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DEVELOPMENT FINANCE IN ASIA AND PUBLIC-PRIVATE PARTNERSHIPS (PPPs)

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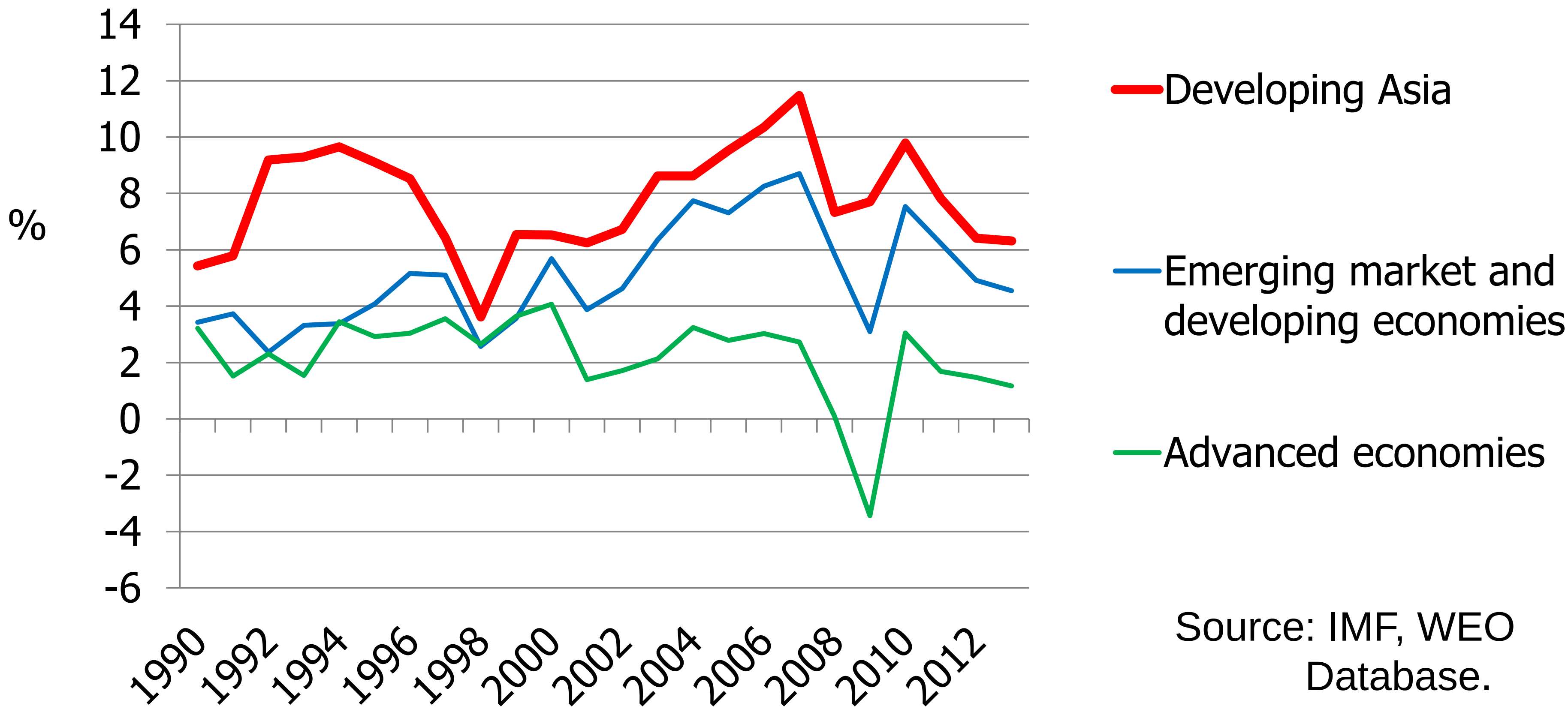
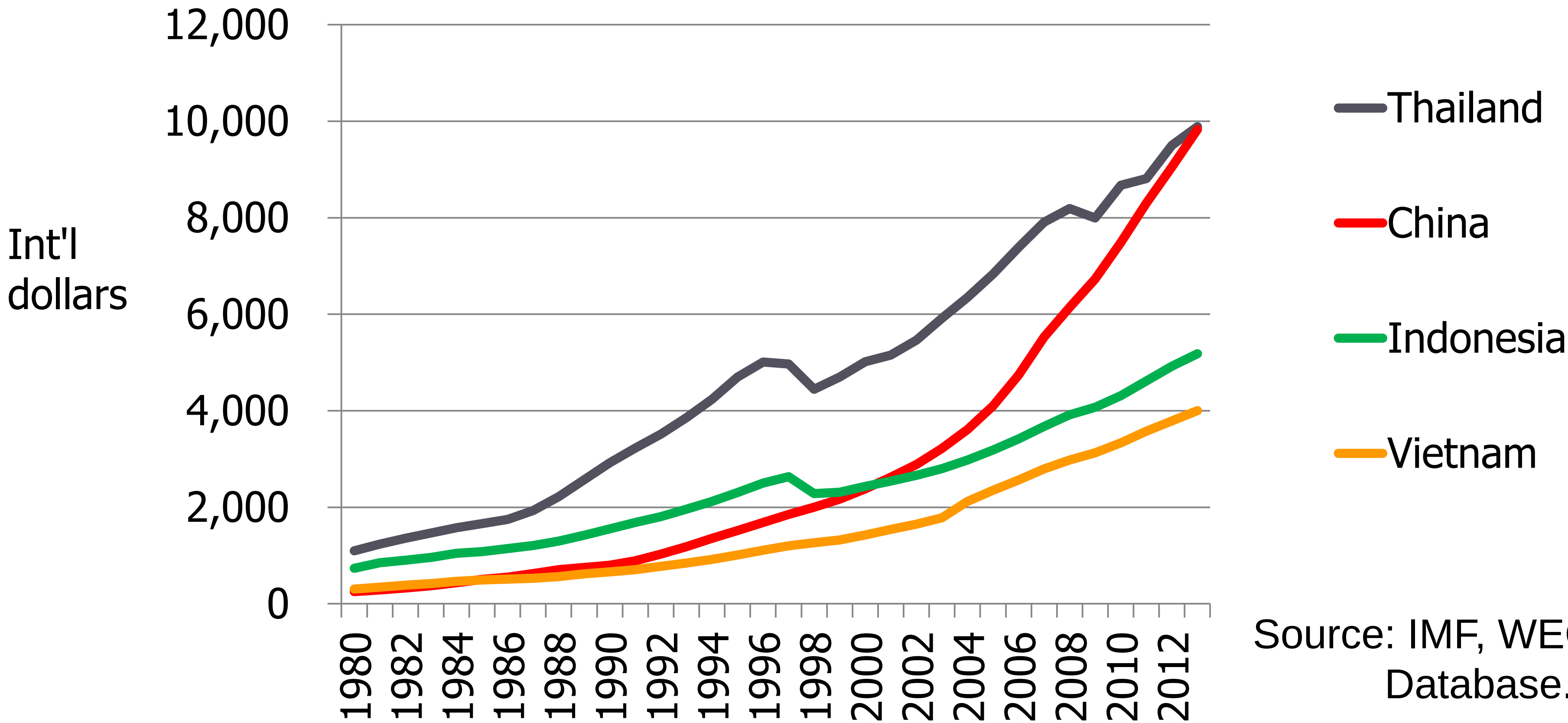
Asian economies have shown a relatively robust growth performance.



