The Role of a Northeast Asian Development Bank in Northeast Asia's Future Development

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INTRODUCTION

Northeast Asia is the Asian continent's last major economic frontier. The region comprises two distinct subregions. The northern subregion includes the Democratic People's Republic of Korea, Mongolia, the Russian Federation's Far East provinces, and the northeast provinces of the People's Republic of China. This subregion contains a vast variety of natural and human resources, still for the most part waiting to be developed. The region's southern quadrant includes Japan and the Republic of Korea, two of Asia's major industrialized nations. Both nations are sources of exportable financial capital and modern technology.

Given the region's combined resource complementarities, Northeast Asia is considered a "natural economic territory." This designation implies that as the Northeast Asian economy is increasingly developed, it will contribute significantly to Asia's value-added chain, and it will become a participant in world trade, commerce, and industry. This future will depend importantly on the ability of the entities concerned to bring together the north's natural and human resources and the south's capital and technology. Accordingly, regional integration holds the key to a better future for Northeast Asia and its millions of inhabitants.

For historic reasons, economic development in the northern reaches of Northeast Asia has lagged behind that of the southern tier (Japan and the Republic of Korea). This imbalance presents a unique challenge and opportunity: to develop the region's economy on an integrated basis, and thereby to create more sustainable and mutually beneficial economic relationships within the region as a whole. Responding to this challenge will require creative, pro-active, and sustained efforts.

The benefit of transforming Northeast Asia from a series of essentially unconnected political entities into an integrated economic whole has received wide attention in recent years. As noted, Northeast Asia promises in due course to become an important source of much-needed minerals, metals, energy and other natural resources. Concurrently, it will develop into a vigorous market for capital goods, plant and equipment, services, technology, which will be needed—and will require financing—to advance the region's economic growth and development.

Lessons learned during the past quarter-century confirm that while the public sector has an important role to play, the primary driver of economic progress in market-based economies is the private sector. However, private investments in resource development, manufacturing, banking and finance, and service industries take place only when potential investors are confident that the infrastructure needed to support and service their investments is in place and is dependable. A key to unlocking Northeast Asia's economic development is therefore ensuring the adequacy of the region's infrastructure—transportation, communications, energy, environmental, and the like.

Infrastructure and Financing Requirements

However, for the most part, the infrastructure in Northeast Asia's northern areas falls short of widely understood and accepted adequacy thresholds. The types of infrastructure that will require improvement and/or expansion include: highway, rail, air, and pipeline transportation systems; communications systems; energy production and distribution; urban facilities such as housing; and environmental facilities, including clean water and waste treatment facilities.

Infrastructure upgrading and expansion on this massive a scale will require huge imports of foreign engineering and construction services, materials, and plant and equipment. A recent East-West Center study estimates that the cost of the region's infrastructure investments amounts to some $7.5 billion a year.

Sources of Infrastructure Financing

A question to be addressed is, therefore, how and where financing for Northeast Asia's projected infrastructure investments can be secured. The East-West Center's study projected that under optimal conditions, financing for Northeast Asian infrastructure forthcoming from (1) private sector credits and investments, (2) bilateral official assistance, and (3) the multilateral development banks (Asian Development Bank and World Bank) might amount (at a maximum) to $2.5 billion a year (see Table 1). The region's financial gap would thus amount to some $5.0 billion a year. If the region's infrastructure investment and its overall development are to proceed as rapidly as possible, this projected funding gap must somehow be filled. It is highly unlikely that additional funds can be made available for this purpose by the "traditional" sources outlined above.

Since long-term capital available in international capital markets could easily finance the region's projected additional capital investment needs, the issue is how best to tap these sources of financing—i.e., how to mobilize and transfer (intermediate) funds from international capital markets to the region. After thoroughly examining a range of alternatives, it has been concluded that a new financial mechanism able to intermediate long-term capital from international capital markets to Northeast Asia offers the best prospects for achieving this objective. This needed capital intermediation function therefore provides both the rationale and the justification for the proposed Northeast Asian Development Bank (NEADB).

