

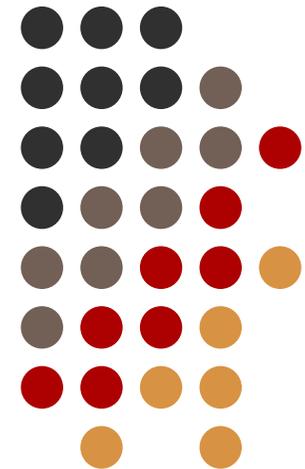


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Changes in Development Finance in Asia: Trends, Challenges, and Policy Implications

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Excerpts from Nishizawa T. (2011), Changes in development finance in Asia: trends, challenges, and policy implications, *Asian Economic Policy Review*.



Abstract

There have been shifts in the composition and nature of development finance in Asia, such as the mainstreaming of private sources of finance and the emergence of domestic resources potentially available for development purposes. In parallel, new trends and challenges are identified in such areas as the transformation of development aid, public-private partnerships, and green finance.

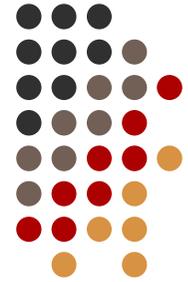
A common challenge is how to strengthen financial intermediaries for longer term sustainable financing from domestic and external sources for investment serving development purposes. To address this, policymakers should bear in mind policy coherence and consistency from macro, sector, and micro perspectives. For various financial resources to bring about tangible benefits, policy makers should take account of complementarities and synergies among the full range of available financial resources.

The effective utilization of private sources of finance depends on commercial viability. The key to success is incentive design and risk mitigation measures.

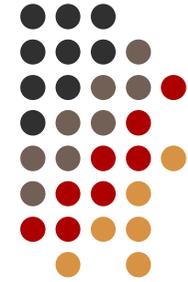


1. Introduction

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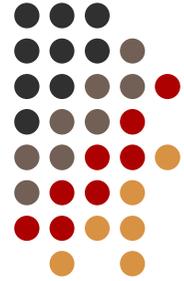
- **In this paper, the scope of “development finance” is defined as financing from domestic and external sources, both public and private, for investment serving development purposes in developing countries.**



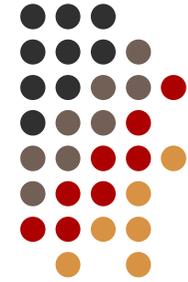
Examples of investment for development purposes are:

- **investment in hard infrastructure with various risks that are difficult for the private sector to bear alone;**
- **investment in soft infrastructure, such as technology transfer and institutional capacity building, which may not be successfully brought about without public sector involvement; and**
- **investment in greening the economy, if not feasible on a purely commercial basis (equipped with a dual nature of hard and soft infrastructure).**

In other words, *investment in developing countries with a public goods nature* is defined as being investment for development purposes.

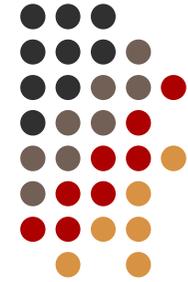


- **Despite this inherently broad scope, however, the focus in this paper is on financing from external sources, while the interconnections between financing from external and domestic sources are also discussed.**
- **I share the mainstream view that the relative importance of domestic and external sources in development finance depends on a country's development stage, the availability of domestic savings, and institutional capacities, among others.**



With this scope in place, the aim of this paper is threefold:

- **to review changes in development finance in Asia during the past decade;**
- **to identify the trends and challenges; and**
- **to draw some policy implications.**



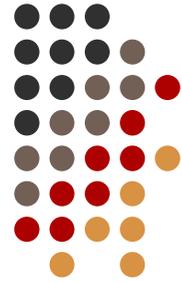
There are three key questions that are addressed here.

- **How have the sources and nature of development finance in Asia changed during the past decade and why have these changes occurred?**
- **What issues are on the common agenda for development finance in Asia to move forward?**
- **What are the respective roles of the public and private sectors for enhancing the effectiveness of development finance in Asia?**



2. Changing Sources and Nature of Development Finance in Asia

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- **From a macroeconomic perspective, we see a change in the savings-investment balance in Asia over the past few decades.**
- **Broadly speaking, the developments since the 1950s until the last decade can be divided into three phases.**

Changing Sources and Nature of Development Finance in Asia



- **In the first phase of almost two and half decades until the mid-1970s, domestic savings, or the domestic sources of development finance, were scarce in Asia.**
- **In the second phase from the 1970s to the pre-Asian crisis of the 1990s, the NIEs (Hong Kong, South Korea, Singapore, and Taiwan) emerged as leading growth centers in Asia, followed by some of the economies in the ASEAN and China.**
- **As a result of their accelerated growth with higher per capita incomes, most of the Asian economies achieved higher savings and investment ratios.**



