

Financing Infrastructure Connectivity in East Asia: Challenges and Solutions

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While the financial crisis is fading away, its deep-seated impacts are still growing. The global economy has, thus, entered into an era of restructuring and rebalancing. With no immunity to these major challenges, East Asia is now also undergoing economic restructuring and transition in its growth model. It is in this context that countries in this region are more keenly aware of the dual roles of regional economic cooperation and integration as both a critical contributor to the great achievements in the past and an instrumental impetus for the transformation of its growth model. A top priority on this agenda will be connectivity cooperation, particularly in infrastructure connectivity. At present, huge financing gap is one of the biggest impediments to infrastructure connectivity. Therefore, how to secure adequate financing through effective regional cooperation for a “seamlessly” connected East Asia will be a great task.

The report consists of four sections. Section one and two illustrate the necessity of financing cooperation from the perspectives of the significance of infrastructure connectivity and the severe shortage of infrastructure financing. Section three analyses the possibility of financing cooperation and section four proposes specific roadmaps and approaches for financing cooperation.

I. Infrastructure connectivity: a new engine for growth and cooperation in East Asia

Given the continued turbulence of the global economy, East Asia—an economy heavily reliant on external markets—finds itself encountering with challenges unmet before. Undoubtedly, a deeper and broader cooperation in infrastructure connectivity will provide a tremendous boost to the region’s shift into an inclusive growth model driven by intra-regional activities.

1.1 Infrastructure connectivity as a robust bolster for economic growth

Regional connectivity is the very foundation for furthering trade and economic cooperation, and people-to-people exchanges as well. It also has a strategic role in facilitating regional economic integration and elevating regional competitiveness, and therefore conducive to the region’s sustained and stable economic growth.

Firstly, infrastructure investment can be a new driver for growth. As estimated by the World Bank, a 1% increase in a country’s capital stock will result in a corresponding 1% increase in its GDP. Therefore, establishing large-scale infrastructure connectivity in East Asia will provide a new source of growth by enhancing each country’s fixed investment and consumption as well.

Secondly, infrastructure connectivity can expand intra-regional trade and investment to boost more inclusive economic growth in this region. The recent international financial crisis was a big alarm for East Asia, an economy that heavily relies on the advanced markets. Undoubtedly, robust intra-regional trade and investment can only be achieved through a safe, convenient and high-quality infrastructure network, in which trade barriers existing in transport, information, technic and finance will be removed as they should, and thus cross-border movement of goods, services, information, capital and people will be facilitated.

Thirdly, infrastructure connectivity can enhance the region’s competitiveness through an integrated market. The transformation and readjustment of the global economy has also posed challenges to the competitiveness of the region’s production network. Reliable supply chains based on infrastructure connectivity in transport and telecommunication will, to a large extent, address the problem of “unsmooth accessibility” in the region’s logistic system. This will be of special significance in forging integrated market, reducing transaction cost, minimizing barriers to personnel movement and finally improving regional competitiveness.

Lastly, infrastructure connectivity can help narrow the development gap at both national and sub-regional levels, thus promoting inclusive and sustainable growth in the region.

1.2 Infrastructure connectivity as a strong driver for economic cooperation

Infrastructure connectivity cooperation has proven to be a major highlight in East Asian economic cooperation.

Firstly, infrastructure connectivity within ASEAN is speeding up. With the Master Plan on ASEAN Connectivity in place, ASEAN countries have agreed in 2011 on a joint investment of US\$60 billion to ensure the realization of the goal of AEC by 2015. The investment will be devoted to infrastructure development in transport, information technology and human resources for the ultimate goal of “a connected ASEAN”. Projects on road, railway and maritime transport have kicked off in 2012.

Secondly, China and ASEAN have been working jointly to promote connectivity in road and maritime transport. Apart from the US\$10 billion of “China-ASEAN Investment Cooperation Fund” set up by the Chinese Government, another US\$15 billion loan has also been committed to supporting over 50 projects, mainly involving joint infrastructure projects between China and ASEAN countries in road, railway, waterway, energy pipelines, ICT and power grids. Leaders of both sides have also put much emphasis on building a multi-level and full-dimensional connectivity network on maritime transport and initiated that effective measures be taken to develop refrigerated vessels, roll-on/roll-off ships and container vessels, for the benefit of a more convenient passenger and goods transport network over the sea. Besides, China also invested another three billion RMB in setting up the “China-ASEAN Maritime Cooperation Fund” and put forward the initiative of “China-ASEAN partnership on maritime cooperation”.

