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APRIL 2018

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Foreword

COVER

A girl climbs ladder at a playground in Duolun county in north China's Inner Mongolia Autonomous Region.
REUTERS/Jason Lee

ASIAN DEVELOPMENT BANK

GROWING UP FAST

It is hard to think of a more appropriate setting for this year's Asian Development Bank annual meetings. Manila, the Philippines capital, has long been a case study for under-investment in infrastructure, but the current administration is doing its best to shake off that reputation with an ambitious development plan.

The Philippines is growing fast, at close to 7% a year. It is investing heavily in infrastructure, reforming its capital markets and stamping out corruption. The buzzwords of inclusive growth, resilience and technology feature as prominently in the Philippines' economic agenda as they do in the ADB's own strategy documents.

Yet the Philippines is also a microcosm of the development challenges facing Asia's emerging markets. How will it fund its "golden age" for infrastructure? Where is the right balance between cheap power and climate change? What does the growth of digital technology and artificial intelligence mean for its booming outsourcing industry?

Similar debates are ongoing across the region. And a new threat in the form of protectionist policies and trade tariffs is adding an extra frisson to the discussions. After benefiting from decades of open trade links with the West, could Asia rely on intra-Asian trade and greater regional integration to protect itself from a US-China trade war?

This special report aims to highlight some of the key themes up for discussion at this year's annual meeting. It also provides an update on the ADB's continued evolution from a simple infrastructure lender to a financing partner capable of supporting development across the full range of Asian economies, from the very poor to the increasingly rich.

The ADB and the region's other multilaterals have an important role to play in mobilising funds for Asia's continued growth. They must also ensure Asia focuses its resources on the projects and initiatives that deliver the broadest and most sustainable long-term outcomes.

But the private sector must also play its part. Banks need to do a better job of supporting small and medium-sized companies and recycling their capital. Asia's institutional investors have the funds to support the region's long-term development, if they build the skills to look beyond the low-hanging fruit.

Regulators also have a responsibility to develop their capital markets and increase investment and financing opportunities for their increasingly wealthy citizens.

The Philippines has embraced these messages, though many challenges remain. ADB staff based in the bank's Manila headquarters have a personal stake in getting it right.

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OUT OF THE SHADOWS

President Takehiko Nakao says the Asian Development Bank can play a bigger role than ever in promoting the region's development.

President Takehiko Nakao officially opened ADB's 50th Annual Meeting in Yokohama, Japan. Asian Development Bank

BY STEVE GARTON

Walking down one of the long corridors in the ADB's headquarters in Manila, it is often difficult to make out who is coming in the opposite direction. With the bright sunlight streaming in from a distant window, faces are hidden in shadow until they are close up.

In silhouette, the ADB's profile today looks much the same as it did when Takehiko Nakao took over as president in 2013. On closer inspection, though, one thing quickly becomes clear: it's bigger. Much bigger.

The ADB has added a few notches to its belt under Nakao. Strengthening its balance sheet in early 2017 by bringing together its ordinary capital resources and concessional funding has given the bank extra financial firepower, with over US$19bn of loans and grants approved in 2017 – up 46% from US$13.1bn in 2012. It has also expanded into new areas, embracing the use of alternative financings such as equity investments and revamping its suite of knowledge and advisory services.

Nakao is now overseeing the finishing touches to Strategy 2030, a long-term roadmap that will guide the bank's objectives for the next decade.

The latest draft, which is up for discussion during this year's annual meetings on May 2-5 in Manila, encapsulates the changes. While the current Strategy 2020 called for "An Asia and Pacific Region Free of Poverty", the updated framework adds a number of new elements to the agenda: "Under Strategy 2030, ADB will sustain its efforts to eradicate extreme poverty, given the region's unfinished poverty agenda, and expand its vision to achieve a prosperous, inclusive, resilient, and sustainable Asia and the Pacific."

Nakao says a lot has changed since the previous document was written in 2008, before the global financial crisis.

"There are so many changes," he said. "We face the reality that we still live in such a volatile world, and capital movement often causes some volatilities, even crises. We know that. We should care more about disasters, and climate change is becoming more imminent. There are global goals – SDGs [Sustainable Development Goals] – and the Paris agreement. We should care about all these issues."

This does not mean the ADB is abandoning its roots. Nakao says Asia has made "remarkable progress" in poverty reduction, but that mission is not yet complete. Some 330 million people are still living below the poverty line of US$1.90 a day.

ADB has the firepower to take on the expanded challenge. The merger of the concessional Asia Development Fund with the bank's ordinary resources added US$30.7bn to the bank's reserves at the start of 2017, taking its equity capital to US$50.3bn without the need to call on shareholders for a general capital increase – no easy task given the current US administration's hostility towards the multilateral system.

With an agreed minimum equity-to-loan ratio of 34% (a conservative number by any commercial bank capital standard), the new capital structure means the ADB can take its outstanding loans from the current US$100.9bn to close to US$150bn before it needs to ask for more money.

That, according to Nakao, will fund the ADB's operations to 2025.

"Although it's not realistic to keep up with the speed of growth of GDP in Asia … we at least want to increase our lending and grant operations without seeking a capital increase," he said.

DIFFERENTIATED APPROACH

There is no doubt that the bank has the opportunity to do more to support Asian development. Finding a consensus around where those resources should be deployed, however, has been far harder.

Some shareholders want it to prioritise lending to the poorest countries, in keeping with its traditional mission of eliminating poverty. Others want it to broaden its vision, to keep pace with new and emerging challenges across its entire membership.

Nakao argues the bank can satisfy both camps.

"Generally MDBs are (being) asked to do several things. One is to use our own equity more efficiently, which we did. Another is to make our system more efficient, including human resources and so on. We are asked to mobilise and catalyse more private resources, in addition to our own resources, by promoting cofinancing with the private sector operations, by doing more work related to PPP ... Some shareholders want us to pay more attention to poorer countries instead of upper-middle-income countries.

"We are doing these things. But in our strategy we want to continue to engage upper-middle-income countries, like China."

This approach is reflected in the Strategy 2030 document, which calls for the bank to take a differentiated approach to its engagement with developing member countries. The framework proposes to treat borrowing nations in three distinct groups: upper-middle-income countries, where the ADB will focus on knowledge sharing and promoting resilience rather than pure financing; low-income and lower-middle-income countries, where long-term financing will be more important; and the small island nations and conflict-affected situations, where the ADB will

prioritise financial support and expand its concessional operations.

"It's not to move away from upper-middle-income countries, but we think different approaches work for different countries," said Nakao.

CHINA STRATEGY

China, Asia's biggest economy, remains a major borrower, accounting for about 15% of the ADB's operations. It is hard to argue that, with US$3trn of foreign exchange reserves, it needs the ADB's money to build more bridges or roads, but recent projects suggest it does see value in the bank's expertise.

The ADB has signed a string of projects in China that focus on environmental issues, such as a US$499m loan last November to help improve air quality in Beijing, the third in a series since 2013, and US$1.2m of technical assistance to support research into carbon capture and storage technology, approved in March.

Nakao met China's then Finance Minister Xiao Jie five times in 2017, underlining the extent of the partnership on both sides.

"It's not lending; it's not the money they care about. It's about financing together with knowledge," said Nakao. "We are doing things together. We share knowledge together. That's very important."

There are other reasons to work closely with China, given the country's importance in the region and the introduction of two new, China-backed multilateral development banks, the Asian

> "For Asia, engagement with China is so important. Without China as a borrowing country our influence and our relevance in this region is more limited."

Infrastructure Investment Bank and the New Development Bank. In all cases, the ADB intends to work in partnership, not opposition.

"For Asia, engagement with China is so important. Without China as a borrowing country our influence and our relevance in this region is more limited," said Nakao.

NEW TECHNOLOGIES

Nakao wants the ADB to move with the times, and is positioning it as a modern, technologically sophisticated institution – not the slow-moving multilateral model that has attracted criticism in Washington and elsewhere.

The Strategy 2030 blueprint makes specific reference to supporting the development of the digital economy across Asia, as well as transforming the bank's own approach to enhance access to its knowledge and create a 'culture of innovation' to respond to its clients' needs.

Work is under way to upgrade the bank's internal systems. And regular visitors will notice that, already, the WiFi routers throughout the Manila offices are far faster and more reliable than before.

