

ADB's New Strategy in Asia Helping Build Quality Infrastructure At Scale

Takehiko Nakao

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Contributor Article

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The Asian Development Bank (ADB) — an institution with 67 member countries and territories, including 22 advanced economies from Asia and beyond — turns 50 this year. What sort of role should ADB play as the international cooperation paradigm undergoes drastic change, with the rise of emerging economies and the establishment of the China-led Asian Infrastructure Investment Bank (AIIB)? In this article, ADB President Takehiko Nakao looks back at ADB’s efforts thus far and outlines its future strategy.

ADB Turns 50

When the Asian Development Bank (ADB) was founded in 1966, Asia was poor. Providing adequate food to people was the most important issue facing the region as populations were growing rapidly. The first area to which the ADB devoted its energy was assistance to the agricultural sector, including irrigation. Thereafter, Asia achieved remarkable development that exceeded the expectations of many people around the world. However, numerous issues still remain.

Now, as ADB marks its 50th year, the bank provides assistance to 40 countries in Asia and the Pacific. Today, our 67 member countries and territories include 40 countries which receive assistance, five that have graduated from ADB assistance (the Republic of Korea, Hong Kong, China, Singapore, Taipei, China, Brunei), three advanced economies in the region (Australia, Japan and New Zealand) and 19 advanced economies from outside the region. Since assuming office 3 and a-half years ago, I have had the opportunity to visit many countries (28 developing member countries as well as 18 advanced economies by August 2016) and engage in candid exchanges with their leaders, ministers and other officials. I have also experienced

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first-hand the new dynamics facing the region, such as the global economic slowdown and the founding of the Asian Infrastructure Investment Bank (AIIB).

In this article I would like to discuss, based on my experience, some of the development challenges faced by Asia, and the role ADB plays — and will play — in solving them.

Long-Term Economic Outlook for Asia Remains Robust

The Asian economy — covering ADB's 45 developing member countries and territories including those that have graduated from ADB assistance — has sustained a high overall annual growth rate of around 6% even after the global financial crisis. But lately, destabilizing elements have attracted more attention, such as the economic slowdown in the People's Republic of China (PRC), the drop in commodity prices, and the weak recovery in advanced economies. However, excessive pessimism is unwarranted in Asia.

Certainly, the PRC economy is losing momentum due to its transition to a new growth model that focuses on consumption and services and is more environmentally friendly. The country is also faced with a shrinking working-age population, rising wages, and the repercussions of massive investments made in the wake of the global financial crisis. Given its size, the PRC's slowdown is having an impact on the global economy through the declining price of resources and contracting trade. The PRC, however, is still a middle-income country with plenty of room to grow.

Countries like India, Bangladesh, Viet Nam, and Myanmar continue to grow their economies by around 7% per year through policies that focus on boosting the private sector and foreign direct investment. Even Indonesia, which has been hit by falling resource prices, is growing at about 5% annually, principally due to domestic demand. The Philippines is posting an annual growth rate of 6%, thanks to growth in consumption and the service sector. Because these countries have a large and young population, they can take advantage of the demographic bonus for a period of time. The growing middle class is also keeping consumption strong.

For Asia to continue growing steadily into the future, however, appropriate policies are essential. Specifically, these include: 1) a steady macroeconomic policy, 2) investments in infrastructure, 3) investments in education and health, 4) open trade and investment regimes, 5) good governance, 6) inclusiveness and sustainability, 7)

vision, and 8) political stability and friendship with neighboring countries.

In addition to loans and grants for projects, ADB directly and indirectly assists on the policy front, such as for public expenditure and tax reforms, the strengthening of financial systems, streamlining of state-owned enterprises, and boosting competitiveness. This is done through policy-based lending, technical assistance, research, as well as through candid policy dialogues.

Utilizing Advanced, Clean Technologies

Having visited various borrowing countries, I have noted that the core tenet of their growth policy is building infrastructure. Eighty percent of ADB assistance in monetary terms is still allocated to building infrastructure. It goes without saying that roads, railways, electricity, seaports and the like are fundamental to economic development. In fact, one of the main reasons why the PRC achieved higher growth than other countries is due to the massive investment in infrastructure led by the government. In contrast, power shortages and logistical issues are seen as impediments to foreign direct investment in India and the Philippines.