Table 1. Financing for Northeast Asian infrastructure investments: indicative requirements, possible sources and amounts (annual amounts in US$ million)

Item		Subtotals	Totals
Total estimated requirements			7,500
Private investments and credits		500	
Bilateral sources (United States, Japan, others)		500	
Multilateral development banks			
IBRD (6 loans per year)	750		
ADB (5 loans per year)	650		
EBRD (2 loans per year)	100		
Subtotal for multilateral development banks		1,500	
Total prospective financing			2,500
Estimated financing shortfall			5,000

The Northeast Asian Development Bank

The proposed NEADB would supplement the work of the existing multilateral financial institutions (Asian Development Bank and World Bank) in the Asian region. NEADB financing would be primarily directed to infrastructure projects that would benefit the countries and the region as a whole. The Bank would also provide technical assistance in the identification, design, evaluation, and implementation of such projects. In addition, the Bank would provide technical advice on the preparation and implementation of policies, legal framework, institutions, and so on, needed to support and facilitate the region's development.

In addition to its ability to raise and transfer additional capital for the region, distinctions between the NEADB and the World Bank and ADB would arise in the structure of the new Bank's membership and shareholding, the supervision and direction of the policies and programs, and the management and supervision of day-to-day operations. The major shareholders of the existing development banks (and the countries that dominate these banks' policies, programs, and lending levels) are the United States, Japan, and the European Union countries. Domestic policy considerations and other preoccupations of these countries have limited and constrained the operations of the established multilateral banks. For these reasons, it may be assumed that they would not be inclined to provide these banks with the financial resources and personnel needed to meet the infrastructure funding needs of Northeast Asia.

To overcome these prospective constraints, it has been proposed that the countries that would take a leadership role in the proposed NEADB would be those with a direct economic, commercial, or cultural interest in and commitment to the development of Northeast Asia. The majority shareholders, and the major decision-making authority with respect to Bank policies and programs, would therefore be countries such as Japan, China, and South Korea. The United States and other nonregional countries would no doubt wish, for commercial and policy reasons, to become shareholders of the Bank as well.

Opportunities and Benefits

A new NEADB, charged with financing Northeast Asia's infrastructure investment needs, would present a number of collateral economic, political, and social benefits in addition to those involving the transfer of resources.

Resource Development

Economic development of the less-developed northern areas of the region would generate large, region-wide, commercial and economic benefits, both in the near term and in the future. The region is a treasure-trove of natural resources of every variety—minerals, energy, water, forests, agriculture, land, and people. Resource-short nations, such as Korea and Japan, would benefit from participating in the development and use of these resources. The NEADB could make a major contribution to this effort by financing infrastructure projects in the natural resource area. Bank member countries would thus benefit from new and/or increased supplies of needed resources.

Market for Services and Equipment

The region's economic development will require huge and continuing imports of construction and engineering services, materials, plant, equipment, financial and informational services, manufactured goods, and the like. The NEADB would finance such imports for its projects. Countries with equity in the Bank would presumably be granted preferential status in bidding and supplying equipment and services for such NEADB-financed projects. Following the precedent of the other multilateral banks, funds for financing Bank-supported projects would be raised mainly through the sale of NEADB bonds in the world's major capital markets. These overseas financial resources would become the major source of financing for projects in the Northeast Asia region. Additional "soft window" resources would represent a possible further source of funds. It is therefore reasonable to expect that the returns to donor-member economies, as measured by the value of contracts and payments received by its firms under Bank-financed projects, would be a multiple of the amount of the country's subscription to the NEADB's capital actually paid in hard currencies.

Regional Status

The NEADB would present an opportunity for countries to enhance their political and economic status both within the region and globally. To illustrate, Japan's active promotion of the Asian Development Bank in the 1960s was critical to the establishment of the institution. Japan's prestige was no doubt strengthened by its demonstration of strong interest and commitment to the development of the Asia-Pacific region. Japan's large commitment to the ADB's capital supported the nation's interest in appointing the president of the Bank, in achieving a major voting position on the Board of Directors, and in a large complement of Japanese staff.

The proposed NEADB would offer similar opportunities to Asian countries. Their active promotion and support for the NEADB would provide a means of gaining prominence within and outside the region. Their commitment to the region's future growth and development would doubtless enhance their role as national and regional actors in the global economy. The NEADB would thus offer a tangible, highly visible international platform for prestige-building activities.