Nakao sees technology as an opportunity to accelerate Asia's development, through the use of more efficient supply chains and productivity gains that can boost consumption and drive economic growth. He points to a recent visit to Dhaka, Bangladesh, where an ADB-backed US$536m project to finance monitoring systems and metering has helped cut losses from the city's water supply to less than 3%.

"We need to redouble our efforts to pay attention to the most advanced technologies, new ideas," he said. "It is really a challenge. If we are not agile enough to take in new technologies we will lose our relevance."

This commitment to embracing technology includes exploring new financial instruments.

Private sector operations accounted for US$3.2bn of the ADB's US$19.1bn of commitments approved in 2017, and included some novel – and profitable – investments.

The bank invested in the initial public offerings of two Thai power producers in 2017, taking a Bt1.97bn (US$57.7m) stake in B Grimm Power's July listing and committing a further Bt2.88bn to Gulf Energy's November float. Those have been enormously successful investments so far, handing the ADB a total paper profit of US$87m with the stocks up 67% and 48% at the time of writing.

The ADB is also poised to take a US$57.5m stake in Bangladesh's Summit Power International as a cornerstone investor in its Singapore Exchange IPO. That stock is due to begin trading on April 30.

"We are increasing our private sector operations, both through loans to private sector companies and investments in private equity. If we can make some money from it, that impacts our equity, and our lending is based on the equity-to-loan ratio," said Nakao.

"We need to redouble our efforts to pay attention to the most advanced technologies, new ideas."

PROTECTIONISM

Nakao hopes that these changes will ensure that the ADB remains relevant as the region continues to grow.

The bank is projecting a healthy 6.0% growth rate across developing Asia in 2018, up from its earlier estimate of 5.8% as a result of strong global trade flows and rising domestic demand.

But he acknowledges that the growing popularity of protectionist policies, especially in the US, is a risk for the region.

US President Donald Trump has escalated trade tensions with China in recent weeks, imposing tariffs on imports of steel and aluminium in March and threatening to target another US$150bn of Chinese goods in early April. That has triggered a tit-for-tat reaction from China and raised fears of a trade war between the world's two biggest economies.

"To me what is important is to understand why this happens and to address these inequality issues and jobs issues in more constructive ways," said Nakao. "Of course trade barriers and protectionist policies should not be the answer, but at the same time what the US has been doing, yes it's worrying, but it is very specific."

Nakao points to a very strong increase in trade in 2017, with exports rising 4.9% and imports by 7.7% in real terms in the region's 10 largest economies, as a reason to be confident for Asia's future. With solid growth in China, firmer commodity prices and improved intra-Asian trade links, trade flows can withstand the threat of tariffs.

"I'm not worried about trade, in short," he said.

The US administration's focus on stimulating the domestic economy has seen it turn away from global institutions, adding to the challenge for multilateral development banks that count the US among their major shareholders.

US Treasury secretary Steven Mnuchin rejected a US$13bn capital increase for the World Bank in October, complaining that it was not using its existing capital well enough.

But the Trump administration has proven hard to read. Recent reports of a deal between Mnuchin and World Bank President Jin Yong Kim suggest that the US may be willing to back the capital raising if the bank scales back its lending to China.

Trump has also claimed his openness to a trade deal with China – at least in his tweets – and has floated the idea of rejoining the Trans-Pacific Partnership, the Obama-era trade deal that he had enthusiastically rejected only three days after his inauguration.

Nakao does not see a big impact on Asia or the ADB's operations, though he is keen to point out that all the bank's shareholders have a say in its operations.

And when it comes to securing donor support for concessional operations and climate initiatives, Asia's growing economies are also taking up some of the slack.

Nakao notes that South Korea and China have expressed willingness to increase their concessional support, even if the US approach has become "more rigorous".

"I'm not worried about concessional support for us," he said.

But in some ways the US has had a big hand in shaping Strategy 2030, by forcing multilaterals to review the way they go about operations and be more efficient in how they use resources.

The 2018 annual meeting is a case in point. The last time Manila hosted the meetings, in 2012, it used the Philippine International Convention Center across town. This time, the sessions are to be held in the ADB's own headquarters in Ortigas, keeping the costs down in an environment that Nakao says will be "less ritual, less ceremonial, with more concrete discussions".

Technology, again, is in line for a central role in the discussions.

"One (objective) is to renew our collaboration with the host country. Another is how Asia can continue to grow and reduce poverty based on its growth momentum and new technologies," said Nakao.

"Technology is one of the important issues to make this meeting more interesting." ●

Leaders of Mekong countries pose for a photo before the Greater Mekong Subregion Summit in Hanoi, Vietnam March 31, 2018. From L-R : Thailand's Prime Minister Prayuth Chan-ocha, Laos' Prime Minister Thongloun Sisoulith, Cambodia's Prime Minister Hun Sen, Vietnam's Prime Minister Nguyen Xuan Phuc, Chinese State Councilor and Foreign Minister Wang Yi, Myanmar's Vice President Henry Van Thio and President of the Asian Development Bank Takehiko Nakao.
Lam Khanh/Reuters

TRADE TENSIONS

Tariffs and trade wars are not good news for Asia's export-driven economies. Can intra-Asian links and China's BRI save the day?

U.S. President Donald Trump holds his signed memorandum on intellectual property tariffs on high-tech goods from China, at the White House in Washington, U.S. REUTERS/Jonathan Ernst

BY STEVE GARTON

The Asian Development Bank's chief economist does not agree with the financial markets. Yasuyuki Sawada struck an upbeat tone at the launch of the bank's Asian Development Outlook report in mid-April, even as fears of a US-China trade war were rocking risk assets across the world.

The US stock market posted its worst week in two years in mid-March after US President Donald Trump announced tariffs on imports of steel and aluminium. Then a tit-for-tat round of tariff threats in early April caused further jitters, dragging Chinese stocks in Hong Kong to their lowest of the year.

As well as steel and aluminium, Trump has announced tariffs targeting US$50bn of Chinese imports and threatened US$100bn more. China, in retaliation, has slapped duties on US$50bn of US goods and said it has more extreme measures up its sleeve.

"The scale of the trade policy change is only 0.4% of GDP for China, 0.2–0.3% for the US. So it's not really a fundamental change," said Sawada.

"So far these have not made a discernible dent in volume trade flows to and from developing Asia," said Sawada, though he conceded that further US tariffs and retaliatory moves from partners "could undermine the region's outlook".

A US-China trade war has emerged as one of the biggest risks to Asia's continued economic expansion. So far, the consensus among analysts and economists is that the two superpowers will eventually come to a deal, keeping the region on track for another strong year of GDP growth.

The ADB's outlook report projects 6.0% growth for developing Asia in 2018, a revision from its latest forecast of 5.8%, on the back of stronger-than-expected trade flows last year.

"We view US trade actions targeting China more as an opening gambit for negotiations than the start of a trade war," wrote Richard Turnill, chief investment strategist at BlackRock, the US-based money manager.

Chinese analysts at ICBC International agree that a "new Cold War" is an unlikely scenario.

"China and the US are so interdependent that their relations are 'too big to fail' … Both will finally come to terms after negotiations," wrote analysts led by Cheng Shi on March 27.

Even if the immediate threat is modest, talk of tariffs is a significant change to the global trade environment. That, in itself, could have big implications for Asia, which has prospered in recent decades on the back of exports to the West.

"Since the end of WW2, Asian countries' continued growth – as well as global economic growth – has been generated by open trade and liberalised transactions of goods and services across borders. So I think we should really reaffirm the importance of a multilateral free trade system," said Sawada.

The ADB's outlook report warns that Asia's strong links with US manufacturing supply chains could be disrupted, or even severed, if US investors move out of the region.

"While the direct tariff costs of the announced measures may be small compared with growth in trade forecast for 2018, their disruption to supply chains could sabotage business expansion plans in related industries, and uncertainty over the global environment could dampen currently strong consumption growth."

REGIONAL SAFETY NET

The US-China spat is putting Asia's own trade initiatives under the spotlight. In the event of further US tariffs, could intra-Asian trade and connectivity take up the slack? And how significant are alternative free trade agreements to the region?

Sawada points to progress on the restructured Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership (RCEP) as positive steps.

"There are other international and global trade regime changes ongoing," said Sawada. "It's very unbalanced to pick one particular policy change to talk about the negatives."

Following Trump's rejection of the TPP in his first week in office, the remaining 11 countries signed a revised deal in Chile in March. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership, to give it its formal title, has been hailed as a victory for open markets and international cooperation. It still covers more than 13% of the global economy, even without the US.

