

World Economic Forum
What is Needed to Advance Infrastructure

**Needed Steps to Advance Infrastructure Finance in Latin
American and the Caribbean (LAC)**

Diagnosis and Challenges of Economic Infrastructure in Lac

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Inter-American Development Bank
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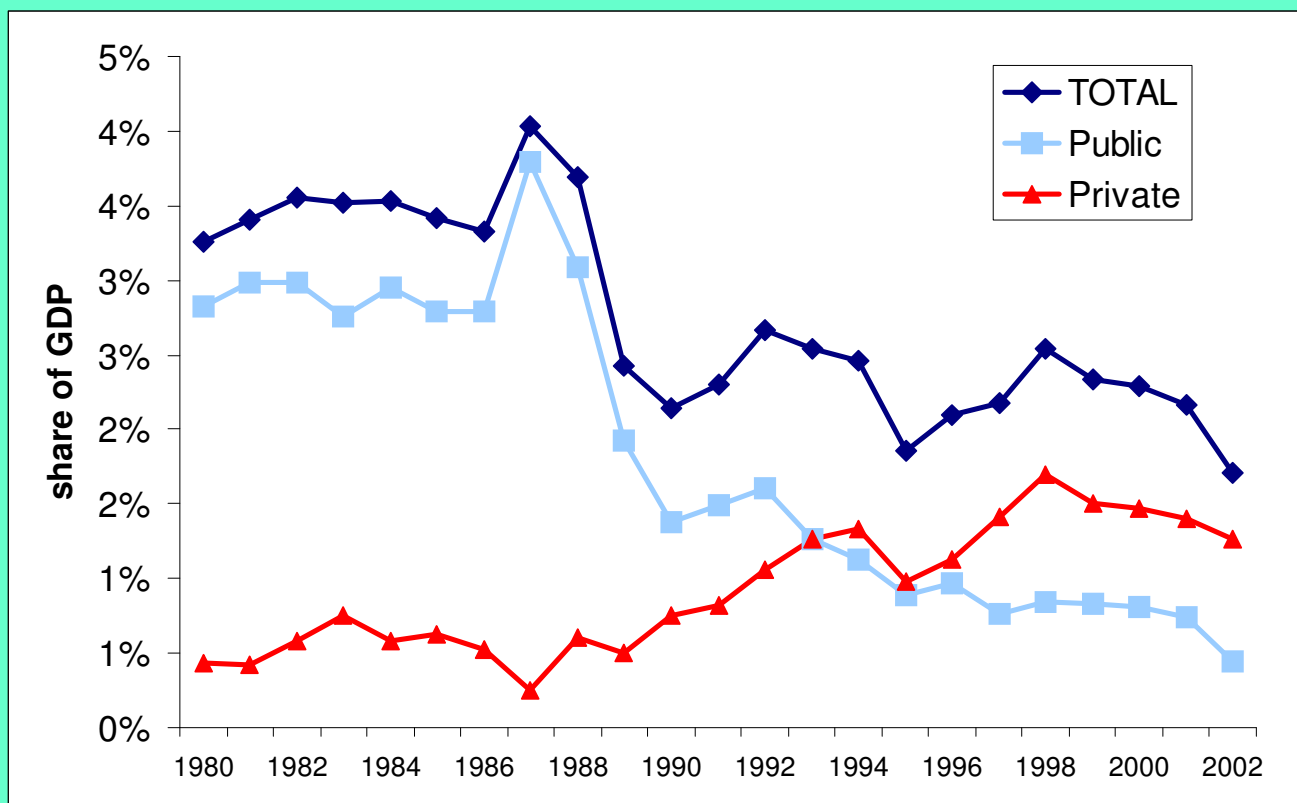
- Infrastructure and Growth
- Private Sector and Growth
- Reforms and public discontent
- Recurrent dissatisfaction, diminished expectations
- LAC falls behind
- Investment needs
- Can reforms be made sustainable?
- Challenges for governments and IFIs

Infrastructure and Economic Growth

- *Good* infrastructure promotes economic growth (as opposed to *White Elephants*)
- Private sector is the engine of growth

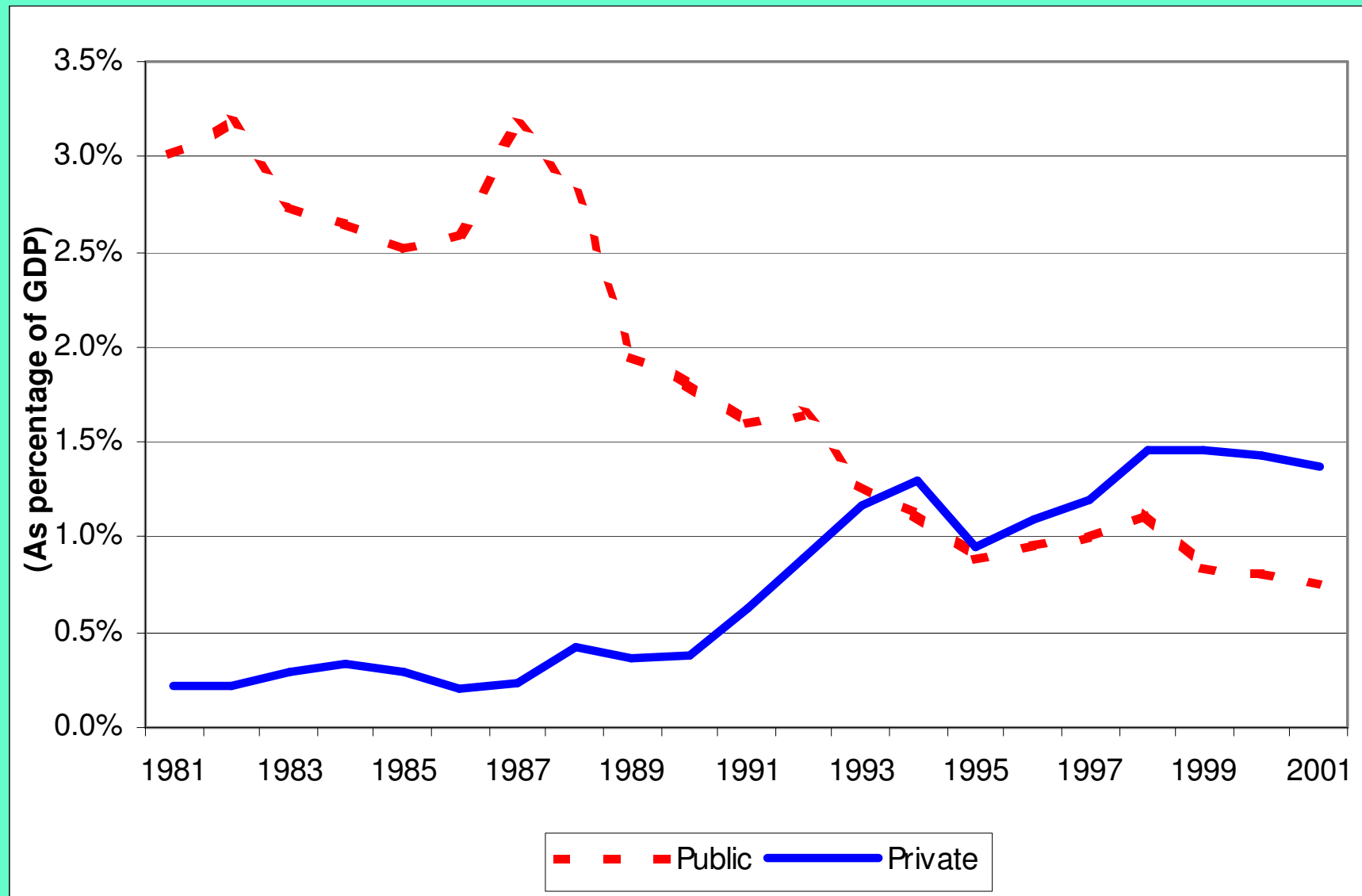
What Happened?

