Infrastructure development: the role of East Asian regional institutions in managing capital flows through financial deepening

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Introduction

The massive capital inflows coming into the East Asian emerging countries as a result of the quantitative easing (QE) in the United States, Europe and Japan do not necessarily translate into productive investment, such as foreign direct investment (FDI). For example, Azis shows that, combined, the net capital flows of Indonesia, the Republic of Korea, the Philippines and Thailand that came in the form of FDI in the post-global financial crisis (GFC) period were rather weak compared to those that came in the form of debt. Meanwhile, central banks in these East Asian emerging countries are busy preparing a mixed suite of unconventional policy tools for the purpose of managing capital flows, combined with a focus on promoting financial deepening so as to better channel capital inflows into productive investments.

This paper will review the importance of the role that regional monetary and financial institutions in East Asia could play in deepening the regional financial market so as to better finance infrastructure development.

Financial deepening and infrastructure financing

Many East Asian emerging countries do not have deep financial markets. Massive capital inflows during the recent period of quantitative easing, undertaken by some developed economies, made it necessary for these East Asian emerging countries to deepen their financial markets, so as to better channel capital inflows into productive investments.

Sarwono has written:

Financial market deepening is [part of] the medium-term priority agenda. In this [regard], the measures are designed to create a deep, sound and liquid financial market through creating [a greater] variety of instruments. A variety of financial
instrument[s], such as the promotion of corporate bonds issuance, is ... very crucial to take advantage of the potential capital inflows and channel them to finance [the] productive sector, especially the badly needed infrastructure investment. On the other hand, a deep financial market could also stimulate a more resilient economy against unanticipated shocks in the financial market.³

Within the Association of Southeast Asian Nations (ASEAN), there are a few initiatives to help promote infrastructure development, many of which focus on deepening financial markets in the region. There is a limited capacity of individual governments to finance infrastructure projects through national budgets. Developing financial instruments to recycle East Asian countries’ excess foreign-exchange reserves into more productive investment, and lowering institutional hurdles that stand in the way of attracting private capital to long-term infrastructure investment, are among the goals of these initiatives.

First, there is the Master Plan for ASEAN Connectivity (MPAC), which aims to connect the region internally, as well as with the rest of the world, in terms of physical connectivity, institutional connectivity and people-to-people connectivity. Key strategies to enhance physical connectivity include completing the ASEAN highway network; completing the implementation of the Singapore–Kunming Rail Link project; establishing an efficient and integrated inland waterways network; accomplishing an integrated, efficient and competitive maritime transport system; establishing an integrated and multimodal transport system to make ASEAN the transport hub in the East Asian region; accelerating the development of information and communications technology (ICT) infrastructure and services in each of the ASEAN member states; and prioritising the processes for resolving institutional issues in ASEAN energy infrastructure projects.

Within ASEAN, there is also the ASEAN Infrastructure Fund (AIF), a source of funding for ASEAN infrastructure development. This fund could help East Asian countries to better channel their excess savings into regional development. The G20 also stands to gain from the AIF’s implementation of its infrastructure investment goals. Established in September 2011 to finance the development of road, rail, power, water and other critical infrastructure needs, the AIF aims to finance six projects a year, with a US$75 million lending cap per project. Total lending commitment through 2020 is anticipated to be approximately US$4 billion, and could be leveraged to more than US$13 billion if it is co-financed by the Asian Development Bank (ADB) and other financiers.
A unique feature of the AIF is its plan to issue debt to target the use of the region’s foreign-exchange reserves in the future. With over US$700 billion in ASEAN reserves, the AIF can thus be used to mobilise ASEAN resources for its growing infrastructure requirements. The AIF debt can be purchased by the central banks’ foreign-exchange reserves, and others. Achieving a high investment rating is certainly the main objective of the AIF in utilising the foreign-exchange reserves. The AIF can also complement public sector financing through better catalysing private and capital markets as well as domestic savings, including foreign exchange reserves.