Meanwhile, the RCEP is a network of free trade agreements between the ASEAN nations and six partners: China, South Korea, Japan, India, Australia and New Zealand.

It aims to produce "a modern, comprehensive, high-quality, and mutually beneficial economic partnership agreement" covering goods, services, investment, economic and technical cooperation, intellectual property, competition, dispute settlement, e-commerce, small and medium enterprises (SMEs) and other issues.

The partners together account for US$23.8trn of GDP and 3.5 billion people, according to 2016 figures.

Sawada describes it as history's largest free trade agreement, covering 30% of global GDP.

"It's a very important stepping stone towards our ultimate target of achieving a global multilateral free trade and free investment system," he said.

Negotiations began in earnest in 2013 and are said to be progressing well. A 21st round took place in Yogjakarta, Indonesia, in February, and a March ministerial meeting reaffirmed a commitment "to intensify efforts in 2018 towards conclusion".

"The ultimate goal of the global economy is to achieve a globally open free trade system so that growth can continue, but … (it) cannot be achieved overnight. We need some step-by-step process."

REGIONAL COOPERATION

Within Asia, there are hopes that growing demand for public goods will drive cooperation across borders, especially as rapid urbanisation continues.

"Large cities are becoming real drivers of public goods. People want a better quality of life, and that is a common agenda across the region," said

Arjun Goswami, technical adviser for regional cooperation and integration at the ADB's Economic Research and Regional Cooperation Department. "There is every reason to believe that will result in collective action, collective mechanisms, greater intra-Asian linkages, and in turn will create the demand for larger connectivity."

Asian integration follows a very different track to that of Europe, where supranational institutions have led the way.

"Ours has always been a market-driven integration process. Private sector demand is hugely important," said Goswami. "If we really want intra-Asian linkages to happen they will primarily be led by facilitating those flows, of trade and investment and capital across borders, and making sure that businesses – including those that are mid-sized or small – have increasing opportunities to take advantage of those flows."

National and global initiatives are important, but Goswami stresses the need for regional discussions to fill a "missing middle" to increase the impact of national actions and help meet Asia's public goods agenda.

The ADB has long played a role in facilitating discussions between economic groupings, such as the Greater Mekong Subregion and the Central Asian Regional Economic Cooperation programme, where the 11 members have expanded beyond their original agreement to cooperate in four sectors.

The ADB agreed a US$450m loan in late 2016 to China that was designed to benefit Vietnam just as much, opening up stronger business linkages between Vietnam and China's Guangxi province. As well as physical connections and trade facilitation, the facility provided for investment in e-commerce, healthcare and agricultural supply chains.

"Linkages are not just about increasing shared benefits. It's also about managing risks across borders," said Goswami.

The ASEAN initiatives, including its own economic community and the collaboration with China, Japan and South Korea under the ASEAN+3 framework, have been "hugely important", Goswami says, pointing to efforts on financial integration, trade and capital markets.

Following the signing of the CP-TPP agreement, the RCEP free trade network would give the region a further boost.

"It means the liberalisation of products and markets across agriculture, services and goods, and getting businesses to really take advantage of that," said Goswami.

"Intra-regional Asian trade and FDI flows have grown past the 50% mark, and they are robust. We never want that to be 100%, because that would mean the region is completely closed."

BELT & ROAD

China's Belt and Road Initiative has given Asian integration a further push. But it has also brought with it warnings that China is using its economic muscle to push for one-sided deals that have little benefit for the recipient country.

Ayumi Konishi, Director General of the ADB's East Asia Regional Department, rejects that notion out of hand.

"Any regional cooperation initiative exists only on the basis of mutual agreement among the countries involved," he said. "Can China do a project in Bangladesh without the other side agreeing?

Key BRI infrastructure projects

PROJECT	VALUE (USD bn)	PROJECT	VALUE (USD bn)
INDONESIA		**MYANMAR**	
Jakarta-Bandung High Speed Train	5.5	Deep seaport in Kyaukphyu	7.2
% of GDP	*0.6*	*% of GDP*	*10.8*
MALAYSIA		**VIETNAM**	
East Coast Rail Link	14.1	Cat Linh – Ha Dong metro line	0.9
Malaysia-China Kuantan Industrial Park	8.4	*% of GDP*	*0.4*
Expansion of Kuantan Port	0.8	**PAKISTAN**	
Malacca Gateway	11.0	Rail line: Expansion/reconstruction of	8.2
TOTAL	**34.2**	existing Line ML-1	
% of GDP	*9.9*	SSRL Thar Coal Block-I 6.8 mtpa & SEC Mine Mouth	3.3
PHILIPPINES		Power Plant(2×660MW)	
Two bridges across Pasig river	0.1	Road: Peshawar-Karachi Motorway (Multan-Sukkur	3.0
Metro Manila Flood Management Project	0.5	Kohala Hydro Project	2.4
PNR South Longhaul Project	3.4	**TOTAL**	**16.8**
Safe Philippines Project, Phase 1	0.4	*% of GDP*	*5.5*
TOTAL	**4.4**	**SRI LANKA**	
% of GDP	*1.4*	Colombo Port City	2.4
THAILAND		Hambantota deep sea port	1.6
Thai-Chinese High Speed Train	5.7	**TOTAL**	**4.0**
% of GDP	*1.3*	*% of GDP*	*4.8*
CAMBODIA		**BANGLADESH**	
Phnom Penh-Sihanoukville motorway	1.9	Padma Bridge Rail Link	3.3
New Phnom Penh airport	1.5	Dhaka Chittagong rail link	6.0
New Siem Reap airport	0.9	Payra power plant (1320MW)	2.0
TOTAL	**4.3**	Marine Drive expressway	2.9
% of GDP	*19.3*	Elevated expressway: Dhaka airport-Ashulia	1.4
LAOS		Four-lane highway: Dhaka-Sylhet	1.6
Chinese-Laos railway	5.8	**TOTAL**	**17.1**
% of GDP	*33.8*	*% of GDP*	*6.9*

Source: Nomura Global Economics estimates.

Of course not."

Nomura economists say the scheme will add 0.1 percentage points a year to China's GDP for the next decade, but also see it as an opportunity for poorer nations.

"The BRI is a platform for lower-income recipient economies to fast track to a higher stage of economic development by increasing FDI inflows, plugging infrastructure gaps, leapfrogging to a digital economy, and, importantly, integrating their trade into global supply chains, which can boost productivity and help lift potential growth," wrote economists led by Sonal Varma in April.

The fact that so many global leaders attended last year's Belt & Road Forum in Beijing also shows the international community's confidence in the scheme.

"That shows that a lot of countries have high expectations of strengthening their economic partnership with China. To that extent it's probably fair to observe that it won't be one-sided," said Konishi.

The ADB and other multilateral lenders are also on board. The ADB, Asian Infrastructure Investment Bank, European Bank for Reconstruction and Development, New Development Bank, the World Bank and the European Investment Bank signed a memorandum of understanding at the May 2017 forum, agreeing to cooperate on BRI projects that meet their existing mandates.

"The concept of promoting connectivity for shared prosperity is not new. We certainly share that vision. We should be able to work together, because we share the same vision."

That cooperation extends to cofinancings with other development banks, including the China-backed AIIB and NDB.

Collaboration between MDBs is an "open mechanism", says Goswami. "Because there is so much demand, there is plenty of room for others to come in."

"There are risks in major infrastructure projects, and these multiply when you cross borders."

Nomura notes that China has built up experience in managing outward investments, and describes the risks of BRI projects as 'manageable'. But the Japanese bank also called on multilateral lenders to help mitigate some of the challenges and enforce high standards.

"We believe China's own investment-led development has taught it valuable lessons, and via new multilateral funding institutions, there will be a focus on promoting the best practice of public-private partnerships and the role of market forces." ●

Asia-Pacific nations sign sweeping trade deal without US

Eleven countries, including Japan and Canada, signed a landmark Asia-Pacific trade agreement without the United States in early March in what one minister called a powerful signal against protectionism and trade wars.

The deal came as US President Donald Trump vowed to press ahead with a plan to impose tariffs on steel and aluminium imports, a move that other nations and the International Monetary Fund said could start a global trade war.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CP-TPP) will reduce tariffs in countries that together amount to more than 13% of the global economy – a total of US$10trn in gross domestic product. With the United States, it would have represented 40%.