Public retrenchment never fully offset by private entry



Source: Calderon and Servén (2004)

Infrastructure Investment in LAC 9



The State of the Opinion

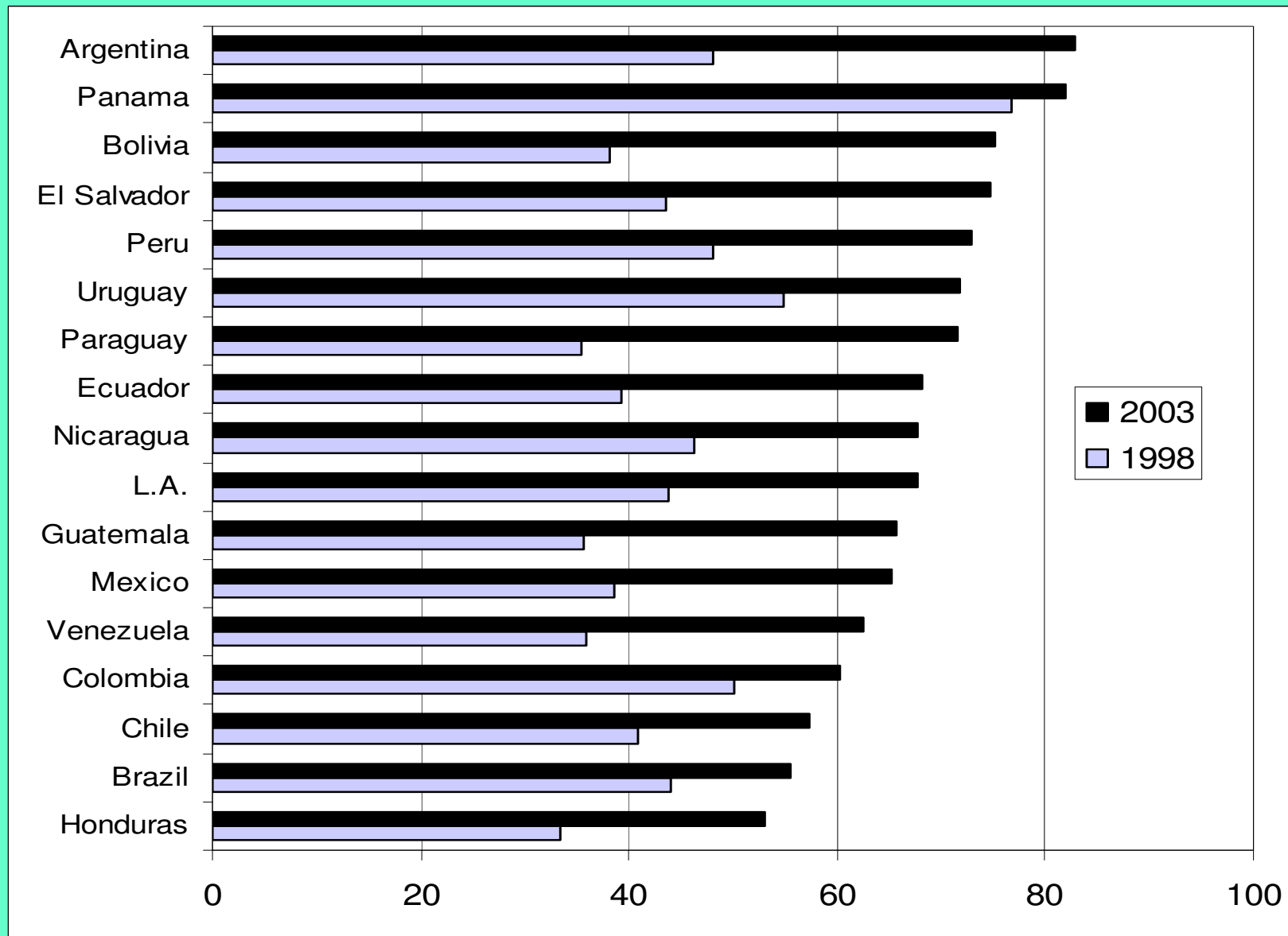
- Infrastructure reforms and privatizations do not go well with the Latin American opinion.
- According to Latinobarometro, a high and growing % of L.A. people disagree that privatization was beneficial for their country: As of 2003, in the 17 countries surveyed, negative views of privatizations ranged from 53% in Honduras to 83% in Argentina, for Latin American average above 67%

The State of the Opinion: A Privatization Paradox?

- Strong public discontent contrasts with rather favourable evaluations of the privatization process in terms of operating efficiency / profitability / output / investment / service coverage / fiscal results / some social indicators (e.g., child mortality) / poverty / income distribution.
- Discontent occurs even in countries where unequivocal welfare gains (more access, lower prices, improved quality) have materialized
- This parallels a generic discontent with reforms / free markets / democracy, etc.

(La Porta & López-de-Silanes 99, Megginson & Netter 2001, McKenzie & Mookherjee 2003, Chong & López-de-Silanes 2004, Galiani et al. 2005).

Percentage of respondents who (strongly) disagree that privatization has been beneficial for their country



Why is this Happening?