Thirdly, sub-regional infrastructure connectivity has borne fruitful results. As of now, more than US\$15 billion has been mobilized for the priority projects in transport, energy and telecommunication in Greater Mekong Sub-region (GMS). A sub-regional infrastructure network has taken its initial shape.

II. Insufficient financing: the biggest challenge for East Asian infrastructure connectivity

A study by the Asian Development Bank (ADB) indicates that there is still much to be done in infrastructure connectivity across ASEAN and ASEAN plus three. Among other things, insufficient funding has become the biggest impediment in this regard.

2.1 Infrastructure investment needs

It is true that in the past few decades, the region's infrastructure has shown tremendous improvements. However, infrastructure investment is still far behind its economic growth. According to the ADB and ADBI's research, Asia will need to invest approximately US\$8.22 trillion in overall national infrastructure for energy, transport, telecommunications, water, and sanitation from 2010 to 2020 and about US\$320 billion on more than 1,200 regional infrastructure projects in transport, energy, and telecommunications. Therefore, the total investment needs amount to US\$ 8.55 trillion, in which East Asia alone will account for at least US\$5.5 trillion. For ASEAN alone, an annual investment of US\$60 billion is required to meet its infrastructure financing needs during 2010-2020. Considering the commodity price inflation caused by the quantitative easing policies of the developed countries, the actual investment need could be even greater.

2.2 Huge financing gap

Though many of great efforts have been made to finance infrastructure projects by all the APT countries and the regional organizations, the funding is still quite slim compared to the region's vast needs. For example, the ASEAN Infrastructure Fund's total lending commitment from 2013 to 2020 is estimated to be approximately \$3.6 billion. With the projected 70 percent co-financing by the ADB and hybrid capital, total commitment is expected to reach about US\$13 billion by 2020. But as above stated, during the same period, the annual investment needs in ASEAN will be US\$60 billion! Funding from the MDBs like ADB and bilateral agencies like Japan International Cooperation Agency (JICA) are also far from enough to fill the massive financing gap.

In addition, countries in the region are highly imbalanced in their financing power, due to different economic development levels as well as political, social, cultural and geographical factors. While Malaysia succeeded in bringing in private investment of US\$49.147 billion, Myanmar secured a mere US\$769 million, 1/64 of the former. This has resulted in a dilemma, i.e., the least-developed countries in the most urgent need of infrastructure are least likely to access adequate funding.

At present, infrastructure connectivity projects in East Asia mainly rely on preferential loans and assistance funds from the ADB, Japan and China. Such a singular source of financing with limited contribution has proven to be unable to meet with the fast-growing dynamics of connectivity requirements in the region.

2.3 Causes of inadequate financing

Firstly, the nature of infrastructure investment matters. The cost associated with infrastructure investments is large and often goes beyond the financial capacities of the less-developed countries in East Asia. Cross-border investment in regional projects is generally perceived to be more risky and complex compared to national projects, with a lot more political and operational uncertainties and even discrimination against foreign investors.

Secondly, financing from both public and private sectors are inadequate. Public financing alone cannot meet the tremendous financing needs as it stands, especially in many developing economies. Private sector, however, tends to be less active in infrastructure projects given the potential operational risks and policy uncertainties. This is particularly the case in East Asia. According to the World Bank statistics, the private sector has invested US\$1.73 trillion on infrastructure projects across the developing countries and regions from 1991 to 2011, only 18.5% of which (i.e. US\$319.4 billion) went to East Asia and the Pacific region. According to the ADB's estimate, only 20% of financing of infrastructure projects in Asia is sourced from private sector. On world's average, the public sector (national and subnational governments, and state-owned enterprises) should meet about 35%–40% of these requirements. Multilateral and bilateral institutions may contribute about 10-12%, and the rest (about 48%-55%) should be mobilized from the private sector, including national and foreign financial institutions. At present in ASEAN, the public sector is unable to exceed about 20% because of fiscal constraints, and the private sector also invests only the same amount or even less in the absence of robust risk-sharing arrangements given the potential operational risks and policy uncertainties. Attracting private participation in regional projects is even more difficult because of the additional risks and uncertainties involved.