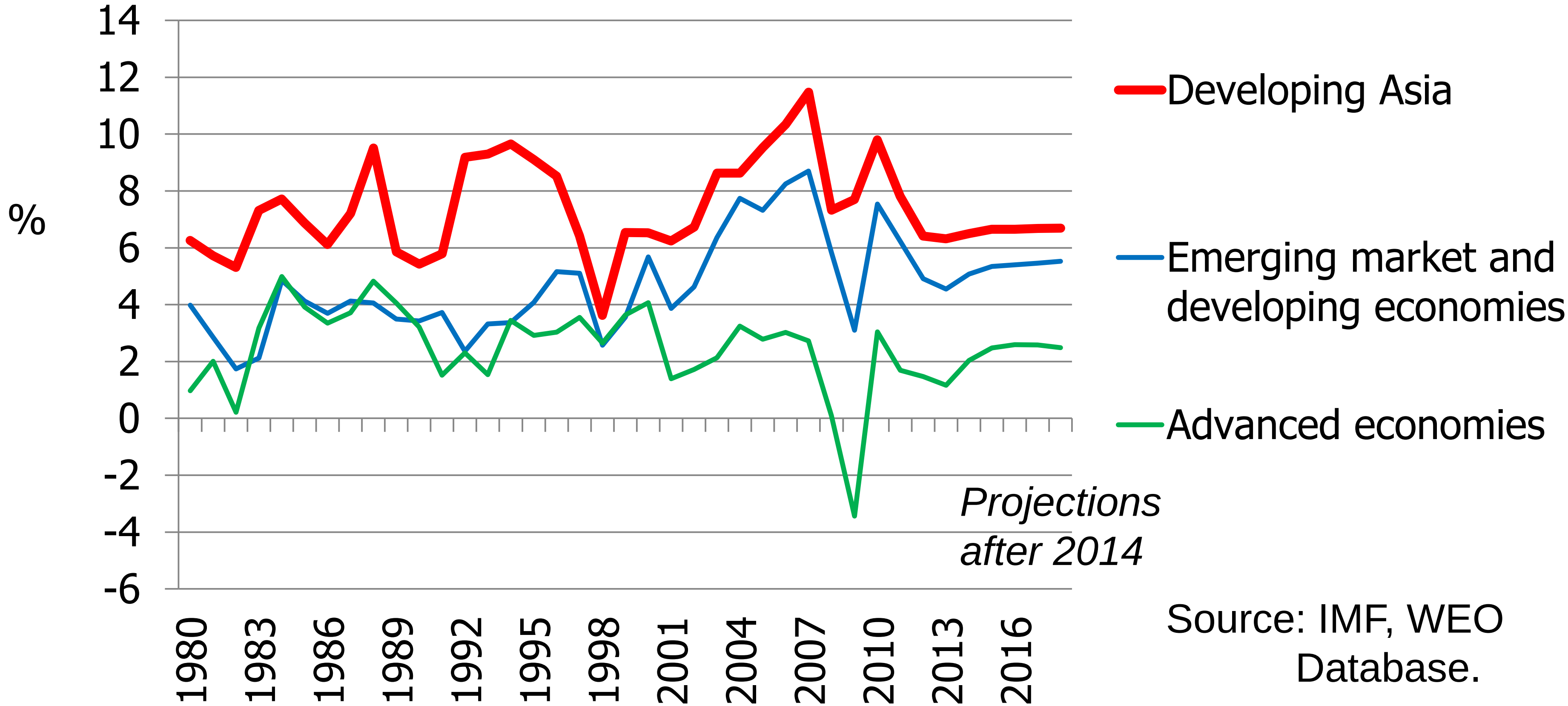
Source: IMF, WEO Database.

