiko Kuroda, governor of the Bank of Japan (BOJ). Earlier this year Kuroda hailed "the wisdom and the practice

[2] IFR Asia, Special Report, April 2016. www.ifrasia.com
[3] For the report in the Financial Times, see: http://www.ft.com/intl/cms/s/0/75b54d4c-107a-11e6-839f-2922947098f0.html#axzz49I7hiS4D

of central banks" that managed to conquer the zero lower bound of nominal interest rates. The BOJ has even taken the infamous Quantitative Easing "QE" policy (whereby for stimulus a central bank not only lowers interest rates but also massively buys financial assets, mostly bonds) a step further by deepening the QE to Quantitative and Qualitative Easing. The BOJ's "QQE" policy specifically aims at lowering long term interest rates by buying long term government bonds in order to drive their (benchmark) yield down[4]. Kuroda, who was president of the ADB until three years ago and never misses an ADB annual meeting, was also in Frankfurt. An open dialogue between Draghi and Kuroda at the ADB meeting in Frankfurt could have eclipsed the Eurovision song contest but was not to be. Instead an exchange of views ensued among Asian policy makers about the role of Asian central banks. They cannot do much say some since the trio of Fed-ECB-BOJ sets a global trend. Others remarked that as interest rates are higher in Asia, the central banks in the region are less limited in action scope.

Asian central banks, followers or showing the way?

Most essential for central banks in the developing countries is their role in channeling financial means to poor people by regulating and licensing. How to make financial services more inclusive is shown in India, where Raghuram Rajan, the governor of the Reserve Bank of India, has licensed a range of newcomer financial institutions. These startup banks (upstarts to the established banks) now pull hundreds of millions into the formal economy using smartphones and the help of little stores that turn into bank branches. Japanese company NEC highlighted the huge opportunities in rolling out ICT infrastructure across the Asian continent, fostering not just financial inclusion, but also education, healthcare, and e-commerce. "Everywhere in India the fintechs are attacking", said Jamuna Rao Verghese of PwC India. They empower an emerging middle class of 400 million people and help lift India's economic growth into the 7 percent range, the highest in Asia.

European banks let it hang out

Beware European bankers because you are lagging behind the curve. That was the implied message from Professor Shenling Ben of Zhejiang University. "In Asia I make payments through a smartphone, here I have to use a wallet." A former banker himself, he lambasted European banks: "their loan to asset ratio is 30-40 percent. European savers do not get a return but their savings are not directed to the real economy. The financial system is supposed to intermediate, it is not doing a good job,...spends time and effort on such things as flash trading instead of on infrastructure." The solution, Prof. Ben says, is "digital finance", connectivity that enables instant money transfers in a transparent and zero-cost way. Fintech is about to revolutionize banking and insurance. It already fosters inclusive finance, it can also bring savings to infrastructure.

The hoped for funds for Asia's infrastructure ambitions may just not come

Infrastructure financing is the focus of the ADB as well as the AIIB. However the ADB and its sister Multilateral Development Banks (MDBs) have the means to fund less than 5 percent of Asia's infrastructure needs which amount to USD 800 billion annually

[4] For a full outline of Japan's "QQE with negative interest rates" policy, read the speech of Governor Kuroda on 2 February 2016. https://www.boj.or.jp/en/announcements/press/koen_2016/data/ko160203a1.pdf

according to ADB estimations, or more: USD 6.5 trillion between 2015 and 2020, estimated by the Mizuho Research Institute[5]. There is a crying necessity to engage the private sector but few projects are commercially viable. A maze of difficulties cannot be solved by feasibility studies but need policy reform, said Peter Wolff of the German Development Institute. "We need a mixture of public and private money, be it PPP or other. It may work in China, but is it really private? It may not work along the OBOR corridor. The political risk is unlikely to be covered well, and we are not facing the challenge of environmental sustainability. In view of all the complexity, the approach is project by project as fostered by China, and country by country, bilateral while it should be multilateral. In sum the huge funds required are just not there."

Private sector participation: A Key Performance Indicator for the Multilateral Development Banks?