- **Then, toward the end of this high growth period, private capital flows surged into the region to boost investment and to sustain external current account deficits.**
- **There came a third phase after the crisis in 1997-1998, in which most of the Asian economies have had an excess of savings over investment or, equivalently, external current account surpluses.**
- **Moreover, the savings/GDP and investment/GDP ratios have shown increasing trends throughout the 2000s, even with a widening positive savings-investment balance after the mid-2000s.**

Changing Sources and Nature of Development Finance in Asia

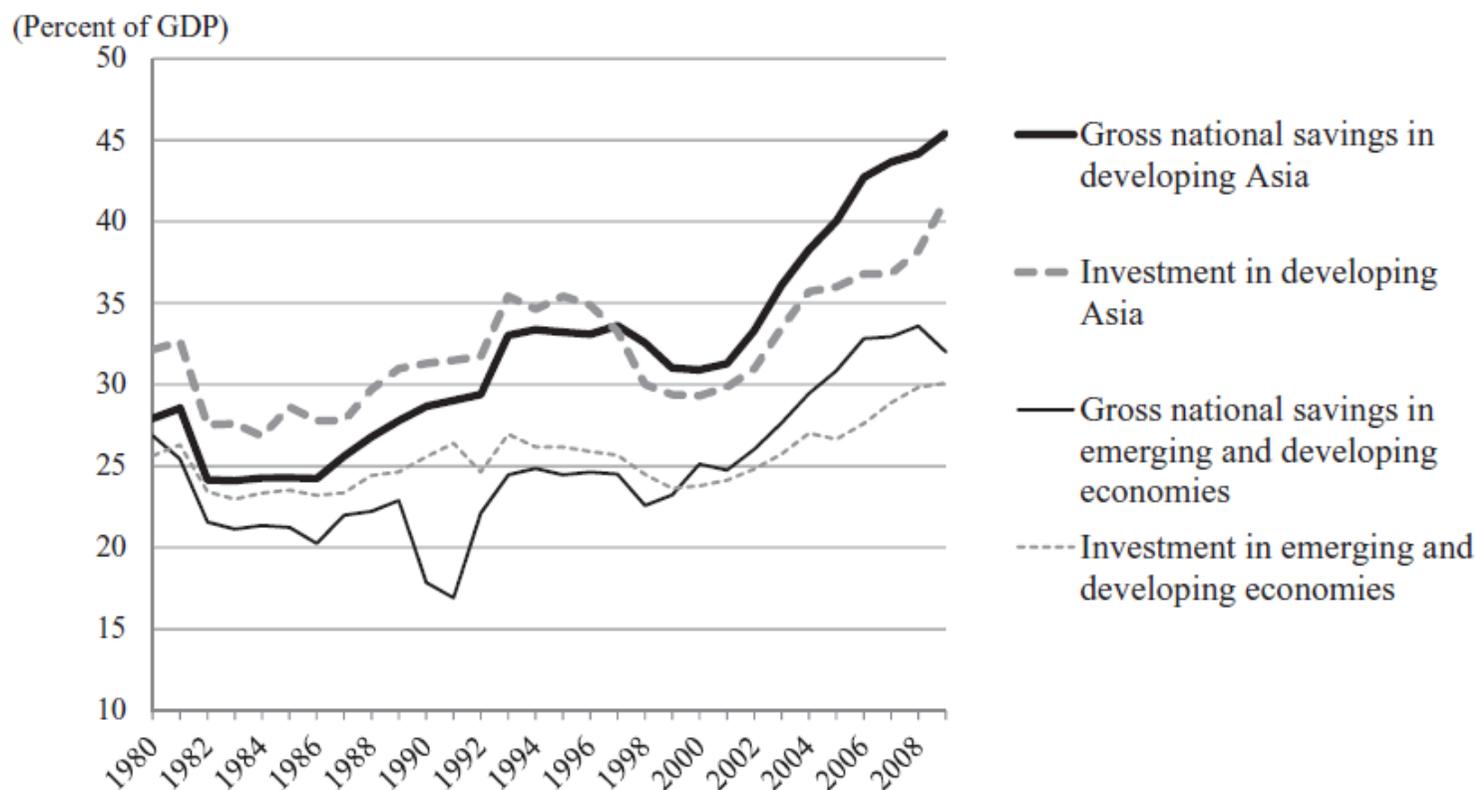


Figure 1 Gross national savings and investment in developing Asia, 1980–2009.

Source: International Monetary Fund (IMF) (April 2011), World Economic Outlook Database.

Note: As defined by IMF, “developing Asia” is composed of 27 countries in Asia and “emerging and developing economies” of 150 countries, both excluding the newly industrialized economies.