- What are some of the causes *del rechazo social*?
Various studies point to different factors:
 - Unequal income distribution, Graham (2005)
 - Perception that benefits accrue always to the same people, Boix (2005)
 - Perception of Corruption, Martimort y Straub (2005)
 - Political and economic shocks, property rights, beliefs, Di Tella (2005)
 - Lack of deepening of reforms, Kucinsky and Williamson (2003)
 - Privatization, deregulation and capital market development

Recurrent dissatisfaction, diminished expectations

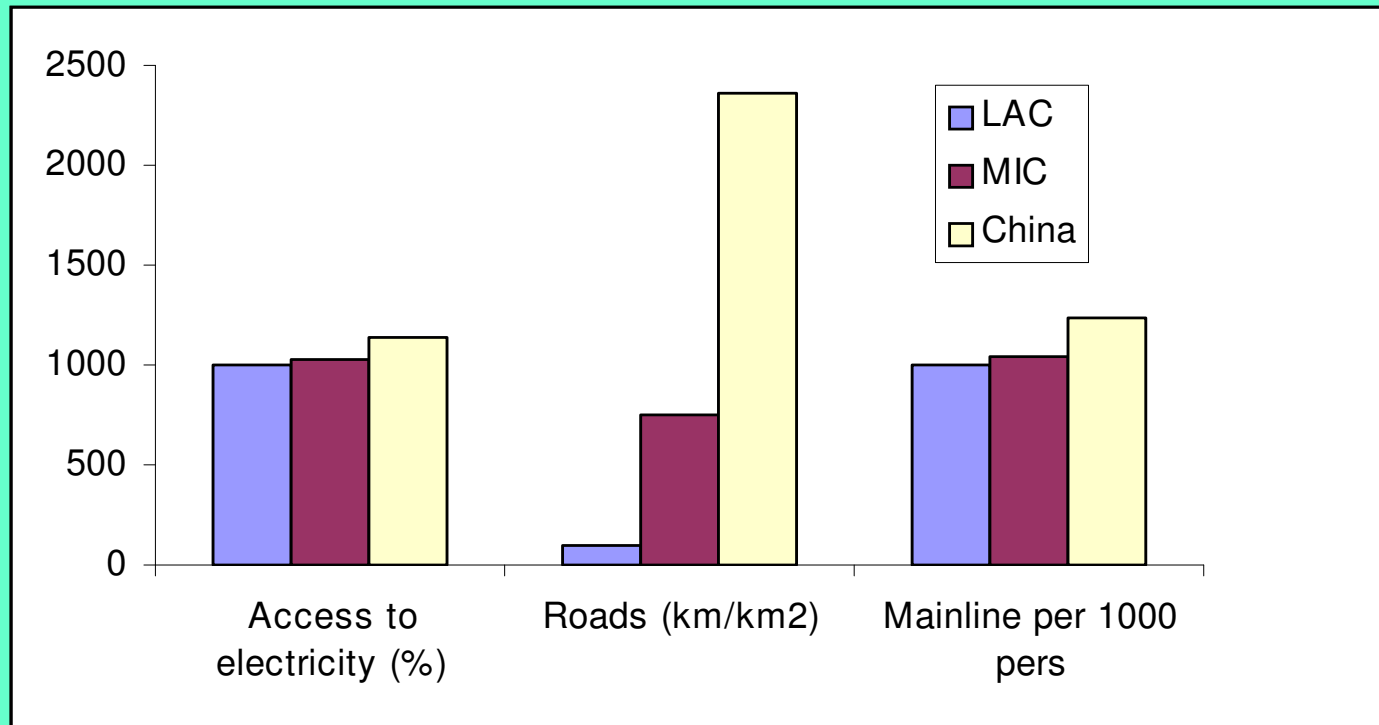
- Distrust in governments makes privatization look as “the same recipe once again” if things go wrong
- Distrust leads to expect that current gains will be expropriated or will reinforce the *status quo*
- Recalcitrant expectations form when property rights can only be defended by those who have the means and skills
- Advance in economic progress, property rights enforcement and inequality reduction needed to develop trust

LAC is falling behind

Various measures of gaps between LAC and other areas (e.g., Asia)

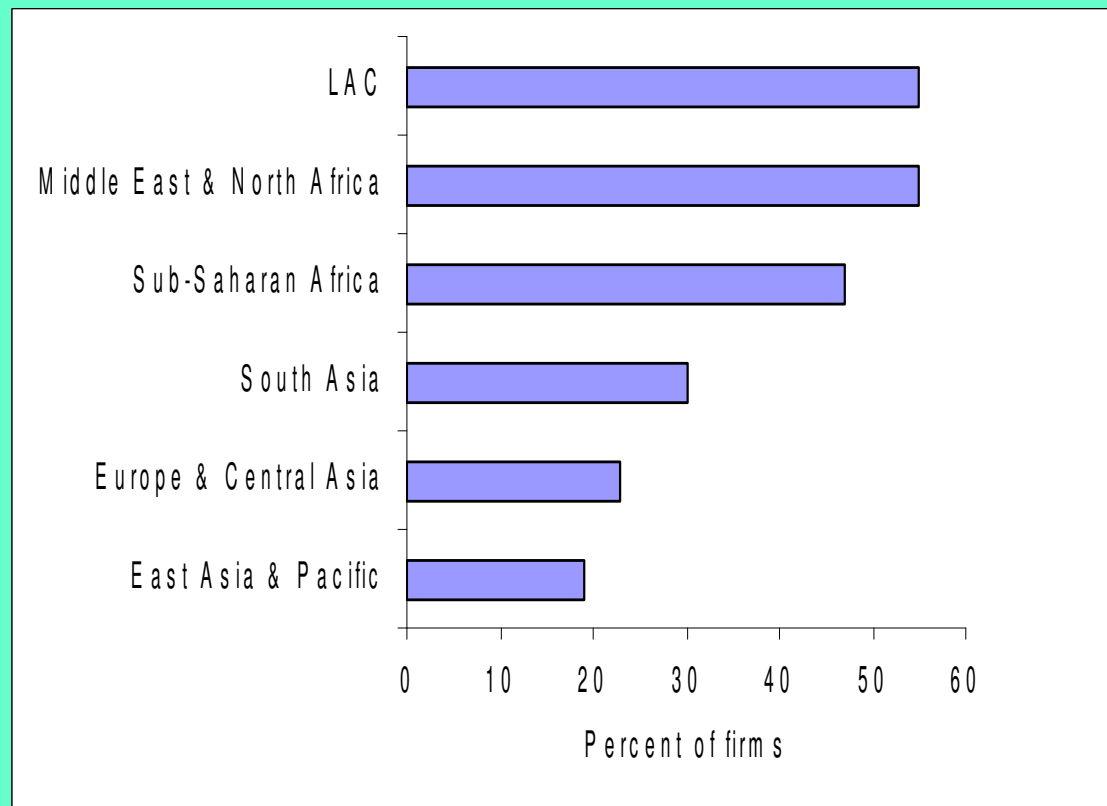
Caveat: geography and GDP composition (Singapore figures cannot be compared with Brazil's)