"Today, we can proudly conclude this process, sending a strong message to the international community that open markets, economic integration and international cooperation are the best tools for creating economic opportunities and prosperity," said Chilean President Michelle Bachelet.

Heraldo Munoz, Chile's minister of foreign affairs, said he expected Chile's trade with China, its top trading partner, to continue growing alongside trade with CP-TPP countries.

Even without the United States, the deal will span a market of nearly 500 million people, making it one of the world's largest trade agreements, according to Chilean and Canadian trade statistics.

The original 12-member agreement, known as the Trans-Pacific Partnership (TPP), was thrown into limbo early last year when Trump withdrew from the deal three days after his inauguration. He said the move was aimed at protecting US jobs.

The 11 remaining nations finalised a revised trade pact in January. That agreement will become effective when at least six member nations have completed domestic procedures to ratify it, possibly before the end of the year.

"We are very hopeful like others that we will see the CP-TPP coming into effect about the end of the year or shortly thereafter," said Australia's Trade Minister Steven Ciobo.

'THE WAY FORWARD'

The revised agreement eliminates some stipulations originally demanded by US negotiators, including rules to ramp up intellectual property protection of pharmaceuticals. Governments and activists of other member nations worry the changes will raise the costs of medicine.

The final version of the agreement was released in New Zealand on February 21. The member countries are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

"We're proud … to show the world that progressive trade is the way forward, that fair, balanced, and principled trade is the way forward, and that putting citizens first is the way forward for the world when it comes to trade," Canadian Trade Minister Francois-Philippe Champagne said.

In January, Trump, who also has threatened to pull the United States out of the North American Free Trade Agreement, told the World Economic Forum in Switzerland that it was possible Washington might return to the TPP pact if it got a better deal.

However, on April 17, Trump appeared to put the idea to rest. "While Japan and South Korea would like us to go back into TPP, I don't like the deal for the United States," he tweeted.

"Too many contingencies and no way to get out if it doesn't work. Bilateral deals are far more efficient, profitable and better for OUR workers. Look how bad WTO is to U.S."

Trump vowed on March 8 to impose a 25% tariff on steel imports and 10% tariff on aluminium imports, although he said there would be exemptions for NAFTA partners Mexico and Canada.

Mexican Economy Minister Ildefonso Guajardo, in Santiago for the CP-TPP signing, told Reuters he would not allow the United States to use the tariffs to pressure it in the NAFTA talks. Champagne told Reuters that Canada would not accept duties or quotas from the United States.

(Reuters)

DAVE SHERWOOD, FELIPE ITURRIETA

Use a scalpel, not a bludgeon

Indiscriminate tariffs are not the answer to the current US-China trade imbalance, especially as China's once overwhelming competitive advantage has dwindled, says Dilip Parameswaran

Since Deng Xiaoping's famous Southern Tour in 1992, when China's paramount leader rekindled the country's economic reforms, and particularly since China's entry into the WTO in 2001, American consumers have gained significant purchasing power from low-cost imports from China. At the same time US manufacturers have lost competitiveness and market share against Chinese suppliers. Although this conflict often colours views of the recent rise in trade tensions between the two countries, it represents just one facet of a complex trade relationship.

For much of the past two decades, the spotlight was on China's exchange rate policy. Despite repeated complaints, particularly from the US, China kept the renminbi-US dollar exchange rate fixed for 10 years until 2005. Throughout this period, the renminbi was widely assessed as undervalued and China's exports gained considerable advantage in the years leading up to and following its entry into the WTO. That said, China also won much praise for keeping its currency steady during the Asian financial crisis when other Asian currencies were devalued substantially.

Successive American governments threatened to designate China a currency manipulator, but none of them carried out the threat. Eventually, China allowed a gradual appreciation of its currency from 2005 to 2014, raising its value cumulatively by 27%. This deflated much of the earlier criticism and many observers, including the IMF, concluded that the renminbi was no longer significantly undervalued. Last year, even the Trump administration refrained from labelling China a currency manipulator. In fact, during much of 2015, 2016 and even 2017, China struggled to keep its currency from sinking as its foreign-exchange reserves declined by nearly a fourth from US$4tr to US$3trn. Thus, on the charge of currency manipulation, we can argue that, whatever advantage China might have gained from its exchange rate in the past, it is no longer guilty.

What, then, accounts for the massive and repeated trade surpluses that have turned China into the 'factory of the world' and inflated its massive foreign exchange reserves? The main reason is straightforward: China simply had a massive low-cost labour pool that could be moved to the urbanised coastal regions to support a huge build-up of manufacturing facilities. To that extent, it was a fair deal that lifted millions out of poverty in China and benefited western consumers through lower inflation and higher consumption. However, this cost advantage is no longer a given as rising wages in coastal areas and stricter implementation of environmental regulations have started denting China's competitiveness. Although the country still rules global manufacturing with entrenched advantages, particularly of scale and infrastructure, its cost advantage is no longer formidable.

Beside low labour costs, China has been accused of tilting the competitive field in favour of its own companies in a variety of ways. At a macro level, it has kept its financing costs low by trapping the savings of households at a low return. Through its dominant state-owned financial institutions, it has directed credit to sectors based not just on their intrinsic viability but on the need to generate growth and employment. Over time, these practices have bestowed a fairly big advantage on its manufacturing industries, sometimes leading to overcapacity, as in steel.

Again, any complaints on that score must balanced against the praise China earned when the same state-directed lending fuelled the building of infrastructure in the years after the global financial crisis, adding to global demand when there was a dire need for it. It may also be argued that it is the Chinese banks, government and people who will eventually pay for supporting unviable industries and the accompanying build-up in debt to the extent of over 300% of GDP.

Another common charge is that, while China has been eager to tap foreign markets for its exports, it has been reluctant to open up its own markets to competing goods and services, particularly in financial services, insurance and technology. Meanwhile, it has been aggressive in mandating partnerships with local companies and pushing for technology transfers, enticing foreign companies with dreams of access to its massive domestic market. As a result, China is now on the threshold of becoming a global competitor in some high-tech industries, such as high-speed railways. Still, it is not easy to measure to what extent these practices have resulted in an unfair advantage and to put a dollar value on them.

What is indisputable is that China has emerged as a manufacturing powerhouse, before subsequently losing some competitiveness because of various factors. Its current-account surplus, which rose rapidly from 2% of GDP at the time the WTO entry to a peak of over 10% in 2007, has now fallen below 1.5%.

What has brought trade issues to the fore is the Trump administration's focus on the loss of American manufacturing jobs, which it has blamed mainly on the trade deficit with China (and within NAFTA). Although US unemployment is at a 17-year low of 4.1%, lost trade has hit some sectors and geographies particularly hard and given the political impetus to threats of tariffs against a range of Chinese products.

Many of the criticisms against China, including undervaluation of currency, have lost their vigour, whether through change of circumstances or passage of time. While other complaints, particularly those related to the opening up of its markets, tilting the playing field through directed credit and aggressive acquisition of technology, have a kernel of truth, tariffs are a blunt instrument in seeking redress. It would be far better for the US administration to address these issues on a sector-by-sector basis, establish a system to filter technologies open for sharing, and adopt a firm stance in seeking access to the Chinese domestic market against transfers of technology. Such targeted measures, implemented in coordination with Europe and other countries, would be fairer and be more successful in nudging China towards being a more balanced and cooperative trading partner.

**Dilip Parameswaran is founder and head of Asia Investment Advisors, an advisory firm specialising in Asian fixed income.*

STIMULATING SUPPLY

Asia has been a laggard in the global growth of sustainable investments, but interest in Green financing is growing fast. The ADB is backing steps to boost both supply and demand.

BY STEVE GARTON

Growing global demand for responsible investments has created an opportunity for Asia to finance more sustainable, long-term projects through the institutional capital markets. Connecting issuers and investors, however is proving a frustrating task.

Asian issuers see little benefit from "Green" financings that are just as expensive as conventional debt – or even more costly, given the additional opinions and monitoring required. And demand for responsible assets is yet to take off in the region's emerging markets, where price and absolute return are the dominant drivers for investors.

The ADB, which has been at the forefront of

Solar panels installed to provide electricity in Sumba Island, Indonesia.
Asian Development Bank

developing Asia's local capital markets since the Asian financial crisis two decades ago, is taking up the challenge.

"Green bonds are a natural fit for infrastructure financing," said Avonechith "Noy" Siackhachanh, senior adviser to the Economic Research and Regional Cooperation Department.