- **The excess of savings over investment suggests that domestic savings have not been fully and effectively utilized as sources of development finance in Asia, or more broadly, within the boundaries of the developing world.**
- **In reality, the excess of domestic savings over investment in Asia has been channeled to the developed world by means of relatively low-yield investments (most notably, the accumulation of official foreign reserves) being only partly offset by private capital seeking higher yields, which has continued to flow into Asia (“a leakage of domestic savings toward foreign assets”).**

Changing Sources and Nature of Development Finance in Asia



Source: The Economist, August 9, 2007



- **Is it worthwhile to keep accumulating official foreign reserves either for “self-insurance” purposes against a possible future balance-of-payments crisis or to seek nominal exchange rate stability?**
- **As long as there remains a need for financing investment serving development purposes, policymakers should find ways to mobilize domestic savings for investment within their national boundaries. The current levels of official foreign reserves are too high to justify the cost of the opportunities forgone. Alternatively, as in the case of China, domestic demand needs to be rebalanced in favor of consumption to reduce excess savings.**

Changing Sources and Nature of Development Finance in Asia



- **The trend in external financial flows into Asia in the past decade is characterized by the continued dominance of FDI, the volatile and pro-cyclical nature of portfolio flows and bank lending, and a relatively small share of official flows.**
- **The emergence of nontraditional financing from outside or within the region, including from the recipient countries of ODA, may be another feature below the surface.**

Changing Sources and Nature of Development Finance in Asia

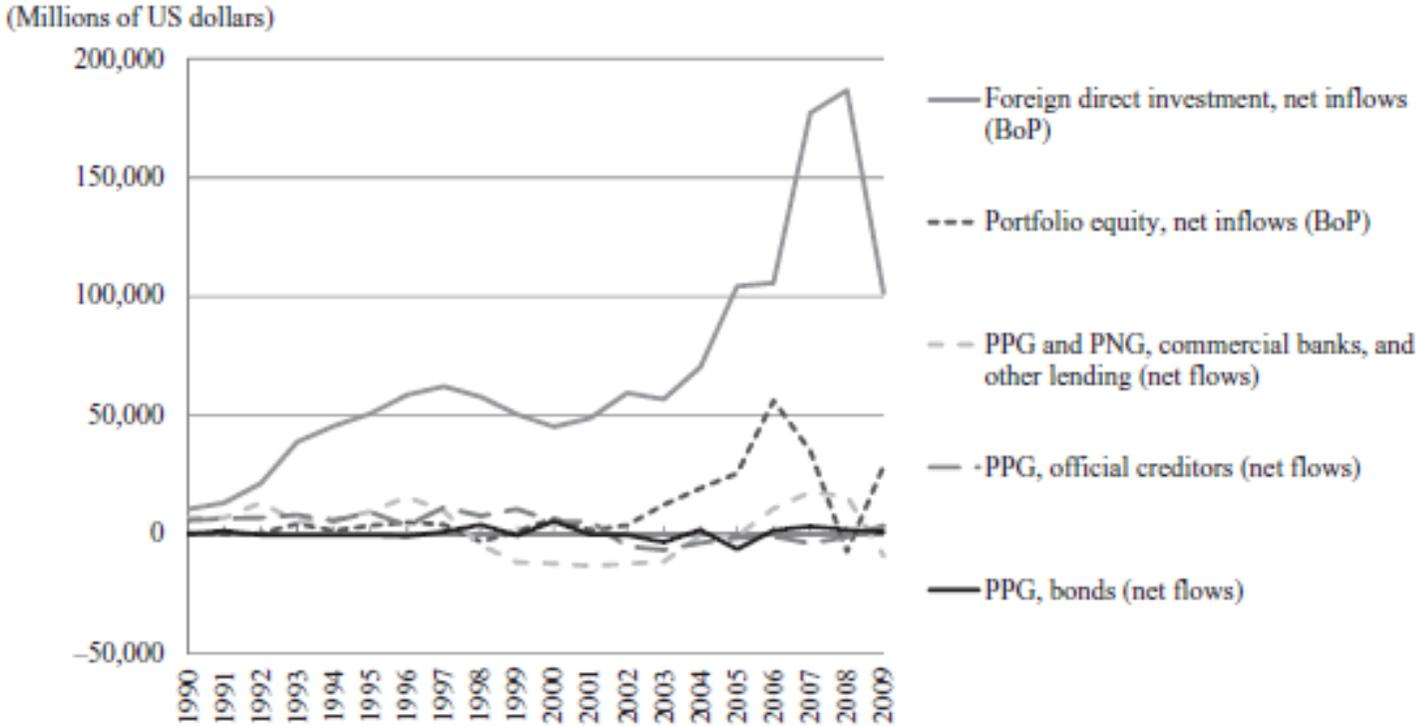
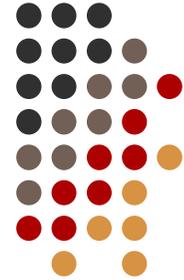


Figure 2 External capital flows to East Asia and the Pacific, 1990–2009.
 Source: World Bank (2011), Global Development Finance (GDF) Database, downloaded in August 2011.
 Note: “PPG” stands for “Public and Publicly Guaranteed” and “PNG” for “Publicly Non-Guaranteed.” BoP stands for balance of payments.