Thirdly, underdeveloped national and regional capital market, especially bond market, is a drag. The current infrastructure financing in East Asia is mainly sourced from bank lending whose operation is strictly subject to the requirements and restraints of Basel III and unable to provide enough long-term loan for long-tenor infrastructure projects. The region's capital market, at the same time, due to the lacking of appropriate instruments and effective guarantee, is capable of neither raising sufficient funding nor addressing the severe problems of “double mismatch”, i.e., “currency mismatch” and “maturity mismatch” in East Asia.

Last but not the least, absence of specialized institutions and mechanisms is a shortfall. At the moment, the ADB is the only regional financial institution who is partly engaged in infrastructure connectivity. However, as a financial institution, ADB's core mission is poverty reduction in a

broader meaning rather than just focusing on infrastructure investment. Financing regional infrastructure is only part of its broader operations. For the time being, the APT members now rely more on their own governments respectively to finance infrastructure project. Region-wide cooperation is yet to be scaled out. A master plan for infrastructure connectivity in East Asia, a financing cooperation mechanism at the 10+3 level and a supportive program of action are all but in urgent need.

III. Financing cooperation: a road towards infrastructure connectivity in East Asia

Infrastructure projects by nature are very difficult to be financed due to the characteristics of long-tenor and high risks. The plight is even aggravated by severe imbalance in financing power across countries in the region. This has made all the APT countries more aware of the fact that separate actions by individual countries cannot effectively fill the huge financing gap existing in the region's infrastructure connectivity and the only feasible way out of this plight is through financing cooperation. The reality in East Asia shows that now it's the right time to initiate financing cooperation for infrastructure connectivity.

3.1 Solid basis: adequate financial resources in the region

With a relatively sound fiscal status, high domestic savings and affluent foreign exchange reserves, countries in East Asia possess a high potential in financing the region's infrastructure connectivity. Most developing economies in Asia have maintained their savings rates above 40% since 2007, far exceeding world's average level of 24% (WEO 2013). With the world's largest foreign reserves holders——China, Japan and South Korea, clustering in the region, the total amount of foreign reserves in East Asia had hit US\$5.6 trillion. Channeling an appropriate sum of foreign reserves into the connectivity projects can, to some extent, address the problem of low efficiency in utilizing the region's huge foreign reserves.

3.2 Objective conditions: an all-round progress in East Asian cooperation

In recent years, East Asia has gradually explored a cooperation pattern that fits its own realities. A regional cooperation framework has now been in place, with ASEAN at the center and a variety of mechanisms mutually reinforcing for the purpose of common development. This has, therefore, set very conducive terms for infrastructure connectivity.

Firstly, ASEAN economic integration has been accelerated. At present, the ASEAN

Economic Community is under intensive progress and will be hopefully accomplished in 2015.

Secondly, Multiple FTA negotiations have been launched. Besides the ASEAN-centered “10+1” frameworks, new progress has been made in terms of some other bilateral and multilateral FTA talks. FTA negotiations between China and South Korea, South Korea and Vietnam were launched respectively in 2012 and the China-Japan-ROK FTA negotiation in 2013.

Thirdly, Continued progress has been achieved in “10+3” cooperation framework. At the “10+3” Finance Minister’s meeting in May 2012, it was agreed that the size of East Asia’s foreign exchange reserve pool would be doubled from US\$120 billion to US\$240 billion, and the IMF de-linked portion would be increased from 20% to 30% of the available country quotas. This has indicated that the “pool” is gaining its independence and the financial cooperation in East Asia is deepening.

Fourthly, the RCEP negotiation aiming at integrating the whole East Asia has been initiated. At the East Asian Summit in November 2012, ASEAN, China, Japan, ROK, Australia, New Zealand and India jointly announced the official launching of the Regional Comprehensive Economic Partnership (RCEP) negotiation. The first round of RCEP talks was started at the beginning of 2013. Negotiations will be completed by the end of 2015, according to the agreed timetable.

3.3 A conducive background: high-level consensus across all parties

Driven by a number of cooperation mechanisms, the APT countries are fully aware of the crucial role of connectivity in the region’s economic cooperation and development. A wider and deeper connectivity is now under way in East Asia.