Per capita income grew as well.



Source: IMF, WEO Database.

However, there are signs of slowing economic growth in Asia ....



Source: IMF, WEO Database.

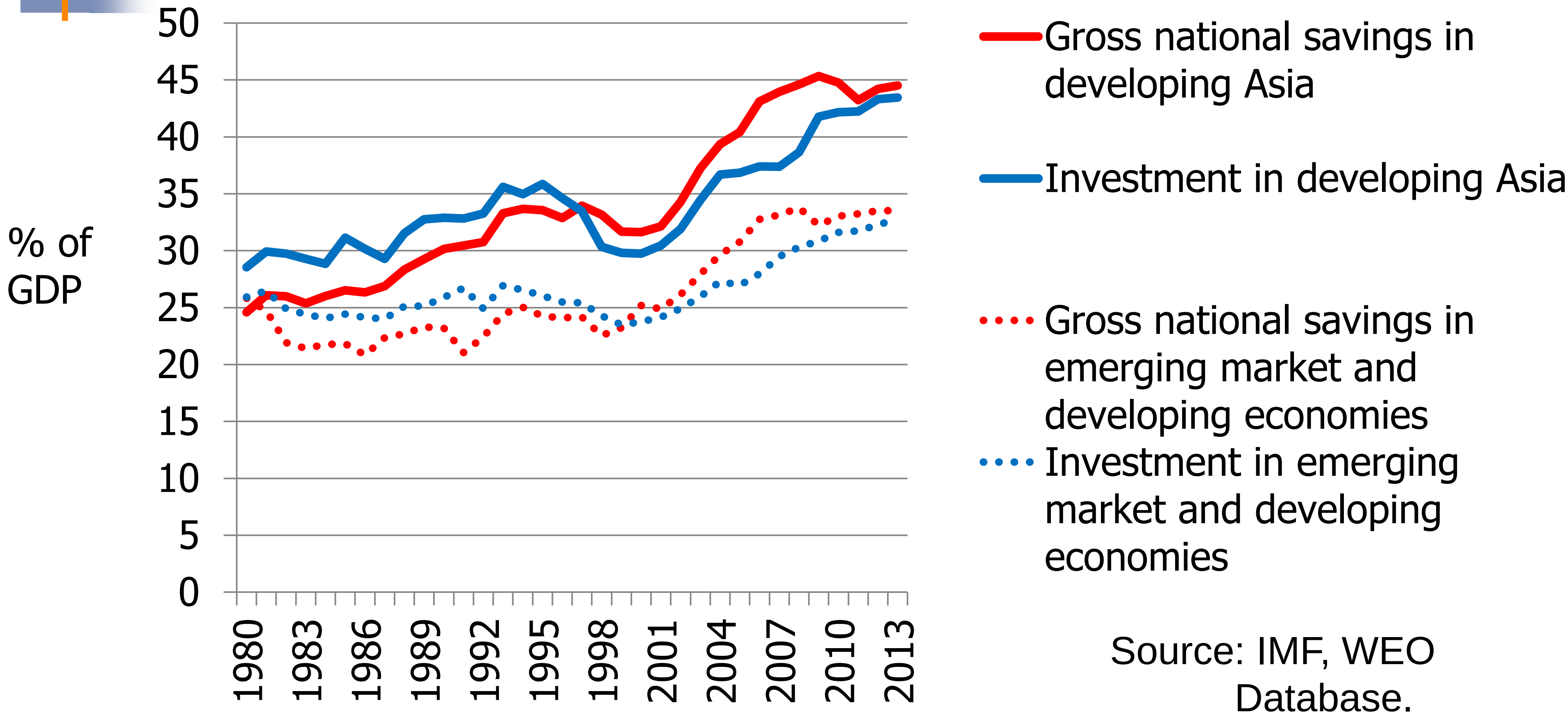
Concerns about the middle-income trap are emerging.

...but there is no certainty that middle-income economies will move through to high-income status...

Many middle-income countries tend to remain in the middle income for a prolonged period of time. For example, of the 113 countries that were classified as middle income in 1960, only 13 have made it through to the high income levels. Empirically, a sizeable number of middle income countries face a growth slowdown, most prominently at income per capita levels of between USD 10,000 to 15,000 in Purchasing Power Parity (PPP) terms. The growth deceleration seen in some countries, impeding the transition from middle-to high-income status, has given rise to the notion of a middle-income trap. For example, Latin American countries such as Brazil, Mexico, Peru, reached middle-income status much earlier than the East Asian countries, back in the 1960s and 1970s, and have remained there ever since. However, other countries, such as Korea and Chile, have sustained their growth trajectories into high income status, suggesting that the so-called middle income trap is neither unique nor inevitable.

(An excerpt from the concept note prepared by the Government of Indonesia for the international seminar "Avoiding the Middle-Income Trap" organized on December 11-13 in Nusa Dua, Bali)

How should we interpret a change in the savings-investment balance after the Asian Financial Crisis?



Source: IMF, WEO Database.

Is investment in "capital" sufficient?

- Probably not, but why?
- Domestic financial intermediaries are still not well developed for longer term investments.
- Perhaps not only in physical capital, but also in human capital to strengthen institutions.

Therefore,

- How to enhance "development finance" remains a challenge.

How could we define "development finance"?