"In the context of more advanced markets like the US or Europe, you want to switch to new technology to promote cleaner development, but in our case we are starting from a low base, in terms of infrastructure. That's why we are promoting Green bonds for infrastructure under the Asian Bond Market Initiative."

The ABMI, and the related Asian Bond Market Forum, is an initiative of the ASEAN+3 grouping covering the South-East Asian region, China, Japan and South Korea. The ADB, which acts as the secretariat, has welcomed the introduction of Green bond standards for the ASEAN region, signed in November last year.

Noy at the ADB describes the growth of Green bonds as "very exciting", both for the development of Asia's financial markets and for the region's push to reduce emissions.

"We are looking at all aspects of the Green market in the region. We want to highlight to policymakers in our region (ASEAN+3) that you can't just promote Green bonds on their own. You have to link it to national strategy in addressing climate change," she said. "It has to be part of the climate initiative or else it doesn't work."

The ADB and the ABMI are backing efforts to stimulate both supply and demand.

On the buyside, Noy recognises that more education

Local markets: Recipe for integration

Asia's emerging capital markets offer a case study in the hurdles to regional integration. While local bond markets are now far deeper than they were before the Asian financial crisis of 1997-98, moving capital across borders remains a challenge.

The ADB and the ASEAN+3 Bond Market Initiative are looking to change that.

"We don't just want to promote local bond markets, we also want to promote regional integration," said Avonechith "Noy" Siackhachanh, a senior adviser at the ADB working closely with the ABMI.

"Sometimes the bond market is way too small or not efficient, so if you have a more integrated market you can pool more resources. You can pull funds from where you have a surplus of savings to areas where you don't have enough."

The ADB continues to promote standardised issuance across the ASEAN+3 region, to make it easier for issuers to sell bonds in another country – and for investors to buy them.

The ASEAN+3 multi-currency bond issuance framework (AMBIF) got off to a slow start, with only one deal completed since the standardised format was first conceived in 2012 – for Mizuho Bank in Thailand in 2015.

But its proponents say that interest is growing.

Cambodia is considering the format as it looks to kick start a domestic capital market, and discussions are under way to issue a corporate bond with a guarantee from the Credit Guarantee and Investment Facility, another ASEAN+3 initiative.

It is far from straightforward. Cambodia does not yet have a government bond market, so there is no obvious pricing benchmark, and even the choice of currency is far from clear. The country's official currency is the riel, but the economy is heavily dollarised.

There is also no custodian bank in Cambodia, so assets would need to be held in custody under the stock exchange system.

"There are a lot of challenges," said Tomo Yamadera, principal financial sector specialist at the ADB.

Still, Yamadera believes the AMBIF format could be used to create a bond market for professional investors from scratch, and is hopeful of completing a first issue in Cambodia this year, perhaps before the end of the first half.

"This would be a remarkable step in bond market creation," he said. "If they can successfully introduce the concept, others could follow."

The concept of a professional-only bond market has caught on in Japan, where the Tokyo Pro-bond format allows overseas issuers to borrow in yen using their existing global documentation, avoiding the costs of translation and local legal services. Japanese buyers, meanwhile, get access to new credits that may offer higher yields that are available in the domestic market.

The AMBIF format aims to do something similar in Asia's local markets. It calls for bonds to be settled domestically and listed on a stock exchange, to ensure continuous disclosure and promote secondary trading. And to maximise cross-border participation, documentation must be in English.

If the Cambodian experiment proves successful, the professional-only format under AMBIF documentation could play a key role in meeting the ASEAN region's commitment to integrate its capital markets – especially after Malaysia, Singapore and Thailand pulled the plug on a plan to connect their stock exchanges last year.

Yamadera acknowledges that many obstacles remain in place. Tight controls on currency speculation mean swap markets are thin, and regulators in many Asian markets place tight restrictions on investments from pension funds or insurance companies – even if a high-quality overseas credit may seem an appropriate fit.

But he sees the region's bond markets playing a bigger role in cross-border financing and infrastructure development. Higher compliance costs and capital charges are restricting bank financings, and more money is going to Asian institutional investors who need to generate steady returns.

"Infrastructure funding has been a challenge because the local markets were too small. Now we see the growth of institutional investors in every market," he said.

"All the ingredients are now in the pot and we are cooking. Hopefully we can make a very tasty soup."

STEVE GARTON

"You can't just promote Green bonds on their own. You have to link it to national strategy in addressing climate change."

around environmental, social and governance (ESG) strategies can help create a broader base of investors for green assets.

"We are recommending to ASEAN+3 that they must look at ESG. They should encourage responsible institutional investors to be more aware of ESG, including the benefits of what it does, and make ESG part of the requirement of licensing to become an institutional investor," she said.

Few Asian institutional investors have signed up to global responsible investment standards, such as the United Nations' PRI programme, and absolute returns remain the primary focus for most of the region's fund managers.

That, Noy says, is not the main hurdle.

"The demand side in our region is not too much of an issue, as there is so much demand for investments," she said. "On the issuer side, they are not so comfortable with the costs and monitoring involved."

Green bonds rarely deliver lower borrowing costs for issuers, since they are also offered to conventional investors and are based on market pricing (although there have been some exceptions in Australia, where dedicated state funds add to demand).

Instead, borrowers looking to meet global standards need to pay for an independent second opinion, which can run to around US$50,000 – small fry for a major issuer, but a significant barrier to Asia's smaller companies.

Singapore and Hong Kong have offered to help offset these costs through grants, in the hope of attracting more issuance and showcasing their own green credentials. Hong Kong this year announced a three-year grant scheme to cover half of the issuance costs for eligible first-time Green bond issuers in Hong Kong, capped at HK$2.5m (US$318,473). The Monetary Authority of Singapore has offered to cover 100% of the costs of an external review, up to S$100,000 (US$76,291) per issue.

Noy at the ADB is in favour of expanding those schemes across the region.

"We are suggesting (to ASEAN+3) that we could set up a facility similar to the one that MAS is doing in Singapore to try to help offset some of the costs for a potential issuer," she said.

But she stops short of promoting tax incentives for investors or less-targeted subsidies, saying these are "not good economics".

Green financing should fit in an issuer's financing strategy, rather than allow it to pile on more debt at a lower cost.

"Why do people want to issue Green bonds? One, they want to broaden their investor base. Two, they want to build their reputation as a responsible issuer," said Noy.

There have been some notable successes. Star Energy, an Indonesia power producer with a big geothermal portfolio, sold a US$580m 15-year bond, callable after eight years, on April 17. The secured deal refinanced project loans in the institutional market and was the first Green bond from Indonesia's corporate sector.

GLOBAL STANDARDS

Asian issuers are also finding themselves at the centre of the global debate around green standards. Some investors argue that green financings do not come with enough safeguards to prevent the proceeds from being misused, since many deals are self-labelled, and compliance is voluntary. And individual countries have imposed their own rules, which often differ from the global standard.

China has a set of mandatory guidelines for state-owned enterprises that require only 50% of the proceeds of a "Green" financing to go towards green assets – putting some of the debt off limits for dedicated green funds.

The ASEAN Green bond guidelines, released in November, are in line with the global Green Bond Principles, a set of rules managed by the International Capital Market Association in its secretariat role.

Even under those rules, however, there are concerns over "greenwashing", where an asset may not be as green as claimed.

A €500m Green bond in 2017 from Spain's Repsol proved controversial, as some green funds refused to invest in debt from an oil and gas company – even though it adhered to the Green Bond Principles and promised to reduce the company's carbon dioxide emissions.

Bangchak Petroleum, a Thai oil company, sold a Bt3bn Green bond in February 2015, split between 12-year and 15-year tranches, to finance a push into renewable energy. Local life insurers bought the self-labelled deal, but the global Climate Bonds Initiative said it did not have enough information to be confident calling it a Green bond.

At the other end of the spectrum, the ADB itself is committed to being a regular Green issuer. It last issued Green bonds in August 2017, raising US$1.25bn in a five-year and 10-year offering. The second opinion on the bank's Green bond framework comes from UN-backed Cicero, the Center for International Climate and Environmental Research – Oslo.

The ADB is on track to double its annual climate-aligned financing commitments to US$6bn from 2015 to 2020, accounting for around 30% of its overall financing by the end of this decade. ●

DON'T FEAR THE DISRUPTER

The rapid growth of digital technologies is bringing with it both fear and opportunity for Asian economies. Productivity gains should outweigh any loss of jobs, but Asia still needs to be on guard.