Changing Sources and Nature of Development Finance in Asia

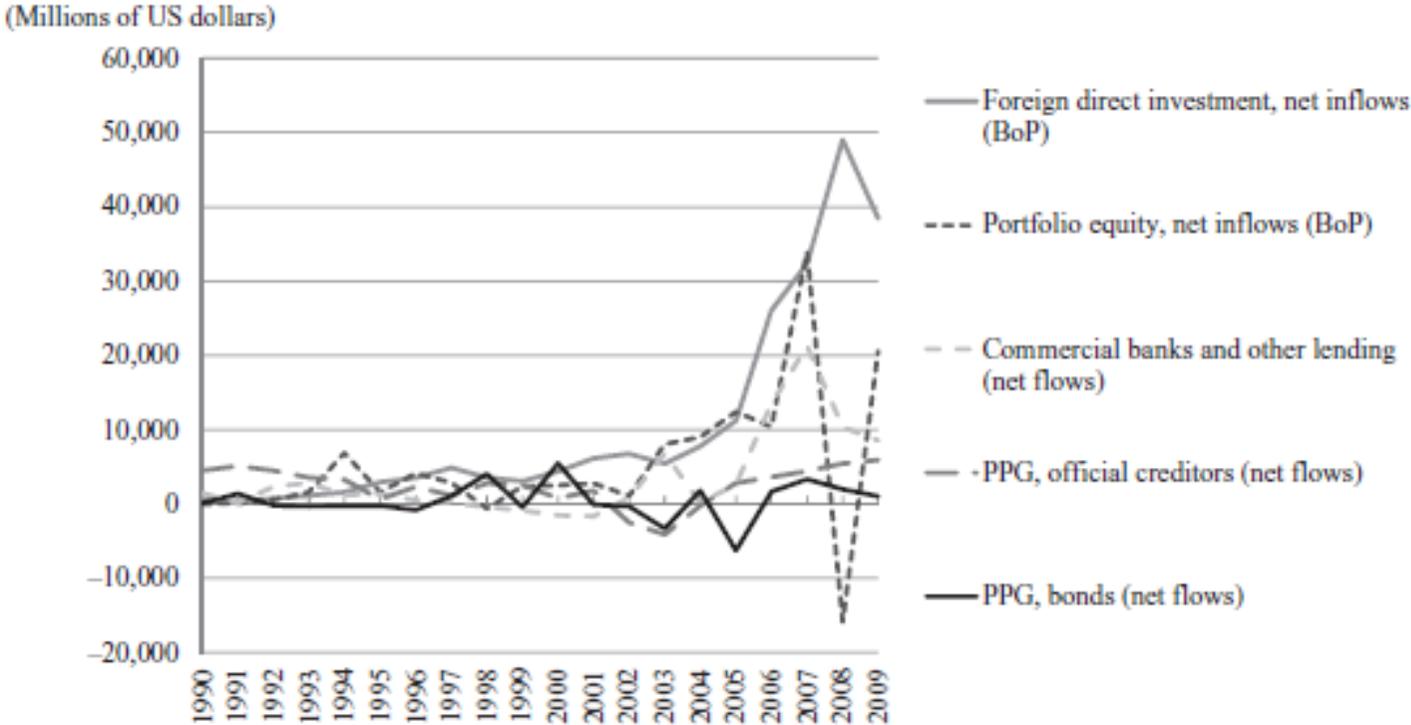
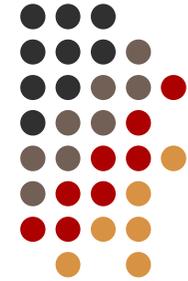


Figure 3 External capital flows to South Asia, 1990–2009.
 Source: World Bank (2011), Global Development Finance (GDF) Database, downloaded in August 2011.
 Note: “PPG” stands for “Public and Publicly Guaranteed” and “PNG” for “Publicly Non-Guaranteed.” BoP stands for balance of payments.