One of the political economic issues that may arise is a power struggle within the AIF, since a more dominant country may be able to have access to more projects in the future. Currently, infrastructure financing in ASEAN seems to be dominated by Malaysia. The ASEAN Infrastructure Fund (AIF) is incorporated as a limited liability company in Malaysia. Therefore, the AIF will be subject to the rules and regulations of that jurisdiction. It is therefore important that the AIF does not become an institution with weak corporate governance and less than rigorous standards for investment; the AIF must maintain good corporate governance and be able to deliver high-quality projects.

Within ASEAN+3, there is the Asian Bond Market Initiatives (ABMI) and the Asian Bond Fund. The ABMI aims to develop and integrate the region’s bond market, where the main objective is to better utilise the region’s excessive savings for productive investment and use in the region. The ABMI’s contribution to the growth and development of the region’s bond markets since its inception in 2003 has been remarkable. To help with the issuance of local currency denominated bonds, the Credit Guarantee and Investment Facility (CGIF) was established in the context of the ABMI. CGIF provides guarantees on local currency denominated bonds to make it easier for companies to issue local bonds with longer maturities. This will help reduce the currency and maturity mismatches that were one of the main culprits during the 1997–98 Asian financial crisis.

Within APEC, there are also multi-year initiatives, including the APEC Framework on Connectivity and the APEC Multi-Year Action Plan on Infrastructure Investment and Development. APEC cooperation on infrastructure development and investment will take advantage of regional expertise, experience and funding sources, including from multilateral and regional development banks, and the private sector. The public–private joint initiatives include:
• the Asia–Pacific Infrastructure Partnership (APIP), where the private sector has worked with governments to boost capacity for the design, finance and implementation of economic infrastructure; and

• the Asia–Pacific Financial Forum, which will work to enhance the region’s financial systems so that the private sector can help deliver new infrastructure and other regional investments, including social safety nets, health and other services. The forum will also work on a convergent approach, so that financial sectors can facilitate regional economic integration. The forum’s first meeting was held in April 2013.

During Indonesia’s chairmanship in 2013, APEC leaders have also endorsed the APEC Expert Advisory Council, with a pilot project of building a Public–Private Partnership Centre in Indonesia.

All these regional initiatives will help to channel capital inflows into more productive investment.

Conclusion

Infrastructure is a multi-faceted issue that cannot be tackled by any one regional or global institution; however, synergy among regional and global institutions is necessary. ASEAN institutions have the advantage of looking at infrastructure from the perspective of development and the need to deepening the financial market in the region, including by developing the regional bond market. ASEAN is also ready with a list of potential projects in the region. APEC has the advantage of looking at infrastructure from the regulatory perspective, with an interest in creating a sound investment climate for the private sector, particularly institutional investors. G20 has the advantage of looking at infrastructure from the perspective of global financing, rebalancing and financial stability, including fiscal reforms.

Uncertainties in the timing and size of quantitative easing (QE) in the United States necessitate a strategy to ensure that massive amounts of capital that flow into East Asian emerging countries do not easily flow out, especially when the QE is tapered or reversed. Good monetary and fiscal policy management is the first line of defence. However, this is not enough. Central banks often have to use mixed, non-conventional policy tools to manage a policy trilemma. This policy trilemma consists of the tasks of managing the volatility of
capital flows, responding to the ensuing exchange rate overshooting (or undershooting), and containing domestic liquidity expansion (or crisis).

However, on top of this, financial deepening is needed to channel the huge capital inflows into more productive investment, such as foreign direct investment (FDI) and sovereign bonds, instead of short-term portfolio investments or non-monetary instruments. The development of the regional bond market in Asia, including the ASEAN+3 Asian Bond Market Initiative, could support the G20’s initiative to address global imbalances by recycling Asia’s excess savings within the region, rather than channelling it into portfolio investment in developed countries. The MPAC and the AIF provide a ready project that could be financed by regional and domestic capital markets, regional and global funds and facilities, private individuals and businesses, and the region’s foreign exchange reserves.

Massive capital inflows to many emerging East Asian countries can be either a curse or a blessing to the region, depending on how they are managed. Regional institutions could help with the management of these inflows.

Notes
1. Researcher and Associate Fellow, Centre for Strategic and International Studies,.