LAC has fallen behind China and Middle Income Countries



Latin American firms see infrastructure as a bottleneck

Businesses that see infrastructure as a serious problem for the growth of their business:



Investments Needs

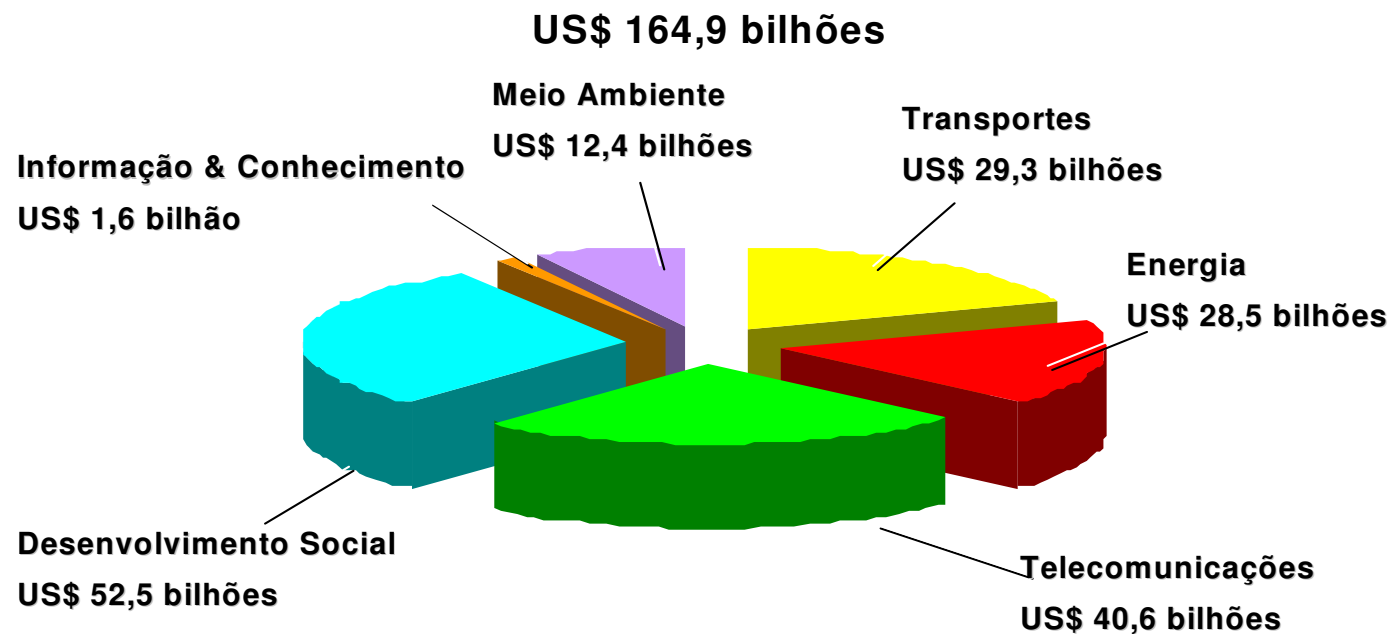
- Various estimations of investment needs for infrastructure in the years ahead

How much is needed depends on the goal

- Universal coverage of water and sanitation?
 - ~ 0.25% over 10 years
- To maintain and rehabilitate existing assets?
 - ~1% of GDP for adequate maintenance
 - Impossible to estimate rehabilitation needs
- For business as usual?
 - ~ 2% of GDP to satisfy consumer and firm demand based on modest growth assumptions
- To grow and take off?
 - ~4 to 6% of GDP to catch up with Korea and keep up with China

Brasil: Expected Investments by Sector

Investimentos Totais (2000-2007)