- **The mainstreaming of private sources of finance from abroad, as well as a diminishing share of official financial flows, is most evident in East Asia and the Pacific.**

Changing Sources and Nature of Development Finance in Asia



- **Another notable fact is that net ODA received in terms of the percentage of gross capital formation has been on a declining trend over the past five decades.**

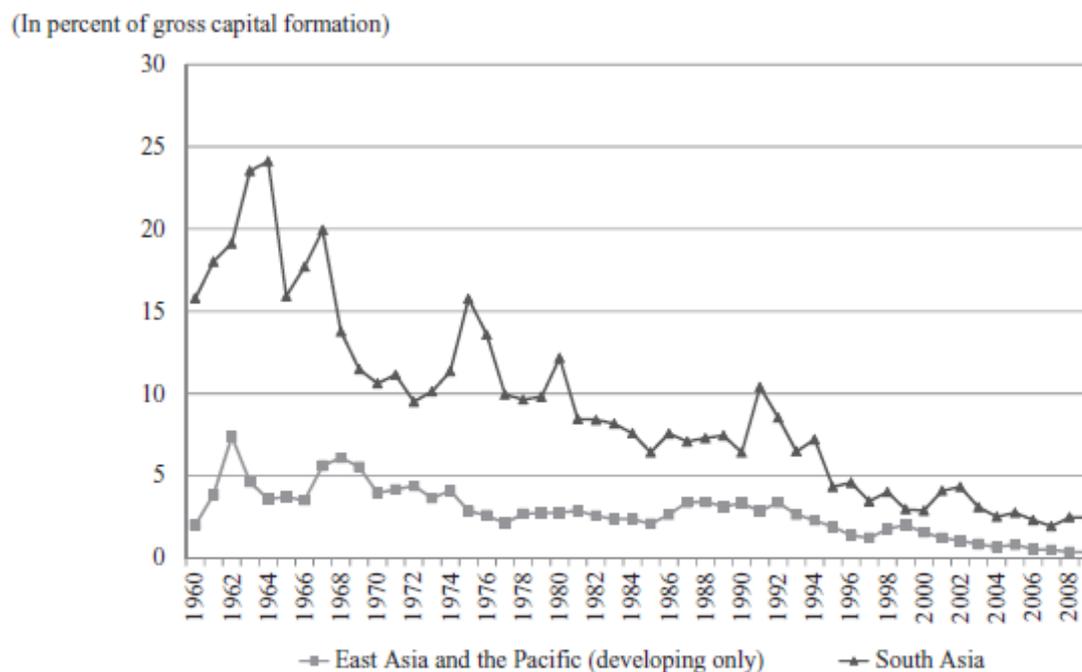


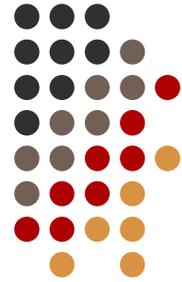
Figure 4 Net ODA received in percent of gross capital formation, 1960–2009.
Source: World Bank (2011), World Development Indicators (WDI) Database, downloaded in August 2011.

Changing Sources and Nature of Development Finance in Asia



- **These changes, coupled with the emergence of domestic resources potentially available for development purposes during the past decade, are new developments.**
- **Reflecting this trend, policymakers in Asia are well aware that a shift in the focus of official development finance is required.**

Changing Sources and Nature of Development Finance in Asia



- **As a consequence, one of the policy challenges in developing Asia now is the effective use of public sources of finance, both domestic and external, as a catalyst for mobilizing private sources of finance into investment for development purposes.**
- **In this context, the key to success for the effective mobilization of private funds is incentive design and risk mitigation measures.**

Changing Sources and Nature of Development Finance in Asia



Table 1 Taxonomy of capital flows and investment in developing countries

Capital flows to a developing country		Domestic investment	
Public		Public	
Bilateral	Official development assistance Other official flows		Government budget State-owned enterprises
Multilateral	Concessional Nonconcessional		Development banks

Public–Private Partnerships			

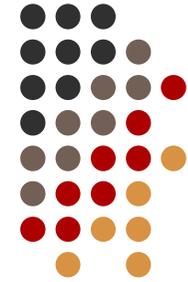
Private		Private	
	Foreign direct investment Portfolio investment		Corporations Nongovernmental organizations Individuals
	Trade credits Bank loans Remittances Grants		Financial intermediaries



3. Trends and Challenges in Development Finance in Asia

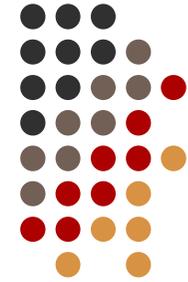
3.1 Transformation of development aid in progress

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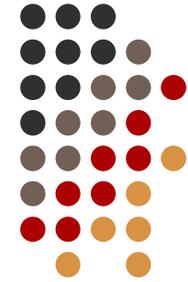
- **ODA flows from DAC countries as a share of their combined GNI turned out to be 0.22% in 2001, a historical low.**
- **Against this backdrop, frustration with an insufficient volume and the ineffectiveness of development aid was shared among policymakers, in both recipient and donor countries, and resulted in a number of international agreements that defined the future course of action.**
e.g., Millennium Declaration and Development Goals (MDGs)
- **One of the fundamental challenges that has been addressed in the past decade is how to improve aid effectiveness.**

3.1 Transformation of development aid in progress



- **Another important milestone toward enhancing development finance beyond aid was the International Conference on Financing for Development in 2002, where the Monterrey Consensus was adopted.**

3.1 Transformation of development aid in progress



Key messages in the Monterrey Consensus are:

- **mobilizing domestic financial resources for development;**
- **mobilizing international resources for development: FDI and other private flows;**
- **promoting international trade as an engine for development;**
- **increasing international financial and technical cooperation for development;**
- **ensuring sustainable external debt financing; and**
- **addressing systemic issues.**

These messages are quite relevant in the context of Asia, where various sources of development finance, including private financial flows, are playing greater roles in meeting development needs.