Greater Stability for the Northeast Asian Region

Economic development and the concomitant improvement in economic relations could translate into greater political stability within the Northeast Asian region. Bringing the less economically developed parts of the region into better balance with other areas of the region could contribute to overall stability. An important corollary of more balanced and harmonious economic relations would be the expansion of regional trade and investment. Important byproducts of greater trust and confidence would include increased interchange among individuals, families, and groups within the region, and greater contacts and comity among the leaders and officials of the countries concerned.

In this regard, the prospects of more rapid development and the transfer of development capital through the NEADB would encourage recipients of Bank loans to maintain good relations with their regional counterparts and could help moderate and reduce pre-existing tension. By the same token, membership in the NEADB would impose the responsibility to participate and to work cooperatively within the Bank's institutional systems and structures for the greater good of the region. In addition, member nations would be represented and have voting responsibilities on the Bank's Board of Directors; and each country would nominate personnel for the Bank's staff. The expectation would be that participants would act responsibly, cooperatively, and apolitically in the conduct of the Bank's business.

Development Burden-Sharing

Economic development in the Korean peninsula and elsewhere in the region would involve large investments of capital for infrastructure. In the absence of a regional financial institution that could ensure that a large portion of needed funding was raised abroad, the burden of financing for infrastructure investments could fall disproportionately on a few countries of the region (e.g., China, North Korea, South Korea, and Japan). However, the establishment of the NEADB as a subregional development bank would make it possible to raise and transfer a major share of these development costs from the region to the international capital markets.

Financial Order and Discipline

At a macro-economic level, the proposed NEADB could help avoid the kinds of disruptive short-term capital flows that created stress in Asia during the past two years. The Bank could help ensure that long-term infrastructure projects were funded by commensurately long-term borrowing. This would reduce the mis-match of borrowing and lending maturities. The Bank could thus contribute to improving discipline in the financial sectors of regional developing countries.

In addition, the Bank would ensure that the projects for which it provided financing would meet international economic, technical, and financial standards and specifications. In that way, the Bank could help ensure that the region's and nation's infrastructure priorities were primary considerations in infrastructure investment decisions. The Bank would of course ensure that over-billing and overpayments practices were avoided. Thus, the Bank could help avoid future "borrow-build-bust" cycles and prevent the waste of resources and the associated social costs.

The Role of the Private Sector

As the above paragraphs suggest, private-sector financing for infrastructure projects involves a number of issues that intersect with the role and operations of the proposed NEADB. It should be noted at the outset that private foreign direct investment, trade-related credits, commercial bank loans and, in the case of fiscally stronger countries, direct borrowing in overseas capital markets constitute important sources of potential long-term capital. Each has a role to play in the region's infrastructure development. Private sector infrastructure financing could take a variety of forms, including straight equity, retained profits, loans from parent firms, technology transfers, supply of equipment, public-private joint ventures arising from privatization programs, and bond (debt) purchases.

While private financing can be useful and should be encouraged, it is important to maintain balance and oversight with regard to such financing. A current proposal (advanced apparently in earnest in some nations) would assign to the private investors the task of meeting virtually all infrastructure financing needs of the developing countries. It would follow that multilateral development banks and bilateral aid programs could be phased out of infrastructure projects. This is a flawed reading of the facts of life in developing countries and a certain recipe for future financial problems.

Modest Levels of Private Funding for Infrastructure

It is useful to recall, in this connection, that U.N. data show that private investment in infrastructure in developing countries has been modest. In recent years most private direct investments have involved transfers within or between the same or related international firms, have been for manufacturing and processing rather than for infrastructure, and have been between and among firms of the industrialized countries. In 1995, only $100 billion—about one-third of total cross-border private investment flows—went to developing countries. Asia accounted for $65 billion of that amount, with China's share amounting to some $38 billion. Most private direct investment went into production and processing plant and equipment; only a relatively small amount was made available for infrastructure. The reasons are self-evident. Infrastructure investments typically carry high repayment risks and involve long and uncertain returns. They are therefore attractive to very few private investors.

Investment Distortions

East-West Center projections indicate that under even the most favorable assumptions, private investment in infrastructure in Northeast Asia would cover only a small fraction of the region's prospective requirements. In any case, it would be folly for countries or regions to turn over to private investors decisions about where and what kind of infrastructure is required. The result could be a distortion of the country's infrastructure priorities, a waste of resources, and the frustration of serious development efforts.