- "financing from domestic and external sources, both public and private, for investment serving development purposes in developing countries"

How could we define "development finance"? (continued)

- investment in hard infrastructure with risks difficult for the private sector to bear alone
- investment in soft infrastructure (e.g., technology transfer, institutional capacity building), not likely feasible without public sector involvement
- investment in hard and soft infrastructure (hybrid type)

"investment in developing countries with a public good nature"

Changing sources and nature of development finance in Asia

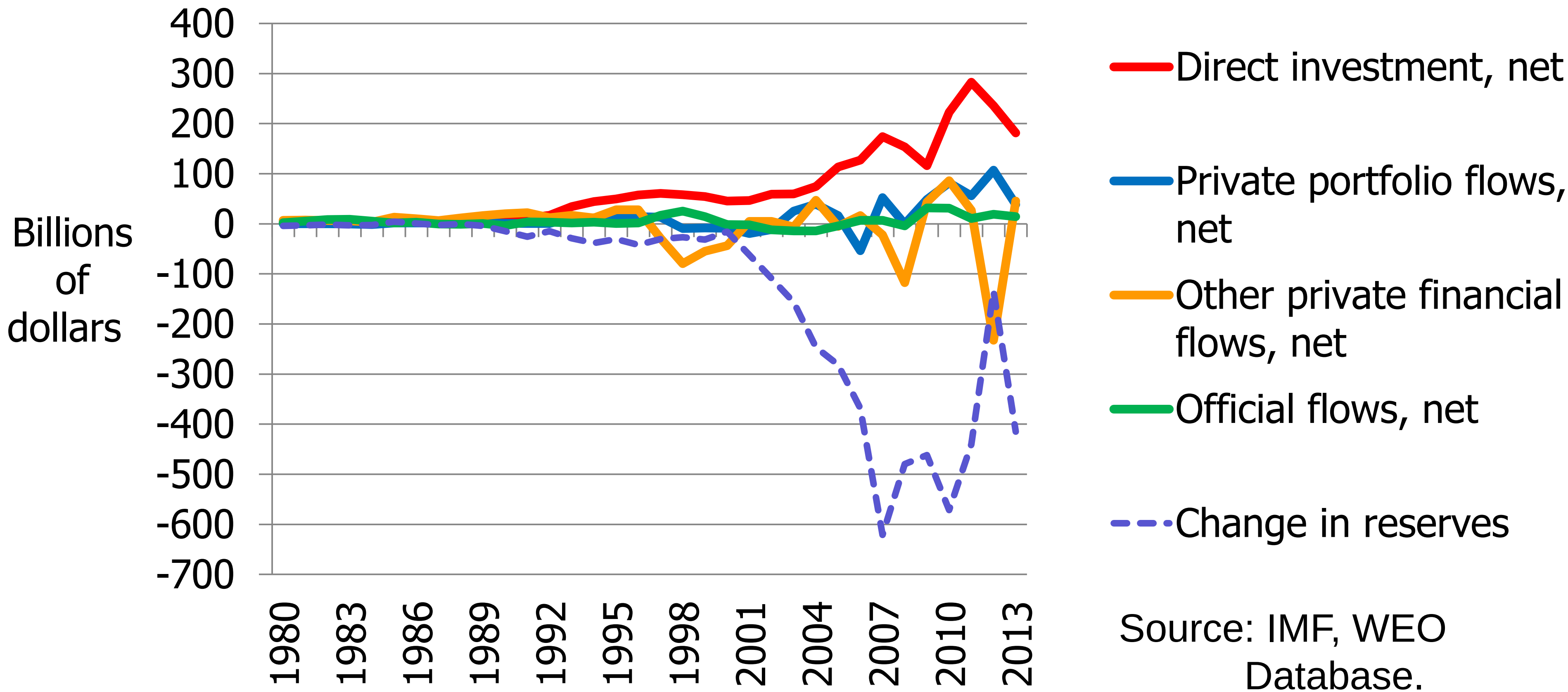
- The excess of savings over investment is a distinctive feature of the Asian economies during the last decade.
- In this setting, policymakers should find ways to mobilize domestic savings for investment within the national boundaries.

Changing sources and nature of development finance in Asia (continued)

What about external sources ...