On one hand, ASEAN connectivity is speeding up. In order to strengthen connectivity within ASEAN and even between ASEAN and its dialogue partners, leaders of ASEAN adopted the Master Plan on ASEAN Connectivity at the 17th ASEAN Summit in 2010, setting up a blueprint for ASEAN connectivity pillared on physical, institutional and people-to-people linkages. In 2012, ASEAN has made great efforts in establishing regional transport network by land, sea and air links. Connectivity has now become a key highlight of ASEAN economic integration and is one of the priorities in ASEAN’s economic development and cooperation for the next three years.

On the other hand, much attention has been given to “10+3” connectivity. As was clearly put by the Chairman’s Statement adopted at the “10+3” Summit in 2010, “commitments will be made to enhance connectivity within ASEAN and ASEAN+3.” During the 2011 Summit meetings, all the leaders involved pledged to provide more input for connectivity development and Thailand’s initiative of building a “10+3 partnership on connectivity” was positively echoed by China. China,

Japan and ROK also expressed their willingness to increase coordination and create synergy to leverage fully on their advantages in capital, technology and human resources in support of the implementation of the Master Plan on ASEAN Connectivity, and lay a solid foundation for East Asian integration by facilitating connectivity. At the 2012 Commemorative Summit of the 15th Anniversary of the APT cooperation, the leaders welcomed the successful activities by the “Workshop on APT Partnership on Connectivity” held in Bangkok, Thailand. At this meeting, the then Chinese Premier Wen Jiabao called for comprehensive connectivity cooperation among APT countries.

IV. Solutions

In the past, infrastructure financing in East Asia was mostly market-driven, taking a bottom-up approach. Such a model, however, does not fit for the needs of its economic development. A top-down cooperation model is more necessary now, which calls upon cooperation among the governments in order to mobilize private investment and turn the region’s savings into infrastructure investment in an efficient manner. To do so, first of all, an inter-state coordination body that can highly reflect the political wills of the member states, namely East Asian Infrastructure Partnership Forum (EAIPF), need to be put in place. Second, to upgrade the existing financing mechanism, it is feasible to expand the ASEAN Infrastructure Fund (AIF) into the East Asian Infrastructure Fund (EAIF). Third, a specialized financial institution, i.e., East Asian Infrastructure Investment Bank (EAIIB), will be needed to run the business of infrastructure investment. Fourth, Asian bond market should be used more effectively for infrastructure financing.

4.1 Establishing the EAIPF

Infrastructure cooperation should be based on shared visions and strong political wills across the countries in the region. The EAIPF would be a major coordinating mechanism among APT countries to carry out exchange and cooperation on infrastructure planning, align national infrastructure development plans with the region’s connectivity targets, lay down a strategic master plan on East Asian infrastructure development and investment, and coordinate and oversee the implementation of the Plan. The Forum can be established on the basis of the “10+3 partnership on connectivity” initiated by Thailand, by expanding the existing mechanism of “ASEAN+3 Finance Ministers and Central Bank Governors' Meeting” to include infrastructure

specialists and other stakeholders (such as representatives from sub-regional infrastructure programs and the international development agencies like ADB, UNESCAP and WB, heads of major private corporations, etc). The EAIPF Summit would be held annually and the major task would be to develop region-wide and sector-wide infrastructure strategies and policies. A standing body or secretariat would be established under the EAIPF to prepare strategies and policies for regional infrastructure projects. As the very first step, Study Groups under the EAIPF can be established to consolidate the concept and make feasible recommendations to push forward APT Partnership on Connectivity

4.2 Upgrading the existing financing cooperation mechanism: from the AIF to the EAIF

At present, the AIF is a most innovative model for sub-regional financing cooperation. Founded in April 2012, the AIF aims to remove poverty, enhance trade, facilitate investment and promote employment within ASEAN. The AIF has shown at least two key innovations. One is that it offers an avenue for mobilizing the region's resources into infrastructure investment by leveraging future potential equity contributions and co-financing, and subsequently demonstrating a means of unlocking a portion of the region's own resources (such as domestic savings and foreign reserves) for its needs through future debt issuance. The other is its decision making mechanism. Each of the shareholders will be represented on the AIF board. All decisions taken at a duly constituted board meeting, except with respect to the fundamental issues, shall be decided by the shareholders who hold more than 50% of the voting power in the AIF and at least 50% of the number of shareholders. This mechanism is a good balance among different contributors. Each shareholder's voting power will be linked to its financial contribution, giving Malaysia and Indonesia the best chance of getting their projects through. Approvals, however, will also require the support of 50% of shareholders – regardless of their capital commitments, which helps to guarantee the interest of the least contributors.