Master Xianfan looks at robot monk Xian'er as he demonstrates the robot's conversation function during a photo opportunity in Longquan Buddhist temple on the outskirts of Beijing. REUTERS/Kim Kyung-Hoon

BY STEVE GARTON

Back in 1980, when automated teller machines were beginning to catch on in the US, a Wells Fargo executive predicted the end of the traditional branch network. Thousands of jobs would go as machines took over the tasks of handling money, since customers would no longer need to visit a physical branch.

In fact, the reverse happened. ATMs did not replace bank branches; they made them more efficient. By taking away some of the routine tasks, the cash machines freed up bank staff to work on more profitable activities, and made the branches themselves cheaper to run. As a result, banks opened more branches.

This often-cited example is still relevant today, at a time when Asian workers are facing the threat of disruption from new technologies.

Will artificial intelligence replace business process outsourcing in India and the Philippines? Will textile workers in Bangladesh be replaced by robots?

The ADB has devoted a considerable amount of its research efforts to answering these questions, including an extensive chapter in April's flagship Asia Development Outlook report.

The overall findings are encouraging.

"Across history, automation has always resulted in displaced workers. This anxiety is as old as mankind's first technological breakthrough," said Yasuyuki Sawada, ADB chief economist. "However, displacement has always been accompanied by rising productivity, the emergence of new occupations and better-paid jobs."

Washing machines, refrigerators or electric cars may still be out of reach for many Asian workers today, but lower costs from more efficient production processes can stimulate demand in the future.

DEMAND AND DISPLACEMENT

The ADB calculates that, in job terms, higher demand has more than offset the disrupting impact of labour-saving technology. Whereas 101 million jobs a year might have been lost in 12 countries of developing Asia between 2005 and 2015 if output had stayed constant as productivity increased in line with technological progress, growing demand for goods and services instead led to the creation of a net 134 million jobs a year, equivalent to an 88% increase in employment, the ADB reckons.

"This whole phenomenon of productivity going up sets in motion a number of different effects that actually leads to job creation," said Rana Hasan, director of the development economics and indicators division, who worked on the report. "Henry Ford's assembly line was able to reduce the number of workers per car produced, but the demand for cars skyrocketed so much that it cancelled out any displacement."

Improvements in technology can also increase earnings through productivity gains. Indonesian motorcycle taxi app Go-Jek is another popular example, raising income for moped owners by connecting them with nearby customers via their smartphones.

"While there are growing concerns that new technology could lead to widespread job losses, there are compelling reasons to remain optimistic about developing Asia's job prospects," said Sawada.

Sawada notes that automation only goes ahead when it is economically feasible. Across Asia, robots are found mainly in capital-intensive sectors that already employ relatively few workers, such as the electronics and automotive industries. Food and textiles, which together account for 31% of Asia's manufacturing jobs, employ less than 1% of the region's industrial robots.

The unknown factor, however, is the pace of change associated with the digital economy – the fourth industrial revolution, as it is often called.

Productivity gains in Asia have so far largely come from improvements in existing technologies within specific sectors. Smart irrigation systems, for instance, do not replace the job of growing rice. Nor do higher-quality fabrics displace textile workers.

The digital transformation challenges these notions. Automating more complex tasks could displace entire industries, shifting manufacturing jobs to entirely new sectors where the existing workforce does not have the skills to compete. A 2016 report for the International Labour Organization found that 56% of all jobs in five ASEAN countries (Indonesia, Thailand, the Philippines, Vietnam and Cambodia) faced a high risk of automation.

Routine jobs are especially vulnerable, including both manual labour and cognitive tasks such as customer help desks. Conversely, robots are not yet capable of displacing non-routine manual workers, such as cooks or hairdressers, or cognitive functions, such as researchers or people managers.

Looking at new job titles recorded in member countries, the ADB's analysis notes that most positions created in the latest year were both non-routine and cognitive in nature – web designers or digital artists, for example. Wages also rose faster in those sectors than for manual tasks.

"Without adequate skills or retraining, workers with weaker foundation skills face hurdles in seizing the opportunities that new technology provides," said Sawada. "Low-skilled workers are also more likely to experience lower wage growth, thereby exacerbating inequality."

The growth of the "gig economy" and entrepreneurial start-ups also poses challenges around social protections. While these jobs may offer higher wages, workers often rely on casual, short-term contracts with limited benefits.

"Governments must respond to these challenges by ensuring workers are protected from the downside of new technology and able to harness the new opportunities they provide," said Sawada.

OPPORTUNITIES FOR ASIA

Rather than fearing disruption, the ADB argues that technology presents Asia with an opportunity to build on its growth momentum.

Improved connectivity and access to the internet can accelerate development and job creation by opening up more remote regions to trade, from the mountains of south China to the Solomon Islands.

Governments also have the opportunity to use technology to improve efficiency, through enhanced tax collection, targeted subsidies and enhanced monitoring. India's Aadhaar card programme, for example, has attracted over 1 billion registrations with the promise of a more user-friendly alternative to the traditional system that relies on different paper licences for each government service.

Financial technology also promises to open up banking services to new groups of customers, enhancing inclusive growth.

Hasan argues that Asian governments can embrace technological advancement without fearing a mass displacement of jobs back to the US and other more developed economies.

"The big message is that Asia is getting more sophisticated," said Hasan. "There are things you can do around preparing for this technological change, around teaching, the delivery of skills and matching workers with jobs."

The ADB's outlook report closes with a call for Asian governments to harness these opportunities for the region's development. The rise of Asia's middle class, the report says, is bringing with it new demand for goods and services that can both drive Asian development and reduce its dependence on exports to the West.

"With the right policies, new technologies can play a key role in this transition." ●

FINTECH: Betting on blockchain

Advancements in financial technology are opening up new opportunities for fast-growing Asian companies to finance trade and expansion, but pose new challenges for the region's regulators. How can blockchain technology help power Asian development, and are Asia's central banks ready to embrace virtual assets?

The ADB has so far been quiet on the topic of blockchain technology or virtual currencies, but the 2018 annual meetings promise to change that. Discussions on the future of finance feature high on the agenda, and ADB President Takehiko Nakao is due to debate the topic in a joint seminar with the IMF and the Philippines central bank on May 3.

The IMF, under Managing Director Christine Lagarde, is playing a leading role in calling for tighter regulation of digital finance. In a speech at the Boao Forum for Asia in April, in front of Chinese President Xi Jinping, she called on China to close a "regulatory gap" in the financial technology arena.

"Here in Asia, we see a blossoming of fintech industries. Yet the rise of fintech is revealing regulatory gaps which, if not closed both domestically and on a cross-border basis, can lead to systemic risks. You do not want to risk that. Instead, transform safely, and be more inclusive!"

Lagarde has warned repeatedly of the potential misuse of alternative financial systems – especially crypto-assets – for money-laundering and terrorist financing, and has put the IMF at the centre of efforts to coordinate a global regulatory response.

But she has also advocated for even-handed regulation that permits innovation.

"Just as a few technologies that emerged from the dot-com era have transformed our lives, the crypto-assets that survive could have a significant impact on how we save, invest and pay our bills," she wrote in a blog post in April. "That is why policymakers should keep an open mind and work toward an even-handed regulatory framework that minimizes risks while allowing the creative process to bear fruit."

The most promising new technology to arrive in the financial sector is undoubtedly the blockchain, or distributed ledger technology, where a secure record of transactions is kept in 'blocks' of data and protected by cryptography. The technology can allow automated verification between parties in a supply chain, reduce the need for intermediaries in a trade financing, or power smart contracts that execute themselves.

Commercial banks are already looking to use DLT to streamline their anti-money laundering checks and automate some transactions. Stock exchanges are studying its use for securities settlement.

Steven Beck, who heads the ADB's popular Trade Finance Programme, wrote in December that a lack of global standards was preventing blockchain technology from helping SMEs access financing.

"The hype is fun and dreaming is important, but to catch up with reality we need to develop some basic infrastructure," he wrote.

Beck advocates the use of digital standards for trade and steps to encourage the digitisation of supply chains, and has called for "a global harmonized identity for all companies, large and small" to simplify transparency and due diligence processes.

Central banks have also begun to explore the use of new technology for their own digital currencies.