While infrastructure reduces poverty indirectly through growth, it is important to note that it also contributes directly to poverty reduction in a broader sense by improving people's lives and empowering people. I visited Myanmar this June and spent nearly an hour with State Counsellor and Minister of Foreign Affairs Aung San Suu Kyi to discuss the country's development strategy and ADB's role. I was impressed by the passion with which the Counsellor spoke about how vital connecting villages with power and roads was to improve lives in lagging areas; how it would promote reconciliation between ethnic minorities; and how it would support education, health, and women's social participation.

Building infrastructure on a large scale is important, but since last year, ADB has also been working on initiatives to introduce advanced technology into its projects. Last year, I had the opportunity to visit our member countries in the Nordic region, Spain and Portugal and to exchange views with top executives of companies that do business in Asia in such sectors such as water supply, bridge-building, and communications. Among these were companies that have been working on infrastructure projects in Asia for over a century. I realized that it is important to continue involving top-notch companies with advanced technology globally in Asia's development.

Procurement in ADB-supported projects is typically conducted through an international competitive bidding where the least expensive of the proposals meeting certain criteria is selected as the winner. But aside from the price, it is increasingly important to incorporate more advanced technology into our projects for the following reasons.

First, addressing the problem of global warming will require an increased use of cleaner and more disaster-resilient technologies. Second, with a growing interest in the durability and maintenance of infrastructure, we must consider the overall life cycle cost of infrastructure assets, along with the cost of initial investment. Third, given that ADB assistance is limited compared to the countries' total infrastructure needs, we can maximize development impact by working on projects with more advanced technologies and thereby establishing a model for implementing similar projects in these countries.

Japan's Meishin (Nagoya-Osaka) Expressway, on which construction started in the late 1950s with assistance from the World Bank, had a great impact not just due to the financial assistance but also from the new ideas and technologies that were provided by the World Bank. It also gave hope to people who were recovering from the devastation of war. Transfers of advanced technologies and knowledge are increasingly important today, as many ADB members have become middle-income countries. Procurement practices that focus solely on cost may result in forcing the borrowing countries that actually conduct the procurement to use the same technologies used in the past. ADB is in the process of introducing more advanced and cleaner technologies by utilizing existing frameworks and revising certain rules related to project design, bidding specifications, and on how we conduct assessments for selecting contract awardees.

To promote this initiative, it is essential that ADB itself raises the bar on knowledge and technology. In January of last year, we established seven Sector Groups on energy, transport, urban, water, education, health, and finance; and eight Thematic Groups on such issues as climate change, gender, rural development, and regional cooperation. By assigning leaders and establishing a secretariat for each group, we are able to gather and share technology and knowledge among our five regional departments and the Private Sector Operations Department, as well as cooperate with external partners including other international organizations, companies, and universities. We will also take greater care in hiring staff with high

levels of competence and expertise.

Another challenge in building infrastructure is to speed up project approvals and implementation. As part of this effort, we are implementing various reforms that will help streamline our overly complex business processes, delegate more authority to our 29 field offices, and adopt, as needed, various country systems for procurement and environmental and social safeguards.

Significant Expansion of Lending Capacity

At recent G7 and G20 summits, leaders have discussed the importance of building infrastructure and mobilizing the necessary resources as part of countries' growth strategies. It was in this context that many countries endorsed the establishment of the AIIB.

For its part, ADB plans to boost infrastructure development and other support to its member countries by increasing its annual approvals (including grants) by 50% to \$20 billion by 2020.

ADB provides loans to middle-income countries through its Ordinary Capital Resources (OCR). It also provides low-interest, long-term concessional loans as well as grants to low-income countries through the Asian Development Fund (ADF). Beginning in January 2017, ADF's concessional loans will be merged with OCR. This will enable us to gradually expand ADB's annual approvals by 50% to \$20 billion from the \$13.5 billion approved in 2014 — including \$400 million in grant assistance — without a general capital increase (i.e. increase of OCR capital). It will allow us to increase both the concessional loans administered under the merged OCR as well as the grant assistance that will continue to be provided through ADF. In fact, we are already off to a good start, as our approvals increased to \$16.3 billion in 2015, in anticipation of the planned merger.