However, the AIF-based financing is far from addressing the real needs of ASEAN infrastructure investment. Due to the very limited initial capital equity of 4,852 million US\$, the AIF, even with 70% co-financing by ADB, can only lead to a total commitment of more than \$13 billion by 2020. This still marks a big gap against ASEAN's total infrastructure investment need of US\$661.6 billion during 2010-2020. The gap will remain if there is no additional capital injection. At the 17th ASEAN Finance Minister's Meeting in 2013, ASEAN members including Indonesia disagreed on the proposal of increasing the equity capital of AIF.

At the same time, the Plus 3 countries have expressed interest in joining the mechanism. Considering the continued assistance from the Plus 3 countries in improving ASEAN's

infrastructure, the ASEAN nations have also showed their willingness to invite the Plus 3 countries to join the AIF, potentially hinting at a similar pan-regional initiative or an expanded second fund further down the line. Therefore, it is highly feasible to expand the current connectivity cooperation framework of 10 (AIF) to 10+3 (EAIF) with additional capital injection from the Plus 3 countries.

We hereby develop a preliminary conception of the EAIF.

(1) Equity contribution: no more contribution obligation will be put on ASEAN countries. The additional equity contribution from China, Japan and ROK will be decided upon mutual consultation based on country-specific circumstances;

(2) Board of Directors: offer China, Japan and ROK the membership of the EAIF's Board of Directors. As the ultimate decision-making body, the Board's main functions include the consideration and approval of the selection criteria for projects to be financed by the EAIF, and the deliberation on the EAIF annual report. Decision-making mechanism follows the suit of AIF, i.e., the double 50% (or 67%) requirements.

(3) Project selection criteria: projects will be selected on the base of economic and financial rates of return, as well as their potential impact on poverty reduction. In addition, three main criteria will be followed to guide the selection of projects: regional cooperation, private sector development, and project diversification at the country, sector, and project levels.

(4) Project operation and administration: a professional team or institution like EAIIB is required to administer the EAIF, whose funding scale and operations will be far exceeding the AIF due to the capital injection from the Plus 3 countries.

4.3 Setting up a new financing platform: the EAIIB

The financing requirement for infrastructure connectivity has far exceeded the capacity of the existing regional financial institutions. For instance, the total scale of operations for the ADB in 2012 was US\$21.57 billion, far from meeting the huge investment need in infrastructure connectivity in East Asia. Therefore, it is most imperative for East Asia to establish a new financing platform, namely the EAIIB, in support of its infrastructure connectivity. The initial conception will be as follows:

(1) Sources of funding: it will involve a two-tier equity structure allowing the separation of the decision-making right from the return right. The right of decision-making is in the hands of the East Asian countries and the right of return is used to absorb funding from outside the region and those commercial financial institutions. Therefore, the EAIIB will include transferrable and non-transferrable equities. Non-transferrable equities are based on the economic weight of each

country and subject to standard proportion of equity contribution. These equities are entitled to decision-making, but not to share project dividends. Transferrable equities are open to voluntary contribution by countries inside and outside the region and commercial financial institutions, whose shares will be decided by the EAIIB Board of Directors. These equities are allowed to access dividend sharing, but are excluded from decision-making.

(2) Modes of investment: loans and guarantee will be the two major businesses. Two principles are to be observed.

Firstly, investment projects should tilt towards economic benefits and basic livelihood of local people. This will actually mean that the investment has quasi-public nature. First, in order to avoid duplication with the operation of ADB and other assistance-based financial institutions, the main business of the EAIIB should be infrastructure-centered. Second, as a trustworthy commitment for long-term project, the proportion of supportive capital from the local institutions should be increased. Third, the focus of financing support should be shifted from sovereignty projects to public-private-partnership projects.