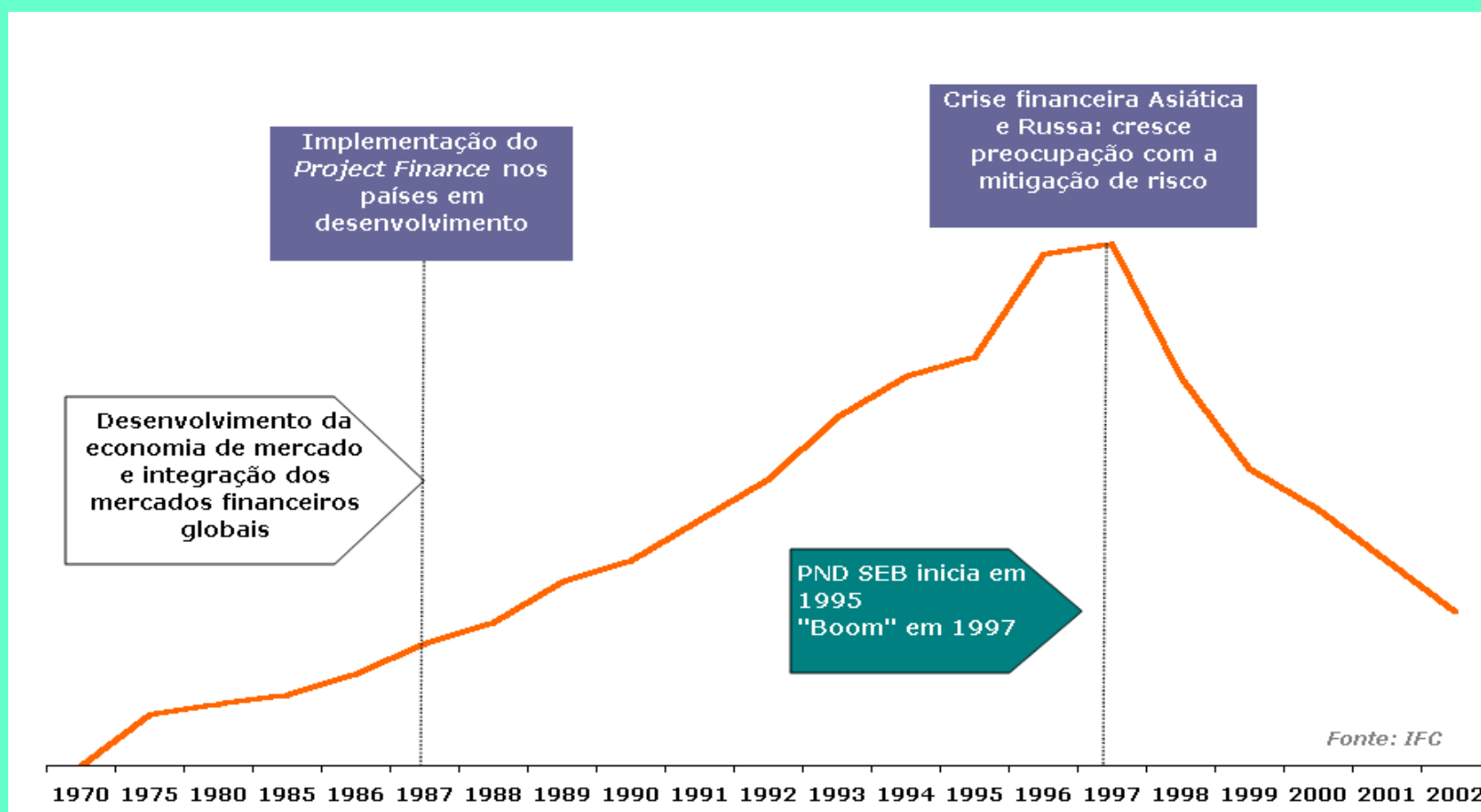


Where is the Funding Coming from?

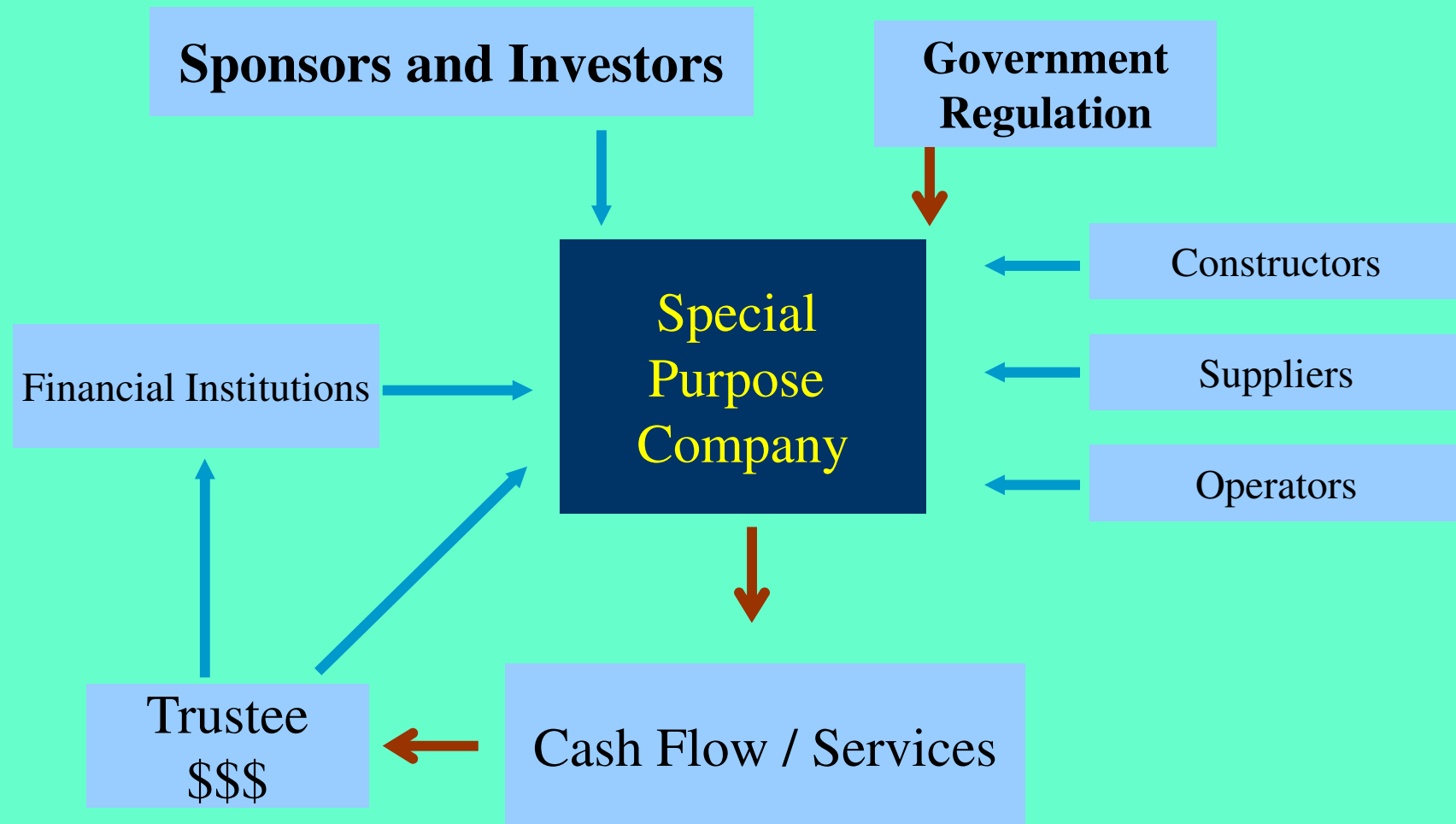
- Foreign Borrowing
- Domestic Markets

Investments

- A growing attention to *Project Finance* occurs when international financial markets become unavailable. Role of Domestic markets and Public sector banks/Funds
- Legal and regulatory environment are not enough to mitigate risks