For some types of infrastructure (such as telecommunications), equipment and systems can be supplied "off the shelf," and most vendors of such equipment can receive exporter credits from their domestic banks. Thus, private investments in, for example, telecommunications infrastructure may be quick and easy. On the other hand, few if any private investors would be interested in investing in irrigation systems or in secondary farm-to-market roads—which may reflect more accurately the country's priorities. In an extreme case of investment distortion arising from the relative ease of financing, a country or region could end up with a cellular telephone for every farmer but no way for him to get water to his fields or his crops to the market. The point is simply that while sound and appropriate private investment should be encouraged, it should be considered in the context of a balanced and defined infrastructure development program. It should not be accepted simply on the basis of what private investors would be able or willing to finance.

A further point to be noted is that the benefits of infrastructure are "social" and long-term in nature. That is, investment returns in the form of economic surpluses accrue over a period of twenty, thirty, or more years. Private investors, however, typically expect to recover their investments within a considerably shorter period, perhaps five to seven years. To do so, they must impose user charges—tolls on highways, long-distance telephone charges, etc.—that are higher than warranted by the economics of the specific project. Or they might decide to invest in new office buildings (rather than workers' apartments) where high rental returns could begin immediately. As a result, the people of the country or region who are supposed to be the beneficiaries of infrastructure investments cannot afford to use them or are priced out of the market.

A final point is that in most countries (the United States and Japan included), infrastructure is seen as generating a "social return"—that is, the benefits of the investment accrue to the country's or region's citizens as a group rather than to particular individuals. However, if the infrastructure investment is built and "owned" by private investors, social returns are converted into private profits. Instead of economic surpluses being devoted to improving living conditions or increasing domestic savings and investments, they end up in the hands of private individuals. These returns often leave the country in the form of private remittances and are thus an unrequited drain on the country's savings and foreign exchange resources.

The proposed new NEABD would avoid these kinds of private infrastructure investment "disabilities." The Bank would undertake financing for projects that were demonstrably responsive to the priorities and needs of the region and countries concerned. By ensuring an appropriate match between the financing terms and conditions and the project characteristics, the Bank could avoid both the need for high user fees and charges, and for disproportionately large payments of interest and principal. In addition, social returns would not be siphoned off by private overseas investors but would remain within the country where they are generated, to be used for public purposes.

COSTS OF PARTICIPATION

A proposed capital structure for the NEADB (see Table 2) suggests an initial capitalization of $20 billion, of which 50% would be subscribed and paid-in for shares over five years, and 50% would subscribed (but not paid-in) in the form of callable capital shares (i.e., a form of "safety-net" commitments that would require no disbursements by shareholders). It is assumed that the regional countries' share of the Bank's capital would be $12 billion, representing 60% of the NEADB's total capital. The 40% balance ($8 billion) would be available for subscription by nonregional nations.

Table 2. Hypothetical allocation of shares in the Northeast Asian Development Bank (based on 1995 GDP per capita, with adjustments for "externalities")

Annual Payment by Members	Shares (number)	Shares (% of total)	Total Amount Subscribed (US$ billion)	Total Paid-in Amount (US$ billion)	Annual Payment (5 years) (US$ million)
"First Tier" of founding members					
Japan	300,000	15	3.0	1.5	300
Russia	140,000	7	1.4	0.7	140
Republic of Korea	100,000	5	1.0	0.5	100
People's Republic of China	200,000	10	2.0	1.0	200
Mongolia	20,000	1	0.2	0.1	20
Democratic People's Republic of Korea	40,000	2	0.4	0.2	40
Total First Tier	800,000	40	8.0	4.0	800
"Second Tier" and other Asian members					
Hong Kong	–	–	–	–	–
Taipei, China	–	–	–	–	–
Other Asia	–	–	–	–	–
Total Second Tier and others	400,000	20	4.0	2.0	400
Total all Asian members	1,200,000	60	12.0	6.0	1,200
Non-Asian members	800,000	40	8.0	4.0	800
Grand totals	2,000,000	100	20.0	10.0	2,000

Note: Dashes (–) indicate amounts to be determined at a later date.

Assumptions:

1. Capitalization of $20 billion evidenced by 2 million shares valued at $10,000 per share.
2. Sixty percent of shares to be allocated to Asian nations.
3. Japan would subscribe to the same approximate portion of the total as in the Asian Development Bank. The United States would subscribe to approximately 10% of the shares of the NEADB (the same proportion it holds in the EBRD).
4. Paid-in portion of shares of 50%; payment of paid-in portion over five years.

