THE AUSTRALIAN APEC STUDY CENTRE

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Asian infrastructure: lifting private finance and institutional investment?

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The expectations on institutional investors are particularly high – but are they realistic?

Infrastructure spending has been trending down in the Western developed world, since the 1980s, to a level of about 2.5% of GDP. In contrast, East Asia has taken the lead in building new infrastructure, led first by Japan, and then by China (over 8% of GDP over two decades). Asia is, of course, not a uniform continent in any sense, nor is the state of its infrastructure. There is need for much more investment everywhere to keep pace with economic and demographic growth, urbanization, social change and climate-related action.

The Asian Development Bank[2] has just doubled its estimates of future infrastructure investment needs in developing Asia to US$ 1.7 trillion per year, i.e. about 6% of GDP. South Asia and the Pacific islands will require a much higher 9% of GDP. Outside Japan and China, the ADB also calculated a more immediate "investment gap" (i.e. the difference between actual and required spending) of about 5% (!) of GDP over the next 5 years.

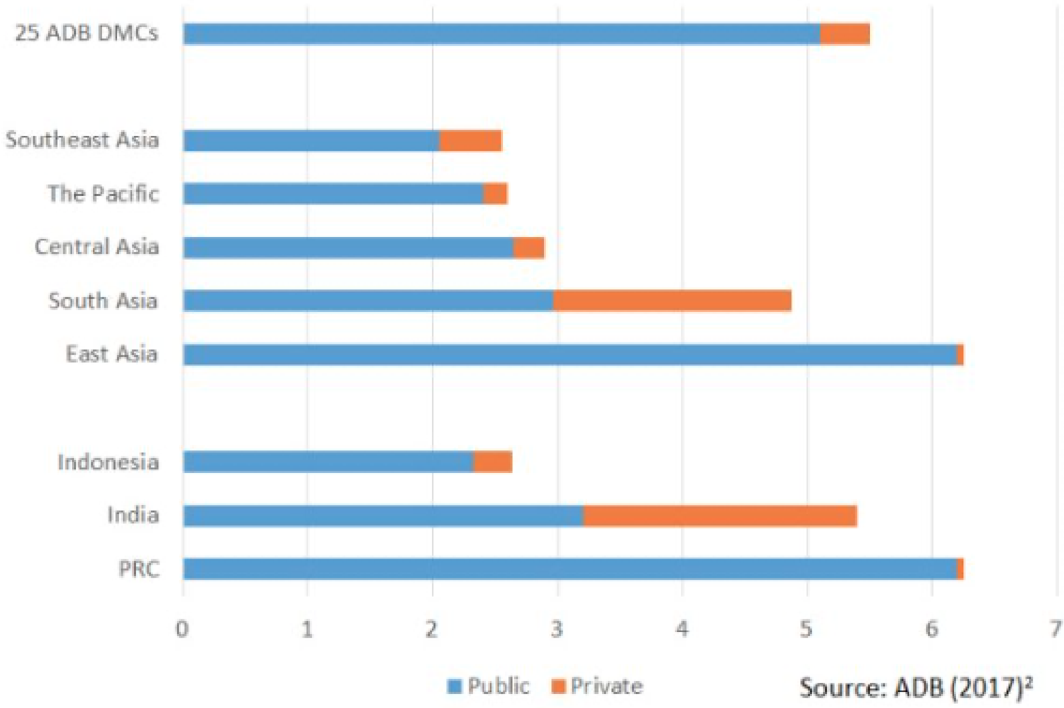
Dominance of state spending and public finance

The question is: where will all the money come from? Many Asian governments now expect the private sector to jump-start its involvement, with the ADB[1] hoping for an additional private finance of 3% of GDP in the nearer term. However, Asia is not starting from the best position in this respect, as a comparison with other regions shows[3]:

- Asia's infrastructure is mainly driven by the state. The ratio of public to private finance is about 2:1 to 3:1 (or even higher in China), compared to a ratio of roughly 1:2 in Europe and North America (Figure 1)