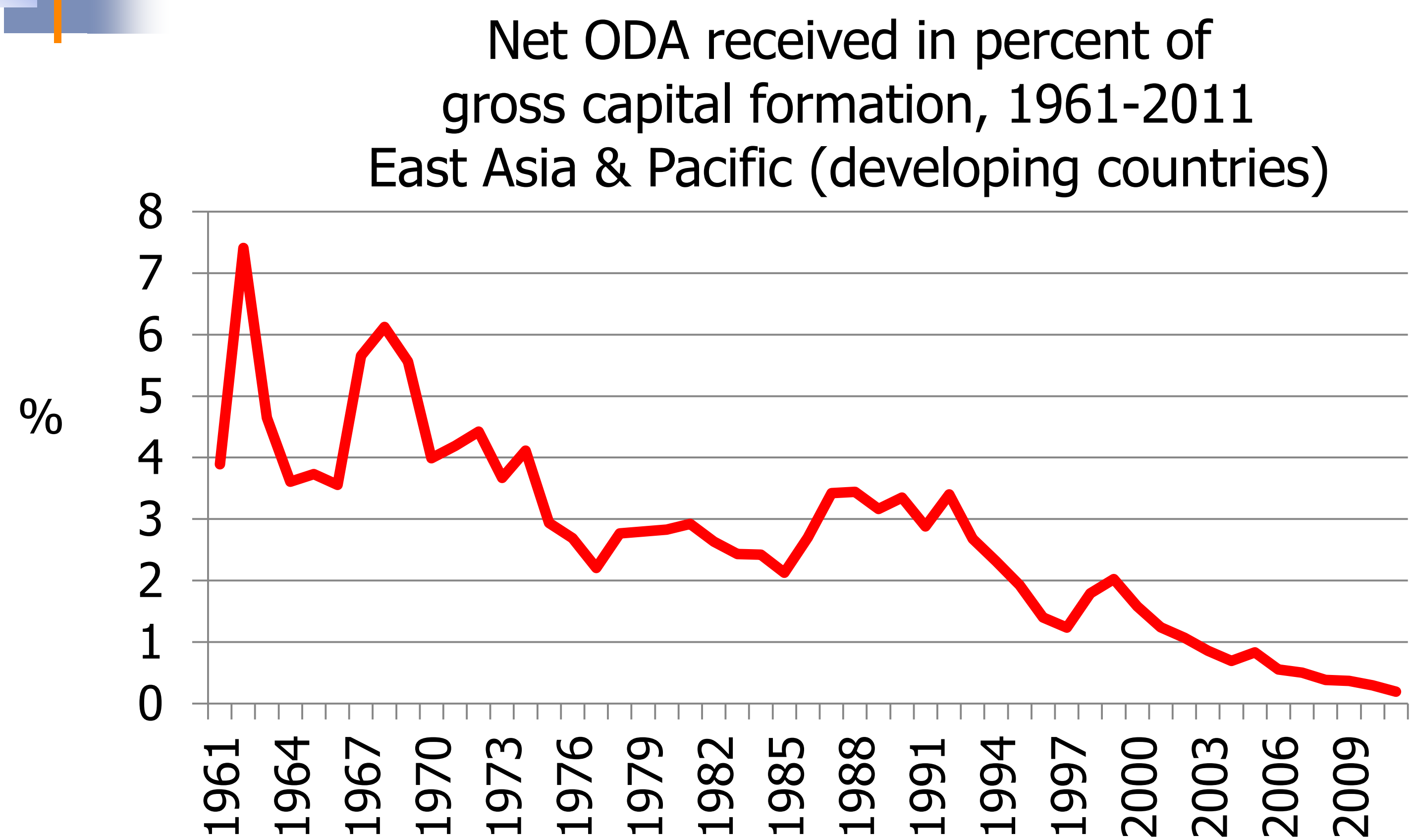
- the continued dominance of foreign direct investment (FDI)
- the volatile and procyclical nature of portfolio flows and bank lending
- a relatively small share of official flows

Changing sources and nature of development finance in Asia (continued)



Source: IMF, WEO Database.

Changing sources and nature of development finance in Asia (continued)



Source: World Bank Open Data.

Changing sources and nature of development finance in Asia (continued)

Most evident in East Asia and the Pacific are:

- the mainstreaming of private sources of finance from abroad
- a diminishing share of official financial flows from abroad

and, AGAIN,

- the emergence of domestic resources potentially available for development purposes

Changing sources and nature of development finance in Asia (continued)

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.

A key question would be ...

- What are the respective roles of the public and private sectors for enhancing the effectiveness of development finance in Asia?

the key to success is ...

"incentive design and risk mitigation"

Public-Private Partnerships (PPPs) as a typical example

Why are governments willing to promote PPPs?

- to seek efficiency gains
- to fill public sector funding gaps

Despite the improved fiscal conditions,
for longer-term public investments,
the public sector is faced with institutional or structural constraints,

resulting in a limited share of investment spending.