Example of Project Finance

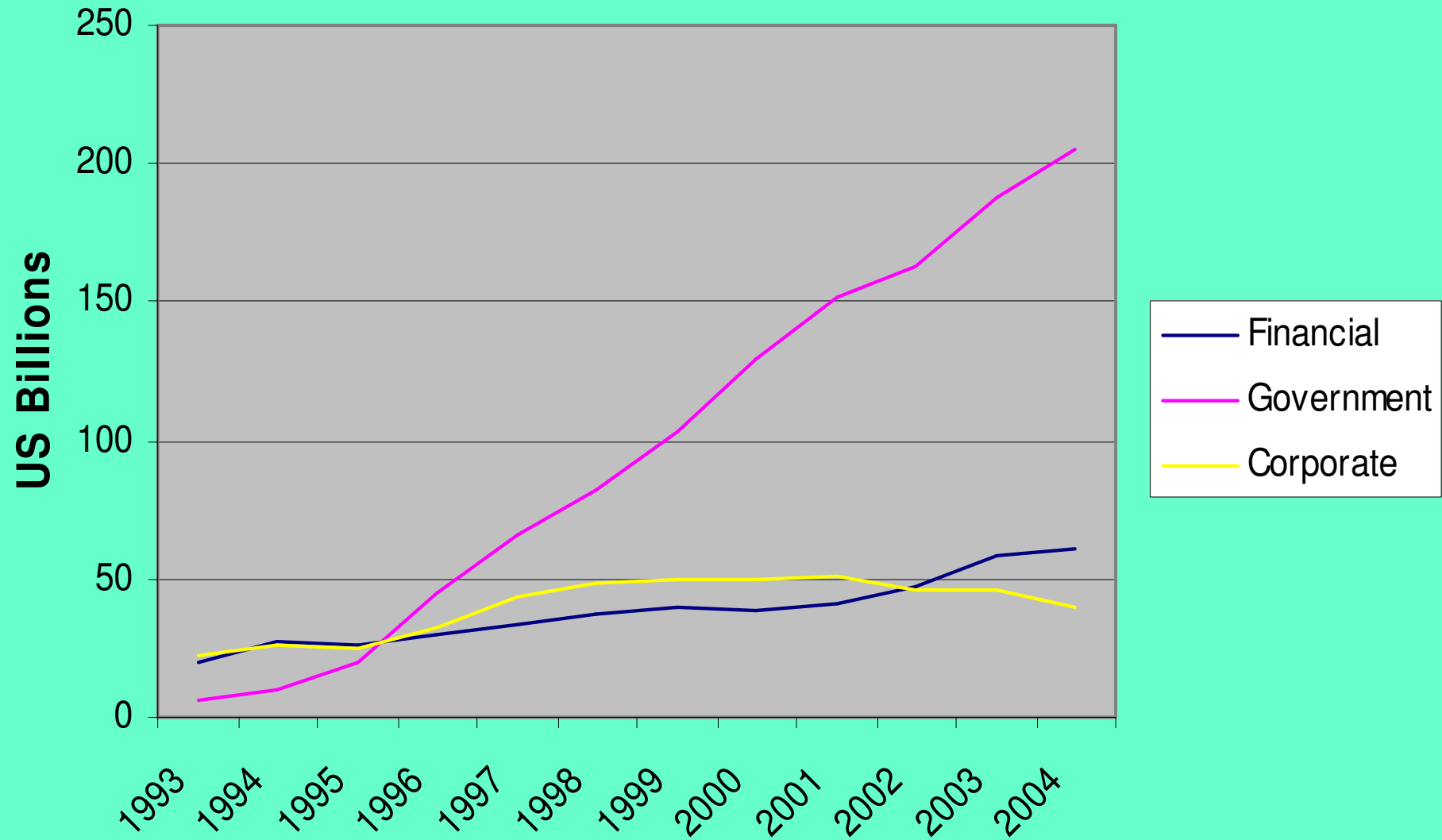


Domestic Capital Market Development

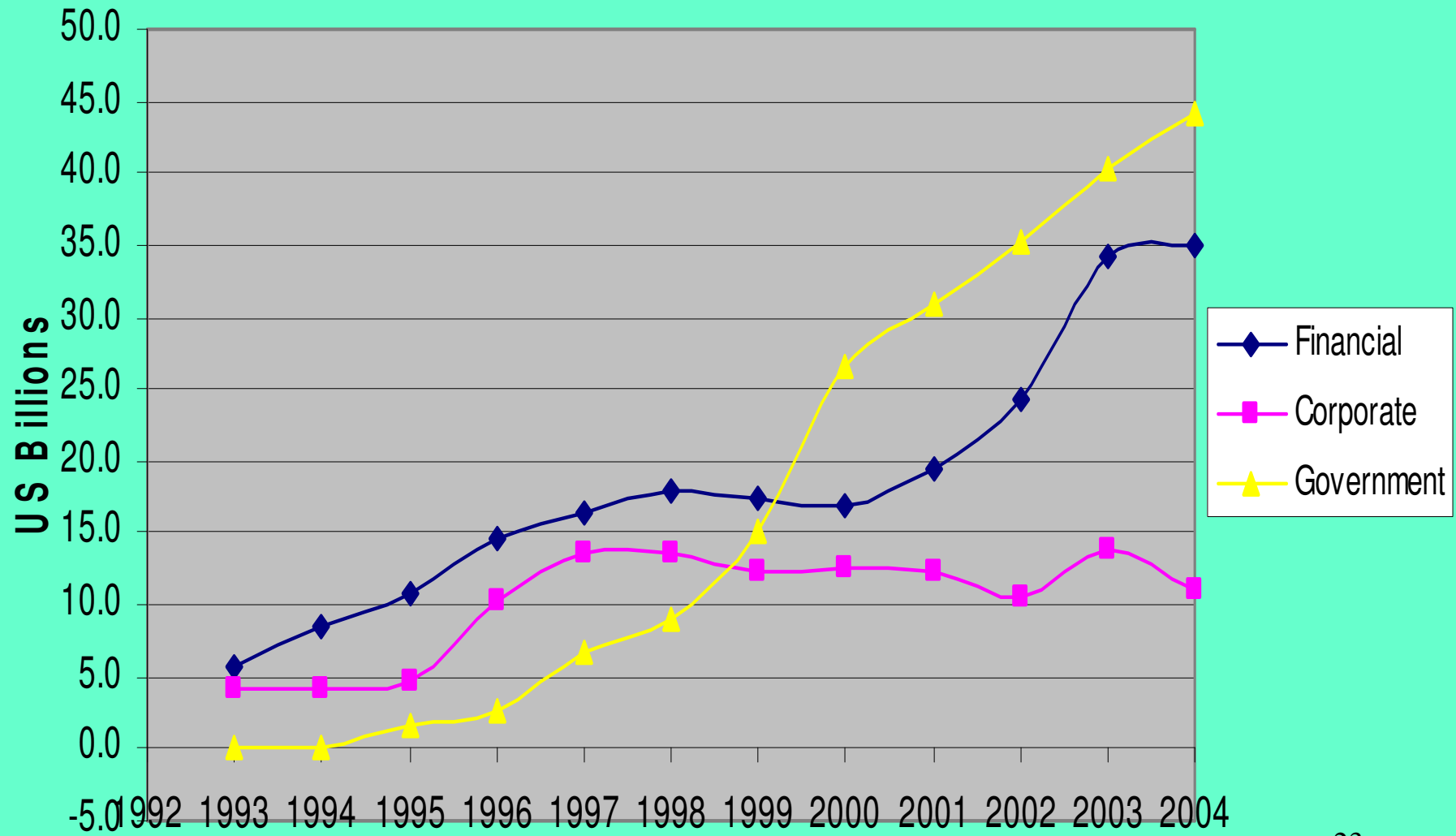
Trade off:

- Capital market – Public sector financing

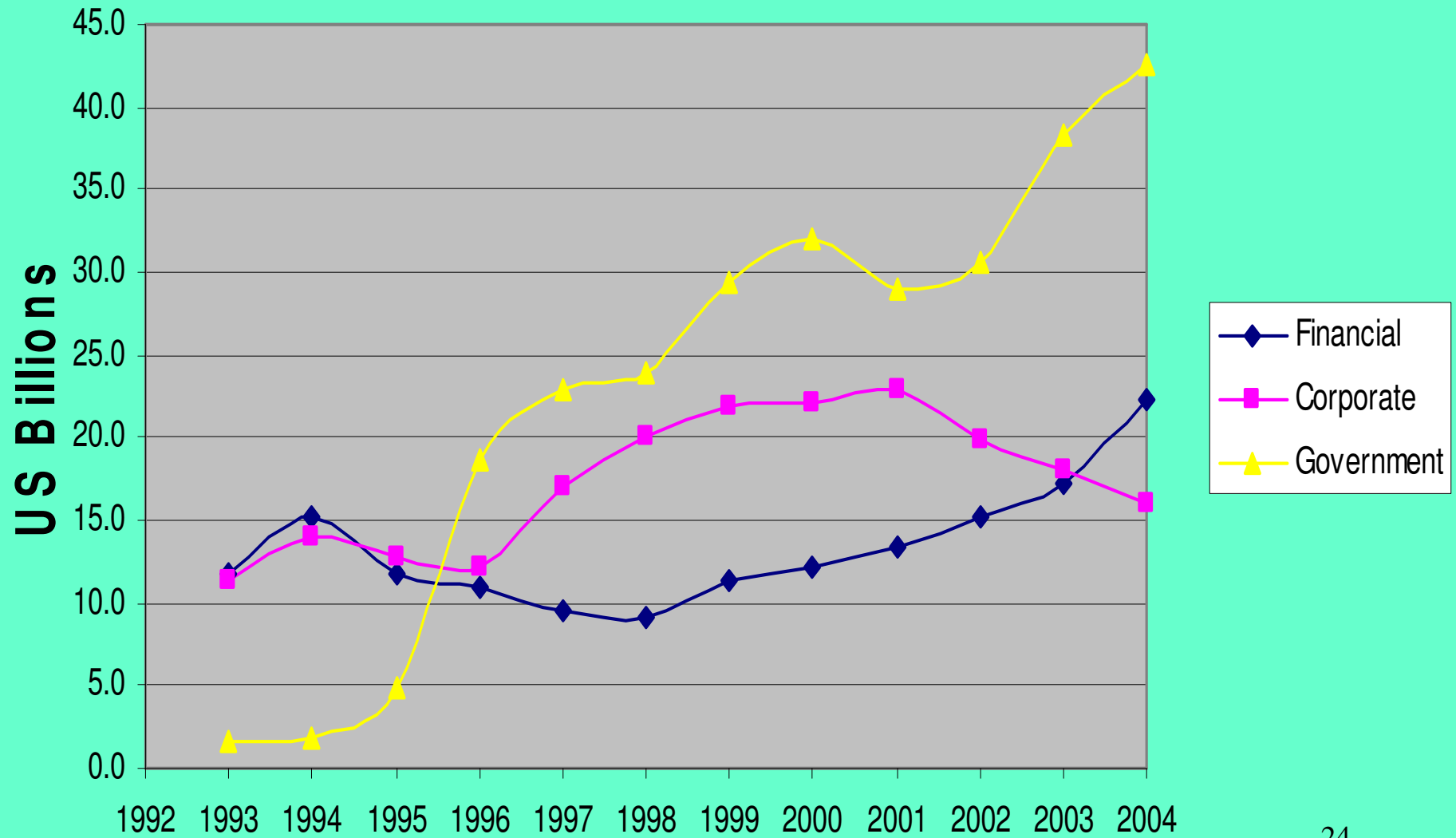
Latin America: BOND MARKET (By type of issuer)



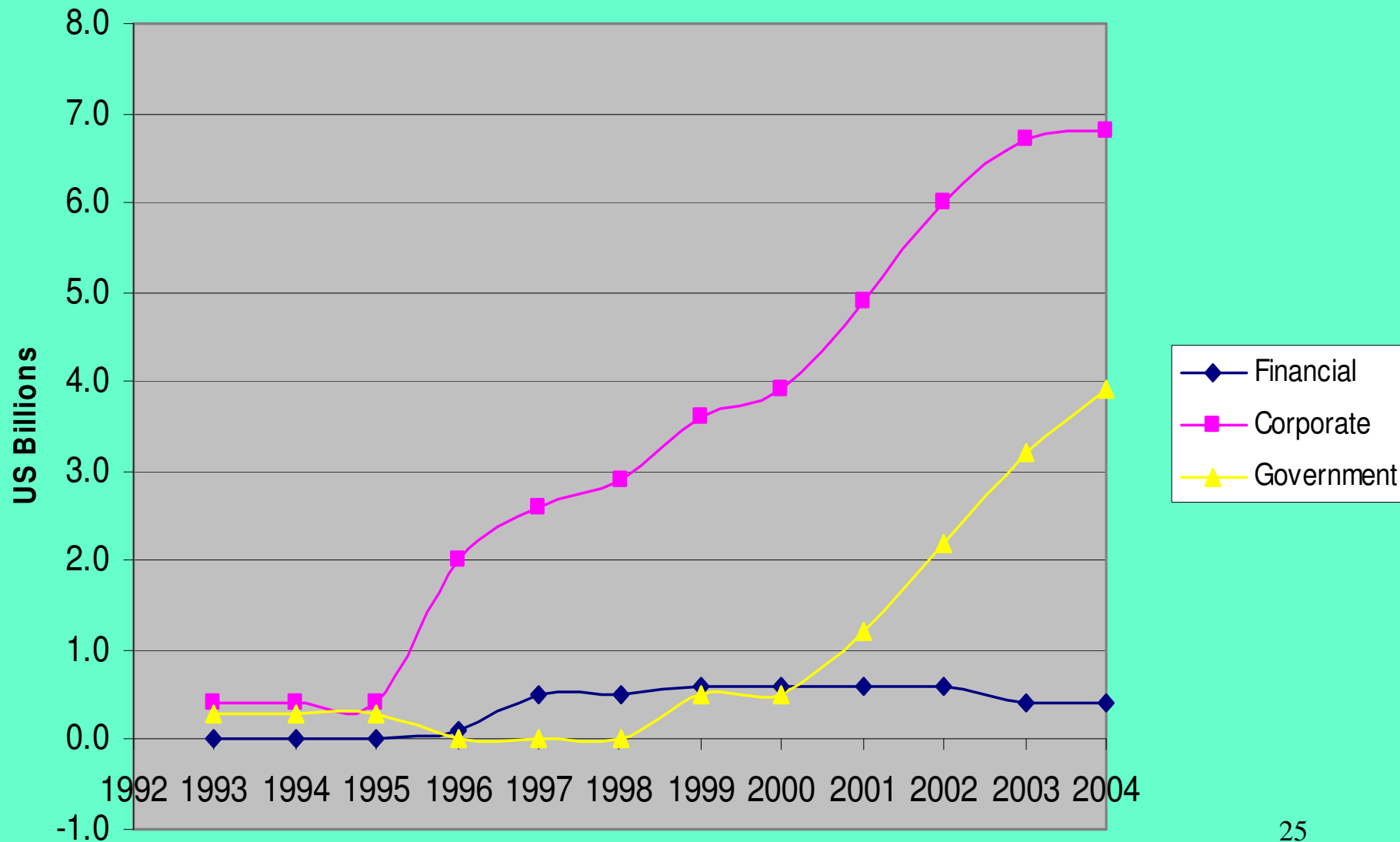
BRAZIL: Bond Market (By type of issuer) (1993-2004)