- The private sector still plays a subdued role, often supported by substantial government subsidies and guarantees. Both privatizations and public-private partnerships (PPP) are below the global average. Frequently, there is not much clarity about the behaviour of state-owned enterprises.
- Private participation in infrastructure investment is still only 0.1%-0.2% of GDP in most of Asia, and much lower than the global emerging markets average of 0.6%-0.8%[4].
- Asia's project finance is very dependent on bank loans, especially from state-owned banks and development institutions. Foreign and non-bank lenders are frequently deterred by low credit standards and excessively cheap funds from public banks[5].

Figure 1: Public and Private Infrastructure Investment, 2010–2014 (% of GDP)



Source: ADB (2017)[2]

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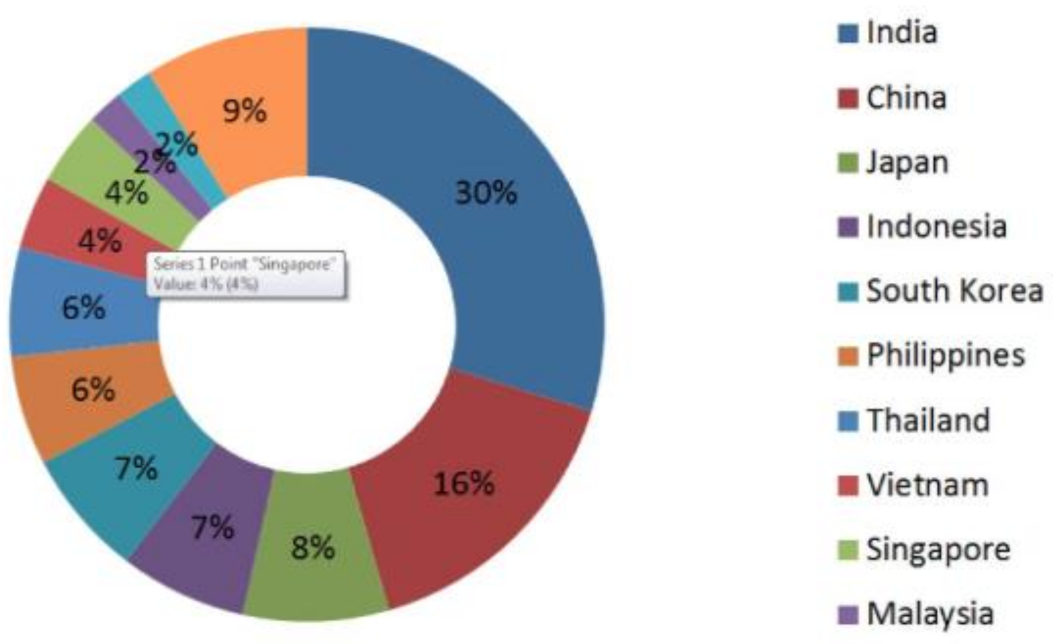
Scope for capital market development

There is scope for more securitisation in this field, even in countries with relatively advanced capital markets such as Korea, Taiwan or Thailand that provide, e.g. stocks and corporate bonds of utility companies. For example, listed infrastructure companies only constitute about 2%-2.5% of GDP in Asia, which is roughly half the global average. The use of project bonds or US style revenue bonds is still tiny overall, although interest is rising in some places[6,7].

Furthermore, there is also a shortage of appropriate investment vehicles for investors. Not too many dedicated infrastructure funds are on offer, with the main focus being India and China (Figure 2, *Source: Preqin Ltd (2015)*[8]). The annual deal flow generated by such funds in Asia is growing but still at a comparatively low 0.1%-0.2% of GDP.

Figure 2: Breakdown of Asian Infrastructure Deals by Country, 2010 - 2015



Institutional investors to the rescue?