So what made this merger possible? The explanation gets a little technical, but let me discuss it briefly. ADB raises funds for OCR by issuing bonds based on the capital contributed by our members. Using these funds, ADB provides loans after adding a spread to cover administrative costs (and to transfer profits to ADF). Thus, while the balance of OCR's outstanding loans at the end of 2015 was \$62 billion, our capital was only \$17 billion (\$6 billion of which was the paid-in capital from our members, and \$11 billion was accumulated retained earnings). In contrast, we have

never issued bonds for ADF and have instead lent out the contributions, or paid-in capital, from 34 donor countries. Therefore, although the balance of outstanding ADF loans was \$27 billion, the ADF capital amounts to \$31 billion, and we have had to come up with additional donor contributions whenever we increased the outstanding loan balance. The expanded OCR, after the merger of the balance sheets of the existing OCR and the ADF loan operation, will have capital of nearly \$50 billion. Leveraging this large amount of capital by bond issuance will vastly expand the scale of our ordinary and concessionary loans, as well as boost our grant assistance through the expansion of profits transferred from the expanded OCR to the ADF (for grant operation only).

This expansion of our lending capacity is often misconstrued as a response to the establishment of the AIIB. But the fact is that, in August 2013, ADB already started this innovative project of merging OCR and ADF lending operations after intensive internal discussions. At that time, the ADB management and senior officials examined such issues as the interpretation of the ADB charter and how to approach governments about the proposed merger. This preceded the autumn 2013 proposal to establish AIIB. By May 2015, we had won the support of all donors and member countries to the proposal.

The traditional idea that we should not use leverage from bond issuance for concessionary loans to low-income countries had been the established position of international financial institutions since 1960, when the International Development Association (IDA) was established within the World Bank. This idea stems from the perceived lack of creditworthiness of low-income countries and their large economic disparity with donor countries. However, with the exception of Afghanistan, debt relief has never been applied to ADF loans. Moreover, converting donor government funds automatically into concessional loans is not a very efficient approach when donor countries' public finances are under strain. Using existing balance sheets to increase lending capacity, as ADB has done, became a method that was later endorsed by the G20.

At the ADF donors conference in May this year, an agreement was reached to replenish the fund for 4 years from 2017 to 2020 (ADF12). Under the agreement, the scale of our grant assistance will increase by 70% compared to the previous replenishment period, enabling greater support to low-income countries like Afghanistan and the Pacific island nations. Meanwhile, the merger of our balance sheets will reduce the burden of ADF donor countries by about half. While Japan

provides significant assistance under ADF, accounting for 38% of cumulative contributions (Japan accounts for 16% shareholding for OCR, on par with the United States), emerging economies like the PRC and India greatly increased their contributions this time — a major accomplishment in the recent fund replenishment.

Utilizing Private Sector Resource, Public-Private Partnerships and Cofinancing

In many countries, governments take it upon themselves to build infrastructure. But the private sector is also often involved in building infrastructure for power generation, tollways, seaports, airports, and water supply. ADB was founded primarily to provide loans to governments, but loans and equity investment for the private sector, which do not come with government guarantees, are also becoming increasingly important. Approvals by our Private Sector Operations Department reached \$2.6 billion in 2015, up by 37% over the previous year and accounting for 16% of total ADB approvals of \$16.3 billion. While support for private financial institutions is vital for financing trade and small- and medium-sized enterprises, ADB is also expanding operations geared toward private infrastructure such as communications as well as renewable energy projects like solar, geothermal, and wind.

In November of last year, ADB and the Japanese government announced the creation of a trust fund allowing the Japan International Cooperation Agency (JICA) to provide equity to ADB. Over the next 5 years, the \$1.5 billion from JICA will be combined with ADB's capital and that of its commercial cofinancing partners to provide up to \$6 billion of support for private infrastructure.

There is also a growing momentum for the use of public-private partnerships (PPPs). It is said that by matching the long-term funds of advanced economies such as pensions and life insurance with the long-term infrastructure financing needs of developing countries, both sides stand to benefit. However, there are many issues to be addressed. Take, for example, a PPP project for a tollway. When a government enters into a long-term contract with a private entity to give them a license to operate, they must address such questions as who will be responsible for land acquisition; whether or not there could be changes in the future to the regulations on setting tolls; who will take on the risk of a loss in the event that the income does not match projections; how will disputes between the private sector and the government be resolved; and how to address remittance and currency exchange risks when transferring overseas, in foreign currencies, debts or dividends from income earned in the local currency?

If PPPs are used too easily to avoid fiscal strains on the government, there is a risk that the project would be abandoned before completion, or the burden for taxpayers and users would increase later on. In that sense, it is essential to set proper rules for PPPs and take into account the increased efficiency the private sector will bring to the project by offering not just the financing but also the technology and business management capabilities. ADB is assisting countries like India, Indonesia, and Viet Nam in creating PPP laws and establishing dedicated PPP centers within the government. One example is the airport expansion project on the Philippine island of Cebu, where ADB has assisted with the financial structure of PPPs and ADB's Private Sector Operations Department along with commercial banks are providing necessary financing for private corporations.