The People's Bank of China is widely seen as the most likely Asian central bank to be first to launch a digital currency. The PBoC has been studying the idea since at least 2014, even as regulators have clamped down on trading in crypto-currencies and initial coin offerings. Then central bank governor Zhou Xiaochuan said in March that the digital currency would be used only for payments and would have no effect on monetary policy, heading off speculation that it would be an alternative virtual asset.

Elsewhere, the Bank for International Settlements warned in a report in March that "a general purpose central bank digital currency could impact bank deposits, a major source of funding for commercial banks, with implications for financial stability". But it said a digital currency showed promise for wholesale payments, potentially making the settlement of securities and FX transactions more efficient.

Lagarde, in a speech at the Bank of England last year, outlined a future where virtual currencies could be more stable than the central banks' traditional paper bills.

"In many ways, virtual currencies might just give existing currencies and monetary policy a run for their money," she said. "The best response by central bankers is to continue running effective monetary policy, while being open to fresh ideas and new demands, as economies evolve."

STEVE GARTON

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BUILDING CONSENT

President Duterte's ambitious infrastructure programme may be laying the foundations for stronger long-term growth, but the government's funding strategy is not keeping everyone happy.

A construction worker stands over the newly dried concrete and secure linking steel bars of the 5.58 kilometre elevated highway in Caloocan City, metro Manila, Philippines. REUTERS/Romeo Ranoco

BY STEVE GARTON

The Philippines' infrastructure problems are immediately apparent to anyone arriving in Manila's main airport. The traffic slows metres from the ageing Ninoy Aquino International Airport terminal, and gets steadily worse throughout the ride to the gleaming new business district of Bonifacio Global City. The five-kilometre journey takes 45 minutes.

President Rodrigo Duterte has run out of patience. A year after he took office, his administration had ramped up infrastructure spending to 5.4% of GDP, from 4.5% in 2016. It is set to hit 7.3% of GDP in 2022.

The five-year "Build, Build, Build" programme has identified 75 flagship infrastructure projects totalling US$160bn–$180bn, including the expansion of Clark airport and Manila's first mass transit subway. Already 23 of those are fully approved.

The increased spending has lifted confidence in the economy, but Duterte's infrastructure agenda also brings with it concerns and contradictions that have not gone down well with everyone.

As well as spending more, the government has shelved many of the public-private partnerships that were in the works under the previous administration. Most of the projects on the new priority list are to be financed by the government, or through overseas development assistance (ODA) loans from richer nations, mostly Japan and China, leading to criticism that the government is piling on debt.

Economists are mostly comfortably with the additional borrowing, noting that the Philippines' solid growth and strong balance sheet (partly the result of under-investment by previous administrations) gives it some room to manoeuvre.

But proponents of the PPP model are less impressed. Only two of the 75 projects on Duterte's list involve private sector partners, and sponsors face an uncertain future for the projects that did not make it on the Build, Build, Build list. Unsolicited bids are allowed, but there are concerns of a lack of coordination.

"The government says it is open (to unsolicited bids) but the entry points are not so well defined," said Sol Castro, managing director at CFP Transaction Advisors, an independent consultancy. "Private sector partners need to create their own market."

Duterte's list dropped the upgrade of NAIA, Manila's main airport, in favour of the rehabilitation of the Clark airbase. But two bidders, Filipino-Indian venture Megawide GMR and a "super consortium" of seven of the country's biggest firms, have since submitted unsolicited proposals to expand NAIA.

The economic development agency has also accepted an unsolicited bid from San Miguel to build a mega, six-runway airport in Bulacan, north of Manila but south of Clark. A group backed by Henry Sy's Belle Corporation has also proposed an airport at Sangley Point in Cavite, less than 20km south of NAIA.

Unsolicited proposals, if accepted, are open to rival bidders via a Swiss challenge, but there is no government funding for feasibility studies, and officials are focusing their efforts on projects that can be completed under the current administration.

That has led critics to claim that Duterte, having complained of delays under the PPP format, has himself caused unnecessary delays to projects that did not make the Build, Build, Build cut.

NO MORE PPP?

Funding for Duterte's projects comes almost entirely from the national government and ODA loans.

The first phase of the Metro Manila Subway project, for instance, is funded by a ¥575.7bn (US$5.3bn) loan from the Japan International Cooperation Agency and US$2bn from the Philippines.

Despite Duterte's well-publicised dislike of the PPP model, the government says it has not abandoned the concept. Finance Secretary Carlos Dominguez said in April that the government was following a "hybrid" PPP model, where projects use a combination of state funds, ODA loans and investment-grade bonds to speed up execution.

Bankers remain hopeful that the financing markets will play a role.

The ADB, and others, have pushed the bond market as a tool for project financings, but take-up has been slow. Aboitiz Power refinanced its Tiwi-Makban geothermal complex through a bond in 2016, using credit enhancement from the ADB and the Credit Guarantee and Investment Facility (CGIF). But the notes were not widely sold, and critics say the credit enhancement was a response to single-borrower limits, rather than a vindication of the project financing structure.

"We can do project bonds in the Philippines. All the workings are already in place," said Eduardo Francisco, president of BDO Capital.

While some completed projects have made their way into the bond markets, efforts to use the capital markets for greenfield projects have yet to bear fruit. The CGIF is promoting a construction risk guarantee to help sponsors access institutional capital before their projects are operational, but Francisco argues that the liquid local banking system is still the first port of call.

"The real reason it hasn't moved is that companies find these guarantees expensive," said Francisco. "Borrowers will first do project financing with the banks, and then later when it is operational they can do a project bond."

The local capital markets have shown demand for infrastructure assets. NLEX, the operator of the North Luzon Expressway, sold Ps6bn (US$115m) of seven-year and 10-year bonds in March to refinance debt. NLEX is majority owned by Metro Pacific Investments, but bondholders do not have recourse to the sponsor.

At least one company is looking at an infrastructure IPO on the Philippine Stock Exchange, which relaxed its listing requirements for PPP issuers in early 2017. The PSE rules waive the track record requirement for major infrastructure projects with a value of at least Ps5bn and minimum contract of 15 years, giving sponsors another option to recycle their capital once the construction phase is complete.

The challenge of actually getting to the PSE, which moved into its new home in Bonifacio earlier this year, may even present another project finance opportunity.

Among the many unsolicited proposals is a plan from Andrew Tan's Alliance Global Group to build a monorail connecting BGC to the existing transit network. And once the subway is completed in 2025, the slow road from the airport may finally be a thing of the past. ●

READY FOR AN UPGRADE

Regulators are hoping that a package of reforms – supported by a US$300m ADB facility – will stimulate the Philippines' capital markets and provide better access to long-term funding for local companies and infrastructure developers.

Children attending school in Barangay Katipunan. Many families from the barangay are recipients of the Conditional Cash Transfer (4Ps) program of the Philippines. Several small infrastructure in the barangay were also funded by the Kalahi-CIDSS progam.
Asian Development Bank

BY STEVE GARTON

The Philippines has established itself in recent years as a favourite among global emerging-market investors. Its sovereign bonds are so popular in the US dollar market that its latest 10-year issue priced in January at 3.0%, a mere 37.8bp premium over US Treasuries.

Strong economic growth and a prudent fiscal policy have lifted the country to a solid investment-grade rating from all three major credit agencies. Fitch raised its sovereign rating to BBB in December, falling in line with Moody's (Baa2) and S&P (BBB).

The ADB projects an acceleration in GDP growth to 6.8% in 2018 and 6.9% in 2019, up from last year's 6.7%. The fiscal deficit shrank to 2.2% in 2017 from 2.4% a year earlier.

The local capital markets, however, do not look so advanced. Investment and capital formation is weak, the corporate bond market is shallow, and liquidity on the stock exchange is poor. The market capitalisation of the entire stock market is barely half that of Indonesia, and far less than Thailand, Malaysia or Singapore.

Outstanding local currency bonds – largely government debt – represent only 34.2% of the country's GDP. Corporate bonds account for around 17% of all issuance, with 87% of that coming from the top 30 companies, according to ADB data. And weak money markets mean Philippines banks – and the national treasury – hold massive amounts of reserves that could be put to better use elsewhere: the government's bond sinking fund sucks up 8% of GDP.

The current administration is taking steps to address those failings, in part to finance its increase in infrastructure spending under President Duterte's 'Build, Build, Build' initiative.

The central bank, securities regulator, finance ministry and national treasury signed off on a sweeping package of reforms in August 2017 to revamp the domestic bond market. The measures are the latest under a policy-based programme agreed with the ADB in 2013, and came with a US$300m loan to support the second phase of the project.