Cash-strapped governments are increasingly pleading for a higher engagement from domestic and international asset owners. However, the local scene is rather concentrated, with a pre-dominance of public reserve funds, social security funds and sovereign wealth funds (SWF). The private pension systems are very small in Asia. Even in the best countries (Singapore, Japan, Korea), funded pension assets are well below the OECD average of 84% of GDP, with developing Asia at less than 5%. In contrast, Asia has a significant share of 40% of global sovereign wealth funds, and there is massive capital with other public institutions, including central banks. Therefore, much will depend on the specific behaviour of large public funds.

Conservative investment policies and regulation

Most Asian investors traditionally run very conservative investment policies with a high allocation to domestic government bonds and deposits. Investor regulation tends to keep insurers and pension funds away from more risky and less liquid assets such as infrastructure debt and equity. The current asset allocation to unlisted infrastructure is estimated, on average, at 1% or less. Some change is change is underway. For example, the world's largest pension scheme, Japan's Government Pension Investment Fund (GPIF), started to move into infrastructure in 2015. An Indonesian state-run pension fund has recently pioneered with a first infrastructure deal.

"Missed opportunity" for foreign investors

But higher commitments to real assets do not necessarily mean more finance for Asian infrastructure. Singaporean and Chinese SWFs have been very active in European real estate and infrastructure markets in recent years, and so has the Korean National Pensions Service, in line with many other large Asian funds.

What about international investors? Asia's attractiveness has so far been sub-par. There are widespread restrictions for FDI in infrastructure sectors not only in China but also in most ASEAN and South Asian countries. Other factors that make life difficult for potential foreign investors include cryptic regulations and land laws, bureaucracy and judicial processes. A number of international asset owners have started to venture into the Asian infrastructure market but is still widely a "missed opportunity".

Diversity of “infrastructure cultures”

So, what is the way forward? The “East Asian model” has worked with massive public expenditure programs from abundant state budgets on the back of strong export revenues. It has produced some impressive results but also expensive overcapacities and huge debt burdens. Most emerging countries are not in such a budgetary position anyway.

Some additional finance will come from the “Belt and Road” and other China initiatives. Development banks are also expanding their activities. Nonetheless, finding more private capital and attracting more long-term investors to Asian infrastructure is now a major challenge.

Encouragingly, the Asian region can build on the existing diversity of “infrastructure financing cultures”. Different approaches work in different places. Korea, Taiwan, Singapore and Hong Kong, for example, are following a more open model with capital markets that attract private and international investors. India has seen substantial domestic private activity in project finance, PPP and private equity funds. Corporate bonds have been widely used in Thailand and elsewhere. Malaysia has developed the world’s biggest market for Islamic bonds (sukuk), including Islamic infrastructure bonds.

Policy consistency

Suggestions for reform in this respect have been made in many places. The ball is in the court of governments. PPPs in particular take good time and trust to develop. When the state is trying to facilitate private involvement, it is often standing in its own way, e.g. with policy reversals, regulatory changes, poor implementation and inconsistencies across government departments.

Too often, the upfront “financing” of projects is confused with the ultimate “funding”, i.e. the revenue stream via user charges or tax payers’ money. Governments need to understand that institutional investors can only be financiers of well-funded assets.

There is certainly merit in having dedicated infrastructure plans. Indonesia and the Philippines, among others, have been experimenting with new PPP institutions to “crowd in” more private capital. Even with the best intentions, progress can be frustratingly slow.

Investor governance and independence

Asia's high saving ratios could be put to work better. Long-term savings institutions need to be established or strengthened. They can help rebalance the wide maturity mismatch between short-term bank deposits and long-term project financing. It is worth looking across the Pacific to places like Australia, New Zealand and Canada for experience with institutional investor involvement in infrastructure[9].

Infrastructure investment is inherently political. Long-term investing requires continuity and predictability of the legal and institutional environment. The worst development would be more political interference in investment decisions, especially by misdirecting funds into poor infrastructure projects.

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