The prospects for private European savings to finance Asian infrastructure projects any time soon are dim. "How do we tell our pension funds to invest in a project in Bangladesh? You must give assurances", said Norbert Kloppenburg of Germany's KfW. He sees a role there for the ADB and other development banks including his own. Currently projects are 80 percent financed by the MDBs. He floated the idea to "oblige the MDB's to finance a minority share, so they will help develop local capital markets, discuss guarantees, foreign exchange- and other risk hedging". In all fairness, and as president Nakao illustrated, the ADB is already doing a lot to develop Asian bond markets, including issuing itself in local currencies. Large infrastructure projects tend to be shared across borders, so an Asian capital markets union that would offer the merits of risk sharing and diversification of financing seems a necessary next step. However for a region where the concept of a free flow of people and of goods is a non-starter, a capital markets union, or a currency union for that matter, is still further off. Even in Europe the banking and capital markets union is still a work in progress. Yet that can already be a reference for Asia. The region's banks are typically domestic, funded by short tern deposits in local currency, and therefore ill equipped to commit long term finance or deal with currency mismatches and other complexities of project finance. That is where the ADB comes in but, said Nakao, the local banks in the region have an important function as value finding agents and for monitoring.

Climate change forces new priorities

Infrastructure projects may be the current focus of the ADB, protection of the environment and climate change mitigation are surely the future focus. Professor Hans Schellnhuber of the Potsdam Institute for Climate Impact Research reminded that the physics of climate change is very unfair to Asia. The region is the most vulnerable and must therefore be part of the solution. The Bengal area and the Philippines are most at risk. The Pacific Island Nations have almost no carbon footprint but face an existential risk. Maatia Toafa, Deputy PM of Tuvalu, said his tiny country had to bear an annual expense amounting to 2 percent of GDP, trying to make his country disaster proof. In response to the growing threat, the ADB plans to double its climate finance to USD 6 billion by 2020. Incidentally, Germany announced it would do the same but did not mention the amount.

[5] The $6.5 trillion question. Can Asia scrape up the funding for its massive infrastructure needs? Nikkei Asian Review, April 11-17, 2016. www.asia.nikkei.com

Decouple the growth of Asia's GDP from energy use, Angela Merkel asks

Hosting the annual meeting under the banner "cooperating for sustainability", Germany made clear that the nation is at the forefront of global efforts to combat climate change, whether in the area of policy, finance or technology. In her speech to the plenary gathering, Federal Chancellor Angela Merkel cheered the Asian economic growth "without which progress in achieving the Millennium Development Goals, and halving the world's poverty since 2000, would have been utterly inconceivable". Observing that Asian countries contributed 1/3 to world GDP but an equal part to CO2 emissions, Merkel impressed on the Asian community that "we know from our own experience in Germany that growth and energy can be decoupled". She added "the ADB and the other development banks can set the standards, they have the know-how and expertise, they can drive developments. But the whole thing needs to be combined with efforts by the private sector." [6]

ADB ponders the strategy…

As the ADB approaches its 50th anniversary, its relevance is challenged by the enormity and the diversity of the region it serves. Asia makes up 1/2 of the world's population and its share of GDP is catching up. Many Asian countries have upgraded to middle income status but see inequality rise while more than 400 million Asians are still living in extreme poverty (making less than USD 1.90 a day) and millions other risk being pushed into poverty when climatical calamities strike. The ADB's annual disbursement of USD 20 billion is a drop in the ocean for a USD 20 trillion + Asian economy. Several countries can foresee in their own financing needs and have "graduated" from ADB assistance, China has not. That testifies of the value that the ADB's so-called "finance ++" approach delivers: complementing funding with expertise and know-how. It adds to the questions about future directions nevertheless.

…Europeans should weigh in

Europe has a lot to gain from the continued welfare of the Asian economy, European country delegates on the boards of the two multilateral development banks in Asia have the opportunity and the responsibility to contribute to their governance. In Frankfurt, Germany rolled out its top elite to assure the Asians that Europe is stand-by to cooperate for sustainability. "President Nakao, I think we should regularly talk about how the private sector can be better involved", said Chancellor Merkel. It was heartening to see that also Belgium, having let pass the chance to become a founding member of the AIIB, pro-actively submitted ideas for the board to consider at this annual meeting[7]. That includes the recommendation for the ADB to concentrate on the modernization of Asian public sector management and tax systems. Belgium also suggested to split off the private sector financing arm with specific rules and procedures, a more adequate location and a specific human resources policy, including salaries and benefits. The advantages include dividends to the ADB from a full-fledged subsidiary, and closeness to clients and

[6] For a transcript of Angela Merkel's speech, see: https://www.bundesregierung.de/Content/EN/Reden/2016/2016-05-02-bkin-rede-asian-develpoment-bank_en.html

[7] See statement from Stefany Knoll, Temporary Alternate Governor for Belgium, at: http://www.adb.org/sites/default/files/annual-meeting/2015/statements/BEL_49thAM_GS-01.pdf?1462356102=

business partners. If Mrs. Merkel would be busy, surely there are other committed people to talk to in Brussels.