For illustrative purposes, if a regional member country were to subscribe to 5% of the Bank's shares (12.5% of the regional total), its total financial commitment would be $1 billion. Of that amount, one-half, or $500 million, would be paid to the Bank in exchange for shares. The payments would be made in five annual installments of $100 million each. The balance of the country's commitment would be "callable" and would remain uncalled except in the unlikely event of a major financial failure. (All existing multilateral development banks have similar callable shares; none has ever called, or expects to call, any of these shares.) Under these assumptions, the annual governmental budgetary cost for a purchase of 5% of the NEADB's shares would be $100 million a year for five years.

CONCLUSIONS AND NEXT STEPS

Conclusions

Northeast Asia holds great promise for economic and commercial development. The region encompasses a vast, differentiated area that, in the north, is rich in natural and human resources and, in the south, has modern technology and surplus capital. It is a potentially huge market for trade, finance, and commerce. At present the region is economically unbalanced. One part has in abundance what the other part lacks and requires, and *vice versa*. Redressing this economic imbalance presents an opportunity and a challenge for the region as a whole. It is a challenge worth meeting since, in addition to becoming a source of needed resources and a vast market for goods and services, the development of the region would yield benefits in the areas of improved security, stability, comity, and cooperation.

The infrastructure in the northern, less-advanced part of the region is at present below the standards required to attract private investment in resource development, manufacturing, and services. Development of this region will require a substantial investment of capital to expand and upgrade the infrastructure base. Investment in infrastructure involves large transfers of external long-term capital. Recent analyses indicate that the region's needs and absorptive capacity will significantly exceed the resources that conventional sources of such long-term financing—namely, the private sector, official development assistance, and the existing multilateral banks (the ADB and IBRD)—will be able to provide.

The establishment of a new subregional bank, the Northeast Asian Development Bank, has been proposed, to help fill the region's long-term infrastructure financing needs and thereby accelerate the region's economic development and integration. As proposed, the Bank would become an important institutional vehicle for mobilizing funds in international capital markets for the region's infrastructure needs. These funds would be raised by bond issues and would be transferred through the Bank's lending operations to finance imports of equipment and services for infrastructure investments in Northeast Asia. Such transfers and investments, along with associated technical advice and assistance, are a necessary first step in developing the region's resources, in attracting private banking and investments, and in creating a long-term Northeast Asian market for goods and services.

In addition to serving this much-needed, long-term, capital intermediation function, the NEADB would ensure that investments it helped finance were for projects in priority sectors of the region as a whole. It would also ensure that projects were free of inappropriate payments and that they could meet internationally accepted standards of technical, economic, and financial feasibility. Moreover, the Bank would provide a means for spreading a significant part of the costs of developing Northeast Asia from the countries of the region to the international capital markets. From a broader fiscal policy perspective, the Bank could help avoid the mismatching of funds and investments that has proved injurious to Asian nations in recent years.

The purchase of shares in the proposed Bank would represent a sound investment for countries of the Asia-Pacific region, as well as for those outside the region. Given the multiplier realized by raising funds abroad, the return on investment, in terms of purchases of goods and services from each nation's exporters under Bank-financed projects, would be a multiple of the amount of the country's paid-in investment in the Bank's capital.

Next Steps

During the past decade, the Northeast Asia Economic Forum has discussed the proposed establishment of the NEADB as a new, subregional development Bank to intermediate financial resources for Northeast Asia's infrastructure investments. Forum participants have examined and assessed the NEADB proposal in considerable detail and from a variety of perspectives. These assessments and deliberations have produced broad agreement on the need and justification for the proposed Bank.

With Asian economies now recovering from recent financial difficulties, it would be timely to bring the NEADB proposal to the attention of concerned central, regional, and urban governmental agencies and authorities as a first attempt to gauge and mobilize support for moving ahead with the proposal. While no commitments would be expected, these officials' reactions would be an important consideration in assessing the utility of further work and elaboration of the NEADB proposal during the coming months.

Accordingly, participants of the Forum meeting in Tianjin may wish to discuss appropriate means of bringing the NEADB proposal to the attention of relevant authorities of concerned governments, for the purpose of soliciting informal views and guidance with respect to the proposed new Bank.