Secondly, it should bring out the leverage effects of the EAIF. This will include efforts to internalize external benefits, translate future returns into current values and undertake risk redistribution of infrastructure projects. The former two tasks will rely on the local governments and worldwide bond markets to transfer external benefits to the project per se through taxation and licensing, and turn future benefits into current values by proper pricing in the bond market. The last task, i.e., risk diversion and transfer, will be achieved through the already-matured derivative security market.

4.4 Facilitating financing through full use of the Asian bond market

The 16th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting in 2013 has approved the study of China's new initiative to promote the development of infrastructure financing bonds, a latest development of the Asian Bond Market Initiative (ABMI). To enable greater infrastructure connectivity, however, a passive do-nothing-but-wait attitude is not the option. Rather, a partial breakthrough needs to be strived for. Proposed measures include:

(1) To separate the infrastructure connectivity bonds from corporate bonds and relax the issuer restraints on the infrastructure connectivity bonds.

(2) To secure a higher credit rating than an individual sovereignty credit rating. For this, credit guarantees for regional connectivity projects should enlist joint credit ratings by the project-domiciled countries or regional financial institutions.

(3) To improve the clearance system for the infrastructure connectivity bond market and

establish an integrated East Asian clearance institution for the infrastructure connectivity bonds.

(4) To give priority to the private market and asset-backed securities market, and bring in various investors with customized contracts and a more flexible interest repayment structure.

(5) To enhance cross-border supervision of the Asian bond market. This will include the establishment of an information sharing and consultation mechanism, an integrated system of supervisory indicators and a mechanism of risk isolation that separates risks in Asian bond market from that in the national financial markets by better supervising the market players and business operations.

V. Conclusion

The message is clear at the moment: this is the time to build efficient and seamless regional infrastructure in transport, energy, and telecommunications for a more competitive, prosperous, and integrated region. East Asia should not pause or turn back, but rather press ahead with the challenging but immensely rewarding task of integrating this vast and diverse region for the benefit of its people. We are facing “RICH challenges to connectivity”: resource mobilization to finance large infrastructure requirements, inclusive in approaching and implementing connectivity initiatives, coordination mechanism to improve the convergence of purposes and actions of various work plans at different levels, and harmonization of policies and laws to translate regional initiatives into national actions. We do have the resources and wisdom necessary to address the challenges, but it is possible only with political commitment and partnership at the highest level, without which all the cooperation initiatives and ideals will be difficult to be materialized. In order to build seamless East Asian connectivity, we need a bold enough step forward in addressing the huge financing gap in infrastructure connectivity. This step will include an inter-state coordination body—the EAIPF, an expanded financing fund—the EAIF, and a specialized bank—the EAIIB. Of course, the Asian bond market should also be developed more effectively for infrastructure financing. The creation and effective operation of this proposed framework—which would require political leadership, vision, capacity, commitment, and partnership of East Asian countries at the highest level—could help unleash the region’s economic potential.

Besides infrastructure financing issue that deserves our attention, there are also a lot of other issues worthy of highlights when we pursue the goal of a seamless East Asia. First, it is vital to understand that connectivity development must go along with the policies and measures on environmental protection. Secondly, software connectivity in policies, regulations, systems, procedures, knowledge and capacity, etc., is equally important. Thirdly, cooperation in other areas,

especially in terms of regional financial cooperation must catch up to facilitate the region's infrastructure connectivity. For example, in order to thoroughly address the problem of "currency mismatch", a basket of East Asian currencies need to be introduced as the main transaction currency in financing infrastructure connectivity, through either the EAIF or EAIIB. Fourthly, while the governments of the APT countries should continue to play a vital role in endorsing infrastructure financing initiatives and forging cooperation with development banks, commercial banks and corporations in project financing, establishing extensive public-private partnerships (PPPs) may be the best way to overcome the financing huddle faced by large-sized projects. South Korea has been a very successful example in this regard. Lastly, it is important to note that the speed of connectivity infrastructure investments is currently held back not only by insufficient financing resources but also by the low capability of some local partners--that is, government review bodies, development banks, commercial banks and corporations--in certain ASEAN members to ensure project quality-at-entry, design risk management strategies, and appreciate the nuances of infrastructure financing. To the extent that project development facilities (PDFs) are weak or lacking in some ASEAN members, there will be a need to use a regional cooperation approach to strengthening or institutionalizing PDFs to upgrade the capabilities of local partners.