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Financing the City- New Approaches to Local Currency Financing

By Mr Burhanuddin Abdullah – Governor of Bank Indonesia

1. Introduction

It is both a pleasure and an honour for me to speak before such a distinguished audience. Today's topic of urban infrastructure financing is at the heart of our Government's priorities. As you have probably known, Jakarta fits with the description of these sprawling Asian capital cities which, together with other cities in Indonesia, need huge investments in urban infrastructures. Currently we are working hard to provide basic public infrastructures. But after the crisis in 1998, the budget ability to finance infrastructure projects are becoming more and more restrictive. Currently, our National Budget can only fund a small fraction of the infrastructure investments needs. To cover the financing gaps, we look for other sources especially within the private sector. In line with these objectives, Indonesian economic authorities have putting a lot of efforts to the development of domestic capital markets that are expected to be able to mobilize longer-term funds needed to finance the infrastructure projects.

Whereas progresses are noticeable, up until currently we are still experiencing the lack of a reliable source of long-term domestic fund to finance urban infrastructure projects. In this respect, it is of relevance for me today to review which financing options that are available to finance urban infrastructure projects, which new financing instruments that can be offered and how authority can be best addressed the problem of lack of financing in this sector

For private investors especially foreign investors, urban infrastructure project are still considered as not attractive. Infrastructure projects, even when they are an income-generated project, usually earn only in local currency. For foreign investors, this will expose them to the currency risk. Infrastructure projects would also require longer term financing and often do not offer financially attractive internal rates of return. In some cases, investors must wait for sometimes before the project can generate profit thus they must also be ready with a deep pocket to finance the negative cash flows stemming from the operation of these projects. The country risk that is attached to the infrastructure projects would also expose the foreign investors with another additional risk. In the process, investors also often confronted with additional problems such as land clearance, tariff stipulation and other technical problems.

All of the above-mentioned features surely limit the ability of infrastructure projects in attracting the private sector financing.

Bearing in mind the background I just described above, in this speech, I would like to address three aspects which I consider as important in order to solve the problems in increasing the private sector contribution to the infrastructure financing: first, the role of multilateral agencies, second, how to mitigate financing risks, third, the policies for enhancing long-term local currency financing.

2. The role of multilateral agencies

Ladies and Gentlemen:

Infrastructure development usually involves a big and complex project. For private investors, calculating the size of commitment, risk involved and projecting the cash flows generated by this kind of project can be difficult. Multilateral agencies do have the ability to play a vital role in solving these issues. As a big organization with members that are coming from several countries, multilateral agency hold a unique regional position as well as access to best practises in various countries. Multilateral agencies can help the investors in providing analysis and other important information related with a particular project. Multilateral agencies have also been building a strong position and credibility in the international financial market. This position can be translated into many important roles that multinational agencies can serve. Among other is by facilitating developing countries to get access to the international capital market. Moreover, their strong financial ability would allow the multilateral agencies to serve as the lender of concessional loan that can provide cheaper financing for the projects. They can also provide a guarantee scheme as well as co-financing for the infrastructure project. By serving these purposes, developing countries would rely on their innovation ability in order to catalyze and mobilize resources into the infrastructure projects.

Having introduced in the Philippines, the ADB has already proposed to the Republic several innovative financial schemes aiming at developing long term domestic financing solutions and we are actively engaged in a dialogue to implement them. These include a currency swap with the Central Bank coupled with a long term Rupiah financing extended to participating banks, infrastructure project developers and sponsors for the financing of infrastructure projects. In reviewing these structures, particular attention should be put on both currency and project / commercial risks.

A currency swap product introduced by the ADB may have benefits when compared with an offshore borrowing by the Republic. It simply changes the currency composition of the cash available unlike increase in public debt associated with offshore borrowing. It helps strengthen the financial sector by aiming to eliminate volatility associated with currency and maturity mismatches also called asset liability mismatches. For countries wanting to pursue a foreign investment led economic growth, swap market development is a prerequisite for promoting bond market development. Foreign investors need existence of swap markets before investing in long term debt instruments of emerging market borrowers.

More traditional instruments proposed by other multilateral agencies have also proved useful and should be considered in structuring the financing of urban infrastructure projects, such as:

- Partial credit guarantee as a way to enhance the creditworthiness of the project and lower its cost of funds,
- Concessional financing to leverage and improve the financial feasibility of the project,

- Co-financing along with other lenders as a way to comfort new lenders and stretch maturities,
- The multilateral agencies can also encourage equity investment by proposing insurance and other risk mitigation products to potential investors,
- They can also take an equity stake along with private investors.