The key to promoting the use of PPPs is to seek out bankable projects and structure them as PPP projects. With this in mind, ADB in September 2014 created a dedicated Office of Public-Private Partnership (OPPP) and began its transaction advisory services for PPP project preparation. We have already concluded detailed service agreements for building and extending the North-South Railway in the Philippines (695 km from Manila to the south) for \$3.8 billion in total; the upgrading of a seaport in Colombo, Sri Lanka; a road project in Bangladesh; and an energy efficiency project in Malaysia. Other projects are also being negotiated in many countries.

To support the work of OPPP, ADB launched the Asia-Pacific Project Preparation Facility in January this year with the support of Japan, Australia, and Canada.

In order to meet Asia's huge demand for infrastructure financing, we will press ahead with cofinancing with the World Bank and other international financial institutions, bilateral aid agencies like JICA, KfW (Germany), and AFD (France), and with private financial institutions. While the annual approvals financed by ADB's own capital totaled \$16.3 billion last year, approvals of projects financed by cofinancing partners amounted to \$10.7 billion. Among our cofinancing efforts is a water project in Fiji in which an ADB loan was combined with a grant from the Green Climate Fund (GCF) — which last year began its work to combat climate change — to promote climate adaptation in the country.

Furthermore, we signed a memorandum of understanding this past May with

the AIIB on broad-ranging cooperation between the two institutions, and in June approved our first cofinancing with the AIIB for a road project in Pakistan.

It should be noted that for project implementation, ADB places importance on environmental and social safeguards and fair procurement procedures. Complying with these practices is a condition for cofinancing with any other institution.

With the Pakistan road project mentioned earlier, ADB staff is responsible for project preparation and implementation, given the AIIB was only established in January this year and does not have a sufficient system in place to take on these tasks. It was therefore decided that ADB will receive a certain fee from the AIIB to cover the administrative costs associated with the AIIB's portion of the loan, from the viewpoint of proper cost sharing.

Efforts to Reduce Poverty and Address Climate Change

Areas directly related to reducing poverty, along with infrastructure, will continue to be a priority for ADB. In Asia, an estimated 450 million people are still suffering from absolute poverty — those surviving on \$1.90 a day or less as defined under the 2011 standard. ADB will place a greater emphasis on such issues as women's social participation, improvement in secondary education and vocational training, universal health coverage, and conditional cash transfers to poor households. ADB is also playing a key role in Asia and the Pacific's pursuit of the Sustainable Development Goals adopted at a summit last September at U.N. headquarters.

In Pakistan, which I have visited in person, for example, we are implementing a project where women in rural areas are given cash cards to efficiently deliver assistance to the poor. In the Philippines, we are promoting children's enrollment in school and regular checkups for maternal and child health through a conditional cash transfer program. In Lao PDR, I have a powerful memory from my visit to a vocational high school we are supporting, where I saw a female student with the dream of becoming an engineer working earnestly to disassemble a two-wheeled vehicle. ADB's efforts to promote regional cooperation are seen in a cross-border project to combat malaria and AIDS in the Mekong Subregion.

Balancing growth with efforts to address climate change is becoming an increasingly important challenge. When I visited Viet Nam in June and met with Prime Minister Phuc, he cited frequent drought and salt water intrusion associated with

climate change as one of the biggest development challenges for the country. In response to commitments at the COP 21 international conference on climate change held last December, many emerging economies and developing countries in Asia are keen to actively contribute to reducing CO₂ emissions. ADB announced last September that it would double its annual climate financing from the current \$3 billion to \$6 billion by 2020. Of this amount, \$4 billion will go to mitigation efforts including renewable energy, energy efficiency, and public transport, while the remaining \$2 billion will be allocated to adaptation measures such as more resilient infrastructure and climate-smart agriculture.

New Long-Term Strategy and Yokohama Annual Meeting

ADB has recently embarked upon the work of formulating a long-term strategy toward 2030. The core tenets of this strategy will be, among others, increased support for infrastructure using more advanced technologies, continued efforts to reduce poverty, addressing climate change, and providing effective assistance to middle-income countries, which now constitute a majority of ADB member countries.

ADB's annual meeting is scheduled for May 2017 in Yokohama. This will be the fifth time for us to meet in Japan since our inaugural meeting took place in Tokyo in November 1966. It will provide us with a good opportunity to look back at Asia's development experience and ADB's history in the past 50 years and a chance to contemplate our future.