3. Trends and Challenges in Development Finance in Asia

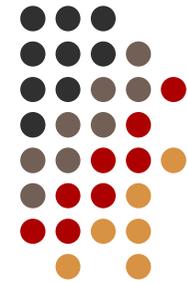
3.2 A renewed wave of infrastructure finance: public-private partnerships

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **We have seen a renewed wave of infrastructure finance called “PPPs” during the past decade.**
- **The key motivation for PPPs is to seek efficiency gains as well as to fill public sector funding gaps through private sector participation.**
- **The fiscal conditions of most of the Asian countries have improved.**
- **However, for longer term public investments, the public sector is faced with institutional constraints, resulting in a limited share of investment spending.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **Notwithstanding the popularity of PPPs in the policy debate, however, the achievements in Asia so far have been mixed.**

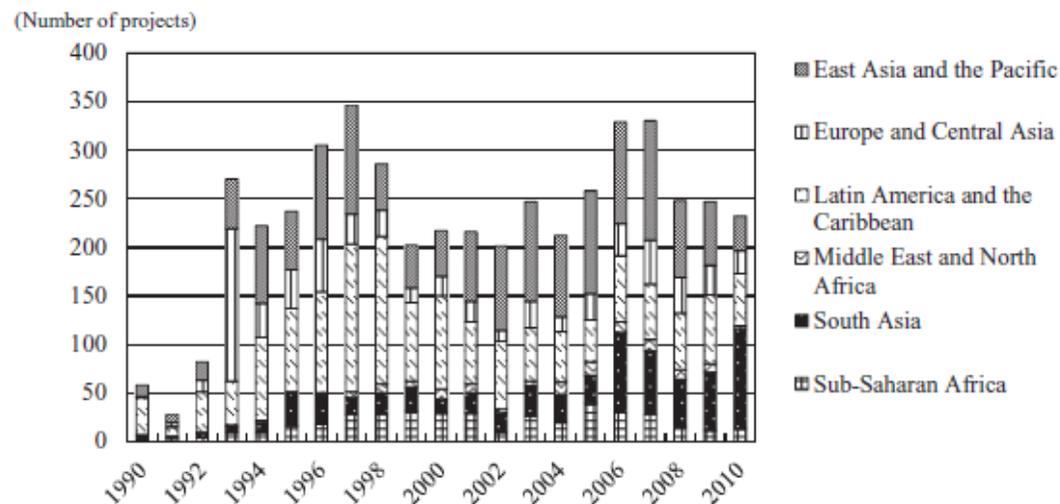


Figure 5 Number of infrastructure projects with private participation (financial closure) by region, 1990–2010.

Source: World Bank and PPIAF (2011), Private Participation in Infrastructure (PPI) Database, downloaded in August 2011.

Note: The database records contractual arrangements with and without investments in which private parties assume operating risks in low- and middle-income countries as classified by the World Bank. For the details of data, please see the database methodology described in the PPI database (http://ppi.worldbank.org/resources/ppi_methodology.aspx).

3.2 A renewed wave of infrastructure finance: public-private partnerships

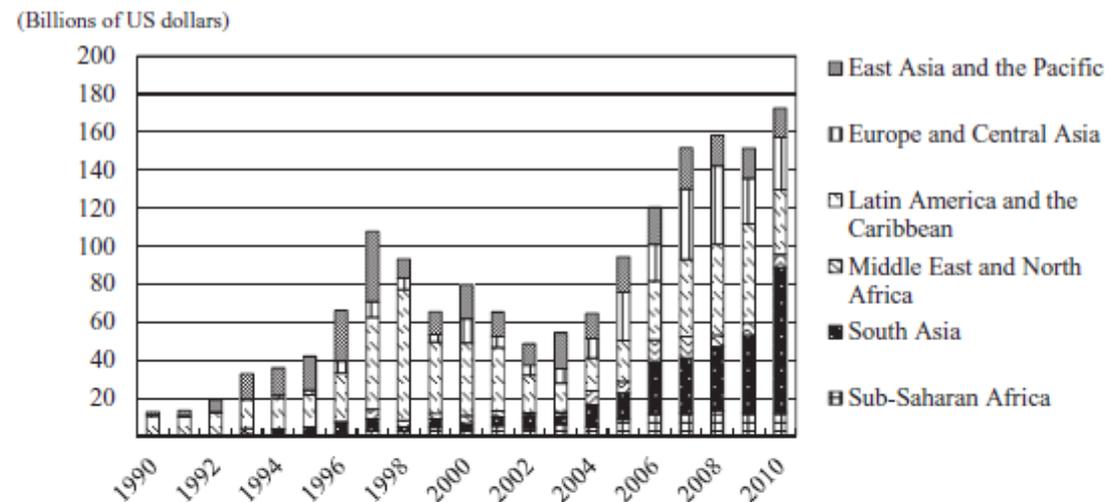
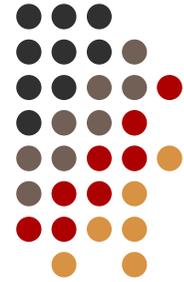