3. Risks mitigation

Ladies and Gentlemen

We would agree that currency risk is one of the major hurdles to urban infrastructure financing beyond other technical problems, and that it should be at the core of our discussions today.

The perceived high currency risk and the potential problem due to financing mismatch have hindered many private investors from making a continued commitment to urban infrastructure projects. This can be understood as foreign exchange rates volatility has proven fatal to a lot of emerging markets infrastructure projects in the past. Besides, in developing countries where hedging market is still very thin, mitigating currency and tenor mismatches can be very difficult. It is also extremely costly and unpractical to hedge all the currency risk of the external financing given the size of some urban infrastructure projects.

Considering the problems that are attached with the foreign currency financing, developing countries must now find financing schemes that are free of currency risk. Equity and domestic financing provided through the capital market would mitigate some or even all of this risk. However, to be able to mobilize the vast amount of long-term funds needed to finance their infrastructure projects, developing countries must first develop the capital market. A developed capital market is also needed to generate innovative schemes that match the needs of many different types of urban infrastructure projects.

In describing how the capital market can serve as the major source of financing for the urban infrastructure projects, I would like to take example from the US experience that finances their infrastructure projects by issuing bonds such as the municipal bonds, state bonds and revenue bonds. The market for these kind of bonds have been growing from a US\$ 2 to 3 billion market in 1959 to a robust US\$ 350 to US\$ 400 billion market in 2004. This market now can offer long term bonds which maturities may go as far as 100 years. Through the bond markets, many cities and states in the United States can finance their infrastructure projects such as toll roads, toll bridges, airports or water systems. One particular feature of these bonds, which make them more attractive to investors, is that the interest of the bonds is exempted from federal tax.

There are many valuable lessons that can be learnt from the success of the US municipals bonds market. But one must notice that the bond market would not be growing so well if investors do not feel secure with their long-term transaction. In this regard, security can only be provided to the investors if the authority can put in place a

credible legal system. With the credibility of their legal infrastructures, the local governments in the US can issue bonds with maturity much longer than a sovereign bonds issued by most of the emerging economies. A credible legal system would provide a guarantee to investors that when a local government or a State made a contract with bond holders, this contract will surely be enforceable and that, at the time of repayment, the borrowing local government may not allocate the debt service resources to other expenditure item, even if it finds a politically more favourable options.

It is clear that in order to create viable sources of fund for infrastructure project one area where major improvement need to be made in emerging countries like Indonesia is certainly the legal aspect including legal infrastructures and law enforcement. By strengthening the credibility of our legal system, we can maintain the principle of sanctity of contracts and their enforceability. When we can provide a secure legal environment then we can expect a better investor appetite to longer term capital market instruments such as bonds. Within this environment, we can also expect the creation of innovative schemes to finance the infrastructure development.

In addition to the establishment of legal infrastructure, we can also increase the private sector's contribution in infrastructure financing by issuing bonds that are backed by tax levied or guaranteed by revenue generated from the related infrastructure project.

3. Policies for enhancing long-term local currency financing

Ladies and Gentlemen:

Besides the options that I just described before, there is also other alternative that we can explore. One viable option is by approaching huge institutional investors such as pension funds, mutual funds or insurance companies to find out how they could support the financing needs of infrastructure projects. So far, due to lack of feasible long-term investments, these institutions are still holding a significant portion of short-term assets in their portfolio. A viable long-term investment opportunity such as the opportunity to fund a profitable infrastructure project should be very attractive to these institutions.

Moreover, we also need to work with the banking sector, which so far still focus upon short- to medium-term working capital and consumer financing. If bank can develop in-house expertise that can make a quality analysis on longer-term projects such as infrastructure projects we then can expect them to increase their contribution in the infrastructure developments.

Last but not least, policy makers should also continue issuing a consistent set of policies aiming at maintaining the macroeconomic stability. Macroeconomic stability will surely decrease the country risk and support the development of both the real and financial sectors. To further develop the capital market, authority must also impose a strict supervision and monitoring of the financial institutions. A more developed capital market would provide a longer term instruments needed to finance infrastructure projects.

Over the last 5 years, we in Indonesia were able to develop and deepen our capital and to our satisfaction build a benchmark yield curve. Nonetheless we still consider that the market still needs to grow further before it will be able to finance the infrastructure financing needs, and the Indonesian Authorities are actively working on it.

I would end my speech here. I am confident that this seminar will help us progress further to the right direction.

THANK YOU