The reforms include a plan to consolidate sales of government bonds into six liquid tenors, to lower issuance costs and produce a more efficient yield curve. Primary dealers will also be required to make markets in an effort to boost two-way trading volumes, and the repo market is to be overhauled. The central bank, in particular, has welcomed the creation of an organised interdealer repo market, which aims to boost liquidity by allowing securities lending and two-way trading of government securities, in line with global standards.

Officials hope the package will enhance liquidity in the government bond market and make the whole system more efficient. By reducing the vast pools of money currently held in reserve, the reforms aim to free up capital for real investment. In time, the improvements should filter down to the corporate bond market, supporting long-term financings and freeing up banks to lend to infrastructure.

BANK LIQUIDITY

There are other hurdles to stimulating the capital markets. Eduardo Francisco, president of BDO Capital, argues that corporate banks are the biggest obstacle.

"The Philippines bond market is small, but it's not underdeveloped. We have all the products," he said. "It's the banks that are holding it back. It's a by-product of the liquidity in the banking system."

Local companies have little trouble accessing bank credit, and long maturities are available for the top names at low cost. That gives borrowers little incentive to make the extra effort to engage the capital markets.

The banks are lending more, too. A spate of big rights issues from the country's top banks points to rising credit growth, the result of booming confidence in the corporate sector. Bank credit to businesses increased 18.1% in January 2018, according to ADB data.

Capital markets bankers, however, see reasons to be optimistic.

Alongside the government bond reforms, market participants hope that broader changes to the tax system will make the capital markets more competitive. President Duterte signed the first stage of the Tax Reform for Acceleration and Inclusion (Train) law in December and is working hard to push the next package through the Senate. There is some talk that withholding tax on securities will be clarified in the second bill, alongside measures to encourage savings and investment.

Things may also be looking up for the local stock market, which is already set for a record year for equity

Reform measures

The Philippines central bank, finance ministry, securities regulator and national treasury announced a package of reforms on August 25 2017 "to spur the further development of the domestic debt market to enhance the country's economic growth and financial sector development".

The reforms include:

(1) a permanent increase in the volume of treasury bills,
(2) the consolidation of government bonds into 6 liquid tenors : 2Y, 3Y, 5Y, 7Y, 10Y, and 20Y
(3) the adoption of common semi-annual coupon payment dates,
(4) the designation of market makers with concomitant obligations and privileges,
(5) the introduction of a GMRA-based repo market,
(6) the consideration of an SRO for a possible organized OTC market, and
(7) regulatory reforms to support the adoption of a market based and IOSCO-compliant market pricing benchmarks.

Source: Bangko Sentral ng Pilipinas

issuance in 2018.

At least eight deals are in the works for a total of over US$4bn, comprising IPOs, follow-ons and rights issues from both the corporate and financial sectors. San Miguel's restructuring, injecting its beer and beverage assets into the former Pure Foods, is set to trigger a US$2bn–$3bn deal that would be comfortably the country's biggest share sale on record.

That would be a big turnaround from 2017, when equity issuance totalled less than US$1.5bn, the lowest in South-East Asia's major stock markets, and only three IPOs crossed the US$100m mark.

The stock exchange is also acquiring Philippine Dealing System Holdings, which runs the country's main fixed-income exchange, in a move designed to improve transparency and liquidity by reducing "double collateralisation" among the brokers.

There is also talk of the first infrastructure listing, which would allow project sponsors to raise capital at an earlier stage, although the introduction of real estate investment trusts remains complicated by strict free-float requirements and tax rules.

It is no coincidence that the reforms have accelerated under Duterte. The controversial Davao strongman has made infrastructure spending a central focus of his presidency, and has both the support and the determination to push through reforms to make it happen.

"It's all about creating an enabling environment for long-term infrastructure finance," said one official involved in some of the reforms. "The government has money, but not that much. They need a good domestic market."

Many of the measures were conceived in the previous administration, but it is the current one that will take the credit for their implementation.

"People have been trying to change the tax system for decades, but [Finance Secretary Carlos] Dominguez gets a lot of credit for getting it done," said the head of one local bank.

Dominguez has been clear about the importance of developing the domestic capital market.

"The development of the domestic capital market will provide complementary local currency resources for our infrastructure programme and reduce our vulnerability to vicissitudes in the external environment," he said in August.

The official involved in the reforms puts it more bluntly.

"The Philippines has an investment-grade rating but a basic bond market ... It's time for an upgrade." ●

Philippines rewrites Panda playbook

The Republic of the Philippines shook up the Panda bond market in March with an exceptionally tight debut that underscored the growing role of overseas investors in onshore renminbi financings.

The Baa2/BBB/BBB rated sovereign priced the Rmb1.46bn (US$230m) 5.0% three-year notes in China's interbank market at the low end of 5.0%–5.6% indicative guidance.

In a first for the Panda market, most of the bonds went to overseas buyers, helping the Philippines smash through pricing expectations and leaving other issuers scrambling to understand the achievement. Offshore investors took an auspicious 88% of the notes.

Final pricing represented a spread of only about 35bp over the three-year notes of China Development Bank, rated Aa3/AA– (Moody's/S&P), and no premium at all over the Rmb10bn three-year issue of Central Huijin, a unit of sovereign wealth fund China Investment Corp, also priced at 5% last week.

Of the five sovereign Panda bond issuers so far, only South Korea (Aa2/AA/AA–), rated five to six notches higher than the Philippines, has priced at a tighter spread over CDB.

Less than two months earlier, the government of the Emirate of Sharjah, rated A3/BBB+ (Moody's/S&P), offered a 103bp premium over CDB for its Rmb2bn three-year Panda at 5.80%.

The other two sovereign issuers, Poland (A2/BBB+/A–) and Hungary (Baa3/BBB–/BBB–), paid 60bp and 83bp over CDB, respectively.

HOME SUPPORT

The stunning pricing was the result of overwhelming demand via the Bond Connect link, which gives international investors direct access to the Chinese market through Hong Kong.

Sovereign wealth funds and Philippine banks contributed significantly to the offshore bid, according to market sources.

"It is likely that Philippines banks supported the sovereign deal, just like Chinese banks back their sovereign deals," said a DCM banker away from the deal.

Orders came in much stronger than expected after books opened last Tuesday, according to sources familiar with the matter.

"The issuer was confident about demand, following the roadshow the previous week. Still, the momentum of the bookbuilding far exceeded our expectations," said one of the sources.

The offering was 6.3 times covered with Rmb9.2bn of orders, the biggest book and the largest oversubscription of any of the sovereign Pandas to date.

The final allocation to Chinese onshore investors was just over 10%. Onshore bids made up half of the total order book, but most of them were outpriced by offshore accounts, sources said. Further distribution statistics were not available.

The achievement caused some soul-searching among some participants in previous sovereign Panda bonds, who were scrambling to explain why their deals had paid a higher spread.

The DCM banker away from the deal said he was drafting a report to clients "hopefully in a tactful way".

Bankers on the deal said the offering demonstrated the importance of offshore support at a time when China's onshore bond market held little pricing advantage for foreign Panda bond issuers.

"The deal shows that reaching out to offshore orders was a good idea for Panda bonds, which we did not think about before," said another Beijing-based DCM banker away from the deal.

Despite cheaper funding in the offshore renminbi debt market, potential sovereign issuers would stick with the Panda bond market, bankers said.

"Panda bonds have a much better marketing effect for sovereign issuers, whose primary goal is to build/enhance relations with the Chinese government," said a banker.

Like other recent Panda issuers, the Philippines also made a play on the Belt and Road theme.

The prospectus said proceeds would be remitted offshore as part of the country's international reserves. Some of the funds may be converted to pesos to fund budget expenditures and to support Belt and Road projects.

METICULOUS PLANNING

The sovereign had started preparing the ground for the offering very early. In late September, Philippine officials visited China to deliver a first pitch and to discuss investment opportunities in domestic infrastructure projects.

In November, the country signed an agreement with Bank of China during Chinese Premier Li Keqiang's visit to Manila. It received approval from the People's Bank of China in February.

Then, a week before the deal, a Philippine delegation, led by National Treasurer Rosalia de Leon and Bangko Sentral ng Pilipinas Deputy Governor Diwa Guinigundo, met potential investors in Singapore, Hong Kong and China.

Bank of China was lead underwriter on the offering with Standard Chartered Bank (China) as joint lead underwriter.

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