Figure 6 Investment in infrastructure projects with private participation (financial closure) by region, 1990–2010.

Source: World Bank and PPIAF (2011), Private Participation in Infrastructure (PPI) Database, downloaded in August 2011.

Note: The database records contractual arrangements with and without investments in which private parties assume operating risks in low- and middle-income countries as classified by the World Bank. With few exceptions, the investment amounts in the database represent the total investment commitments entered into by the project entity at the beginning of the project, not the planned or executed annual investments. For projects that involve investments, the database figures reflect total project investments encompassing the shares attributable to both the private and the public parties. The database does not provide data on funding flows coming as debt from private sources. For the details of data, please see the database methodology described in the PPI database (http://ppi.worldbank.org/resources/ppi_methodology.aspx).

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **The core task of structuring a PPP project is to reconcile the interests of the various parties from the private and public sectors.**
- **These parties include investors, lenders, and contractors on the private sector side, and the government and other related entities on the public sector side.**

3.2 A renewed wave of infrastructure finance: public-private partnerships

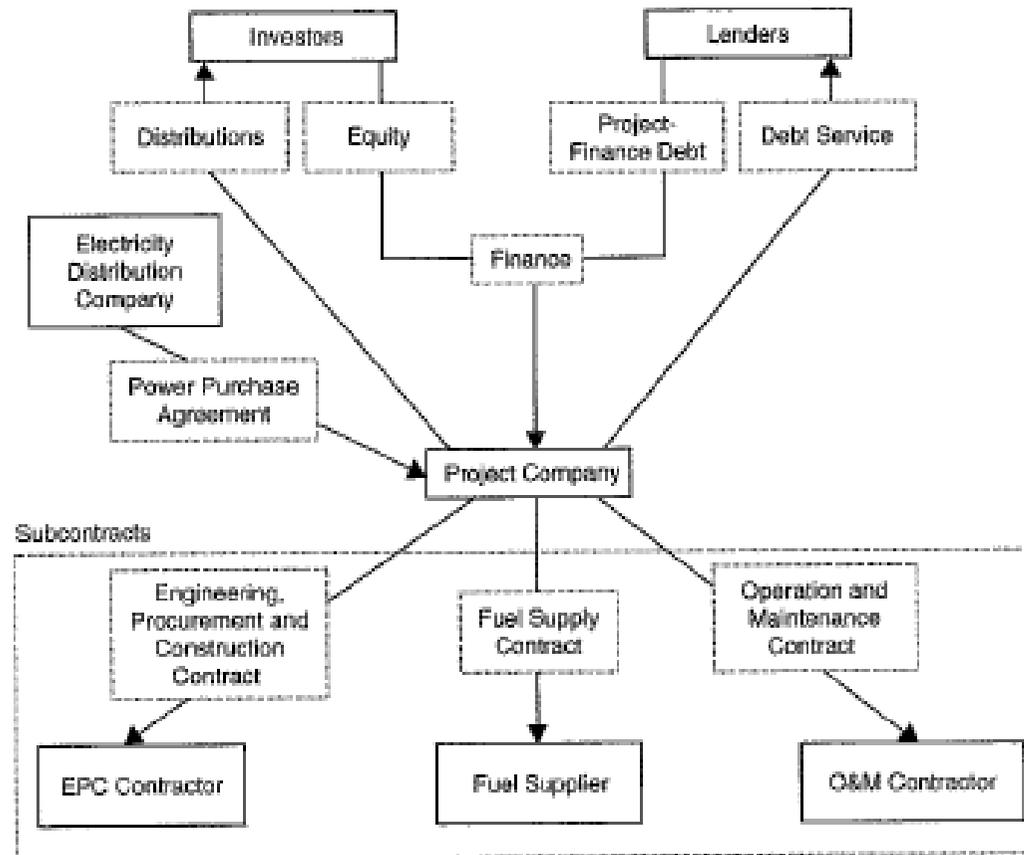
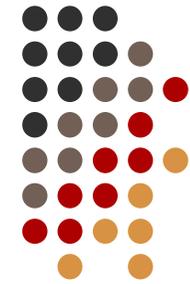


Figure 1.1 Project Finance for a Power Purchase Agreement (PPA)

Source: Yescombe E.R. (2007). **Public-Private Partnerships: Principles of Policy and Finance.** Oxford: Elsevier.