Nature and potential benefits of PPPs

What is the basic nature of PPPs?

- PPPs are a long-term contractual arrangement between a public sector procurer and private parties,

  typically by means of the project company created by private sector equity investors to undertake the activity defined in the contract.

What is the basic nature of PPPs? (continued)

- This arrangement also involves:

  contracts with subcontractors to build, operate, and maintain the facility, and

  credit agreements with lenders to finance a PPP project (or project bonds, still to a limited extent).

Why do PPPs need many contracts between various parties?

- The core task of structuring a PPP project is to reconcile the interests of various parties from the private and public sectors *(i.e.*, investors, lenders, contractors, the government and other related entities), or in other words,
- PPPs are a risk sharing arrangement among various parties from the private and public sectors.
- Agreements creating enforceable obligations are needed.

How and why are risks shared among private and public parties?

- 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.
- Therefore, risks are transferred to the private parties.
- One of the potential benefits of PPPs is encouraging the public sector to identify project risks and consider risk transfer.

How and why are risks shared among private and public parties? (continued)

- 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 in order to ensure that the project is viable and that all obligations in a contract can be safely fulfilled.

But, are they always in conformity with each other?

Public interests versus private interests, and inevitable contingencies

Could the inherent conflict between public and private sector interests be compromised, most notably in price setting?

- The government under political and social pressures tends to prefer reduced prices.
- On the other hand, private sector investors pursue sufficient cash flows by setting prices high enough to ensure that the project is commercially viable and to secure higher equity returns.

How could they fill the gap?

- Subsidies, financing, or guarantee provided by the government are likely options.

Are private sector parties always comfortable with government action?

- Private sector parties may not be certain that the government is financially capable of and committed to ensuring the soundness of public utilities or maintaining conducive policy and regulatory environments.

political risk

Are private sector parties always comfortable with government action? (continued)

- If perceived risks are large, private sector parties ask for additional premium for taking such risks.
- Therefore, the commercial viability of PPP projects depends, to a large extent, on government capacity, commitment, and policy.
- But, in reality, "PPPs may be promoted for short-term political advantage" without firmly establishing government capacity, commitment, and policy.

Could a risk be borne by the party who can manage that particular risk with least cost?

- A PPP contract, as a typical “incomplete contract,” cannot provide for all possible future eventualities,

  and even worse with infrastructure investment because the longer the term of the contract, the more difficult to provide for unforeseeable circumstances.

What would be the likely consequences?

- The inherent conflict between the public and private sectors as well as the inevitable contingencies could entail risks for the government to assume excessive fiscal burden through subsidies or in the form of contingent liabilities.
- Ironically though, the growing popularity of PPPs is due to public sector fiscal constraints.

What are the pitfalls?

- For financing PPPs, the bigger the perceived risks for the private sector, the higher the costs incurred on the government or eventually on taxpayers.
- Mitigation measures can help reduce perceived risks. However, without removing the root causes of risks perceived by the private sector, either the government or users will eventually have to bear the cost that private sector parties require for their risk assumption.

What are the pitfalls? (continued)

- Also important is the management of government contingent liabilities. PPPs may entail significant fiscal risks arising from bypassing spending controls and moving public investment off the budget and debt off the government balance sheet.

Are PPPs a panacea?

- PPPs sound promising, but are in reality very complex and most likely costly.
- Risk allocations are challenging because of the public nature of infrastructure services provision and inherent uncertainties over the long term.

PPPs are clearly not a panacea.

Then, how could we make the most of PPPs?

Incentive design and risk mitigation

How could we attract private sources of finance for infrastructure investment?

- In an effort to attract private financing for infrastructure investment, we should avoid what is generally appealing, but not commercially viable.
- The key to success is *interim* risk mitigation measures and incentive design more fundamentally, rather than heralding elusive benefits brought about by private sector participation.

How could we attract private sources of finance for infrastructure investment? (continued)

- Private sector parties need to be convinced that the government is financially capable of and committed to ensuring the soundness of public utilities or maintaining conducive policy and regulatory environments.
- Another caveat is that risk mitigation or any public support to correct market failure should be designed to avoid moral hazard on both the public and private sector sides.

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Thank you.

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