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **In a PPP project, the public authority specifies the requirements of public services to be provided by the facility, but leaves the private sector to decide how to meet these specific requirements.**
- **Private sector investors and lenders involved in a PPP project have capital at risk and, therefore, a greater financial incentive to ensure that the service is provided as required in the contract.**
- **Moreover, lenders may provide benefits through independent due diligence and control of the project, because they want to ensure that the project is viable and that all obligations in a contract can be safely fulfilled.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **With this separation of duties between the public and private sectors, risks entailed in the design, construction, market demand, technology, operation and maintenance are transferred to the private parties.**
- **One of the potential benefits of PPPs is encouraging the public sector to identify project risks and to consider risk transfers in a way that differs from conventional public sector procurements.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **One of the fundamental questions relating to PPPs is whether the inherent conflict between public and private sector interests most notably in price setting could be compromised.**
- **The government tends to prefer lower prices due to political and social pressures.**
- **On the other hand, private sector investors involved in a PPP project pursue sufficient cash flows by setting prices high enough to comfortably ensure that the project is commercially viable and to secure higher equity returns.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **For private sector parties, it may not be clear, for example, whether the government is financially capable of and committed to ensuring the soundness of public utilities or maintaining conducive policy and regulatory environments.**
- **As such, the commercial viability of PPP projects depends, to a large extent, on government capacity, commitment, and policy.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **Those aspects are typical of PPPs and may imply that the dynamic incentive mechanisms embedded in the standard theoretical model are not competent to bring about the intended outcomes of efficient service delivery or are not even able to attract private sector partners without government budgetary support or all contingencies being provided for in the contract.**
- **In theory, a risk should be borne by the party who can manage that particular risk at the minimum cost.**
- **However, some assumptions of the theoretical model are unrealistic, for example, for its negligence of the incompleteness of contracts and inevitable contingencies.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **The reality we have to recognize is that a PPP contract, as a typical “incomplete contract,” cannot provide for all possible future eventualities.**
- **It is even worse because the longer the term of the contract, as is the case with PPPs in infrastructure, the more difficult it is to provide for unforeseeable circumstances.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **Thus, the inherent conflict between the public and private sectors as well as the inevitable contingencies, if not properly managed, could entail risks for the government to assume an excessive fiscal burden through subsidies or in the form of contingent liabilities.**
- **Ironically though, the growing popularity of PPPs globally is due to public sector fiscal constraints. PPPs do not require public sector funding today, meaning that its capital cost is spread out over the infrastructure facility's whole life, rather than charged immediately against the public budget.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **The cost of building, operating, and maintaining infrastructure facilities eventually has to be either paid for by the users or charged to the public sector budget. *No free lunch either for the users or for the government (or the tax payers).***
- **On top of this, for future negative eventualities, the likely scenarios include the assumption of costs incurred by the government.**
- **The government, being responsible and accountable for infrastructure services delivery, is likely to be under pressure to incur further costs to maintain delivery, in the event a PPP project fails.**

3.2 A renewed wave of infrastructure finance: public-private partnerships



- **PPPs, while sounding promising, are in reality very complex and most likely costly.**
- **Risk allocations are challenging because of the public nature of infrastructure services provision and the inherent uncertainties over the long term.**
- **Difficulties also arise from the different attitudes of investors, the government and lenders, as well as the general public.**

3.2 A renewed wave of infrastructure finance: public-private partnerships

- **PPPs are equipped with a very commercial and contractual structure and operational modalities, but at the same time are extremely political, especially in the implementation stage.**
- **PPPs are clearly not a panacea.**





4. Policy Implications



- *Macro, sector, and micro perspectives: policy coherence and consistency*
- *Full spectrum of financing for development: complementarities and synergies*
- *Effective and sustainable use of private sources of development finance: incentive design and risk mitigation*

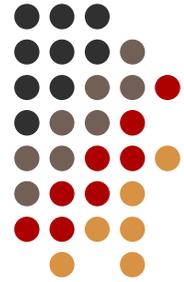
Concluding remarks



We will need to take into account three key notions.

- **First, sustainability matters—how to address global macroeconomic imbalances, global climate change, political and social imperatives, and the leading role of the private sector.**
- **Second, to achieve the goal of development, institutions matter.**
- **Third, sequencing matters.**

Concluding remarks



- **All of these notions should be interpreted by taking into account Asian contexts to come up with workable policy options.**
- **Finally, discussion among practitioners and academia should be further encouraged.**

Thank you for your active participation in discussion!



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