Mexico: Bond Market (By type of issuer) (1993-2004)

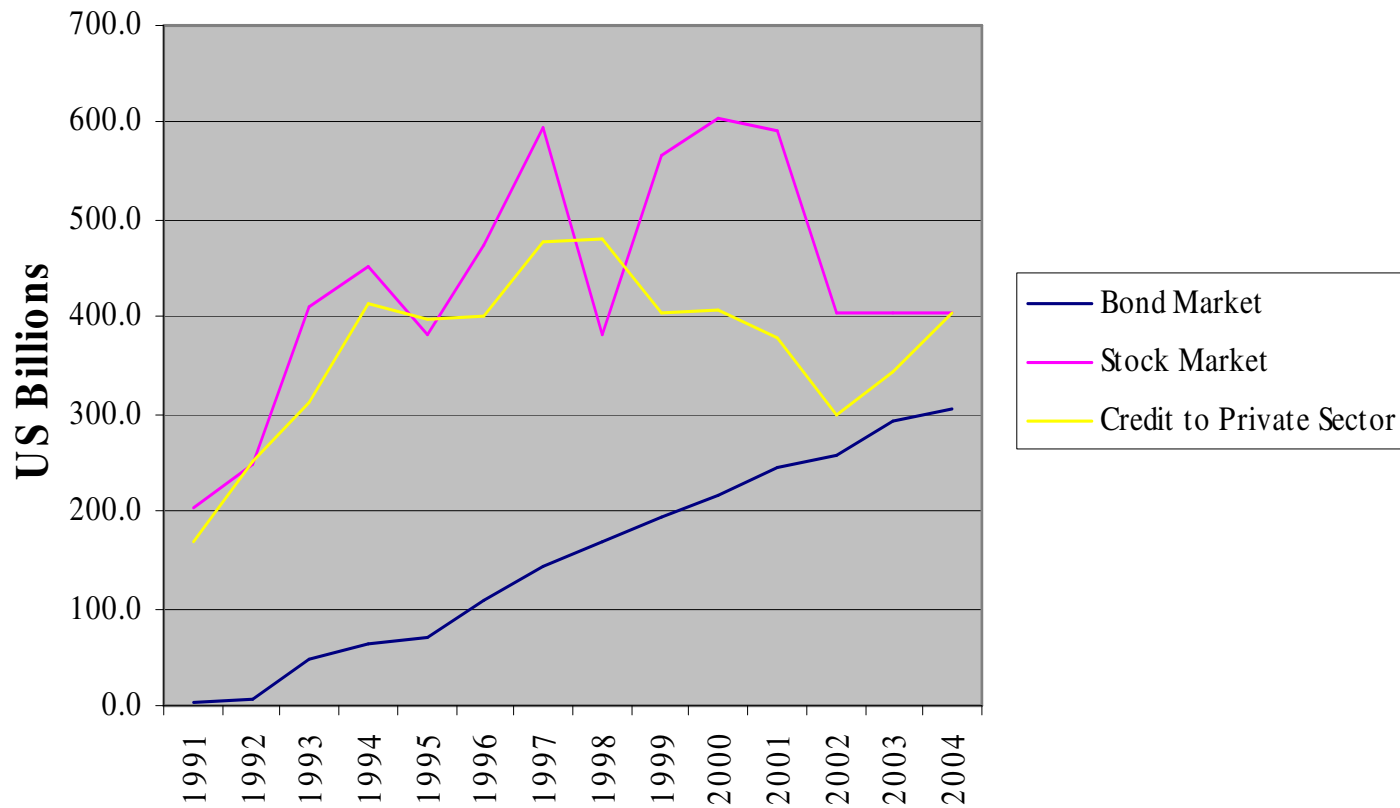


CHILE: Bond Market (By type of issuer) (1993-2004)



Putting all
together.....

LATIN AMERICA: Bond Market, Stock Market Capitalization and Credit to Private Sector 1991-2004



Reasons to Develop Capital Markets

- To satisfy -supposedly efficiently- the financial need of Government
- To allocate resources efficiently

The key to success is to find and maintain the *right mix* between these two functions that may create opportunistic actions, and conflict of interests

Development of Capital Markets

As the economy grows -particularly in relatively large countries- and the possibilities of external financing are limited, corporations need long term financing possibly through capital markets.

Alternative to Capital Market Development

- Creation of Development Banks (DBs) to provide long term financing not otherwise available
- Historically, this is the experience in Europe and also in LAC countries
- However, economic efficiency was not the objective of these institutions (e.g., political theory of development banks) and mismanagement and corruption were the rule rather than the exception and financing the economy took a back seat

Competing or Complementary Courses of Actions?

State Model



- **Long term financing provided by DB and external sources**

Market Model



- **Long term financing provided by capital markets**

Other additions to the toolkit

- Infrastructure funds and unbundling of building and financing in project finance
- Mezzanine structures and equity kickers
- Better use of guarantees

Other additions to the toolkit

- Financial structures adapted to local context
- Governance measures to level the playing field between contractors and governments
- Governance measure to proactively manage risk and avoid project collapse

Financial structures for economically sound transportation projects

Case 1: HIGH fiscal space credibility

(+) Private profitability (-)	- PPP _A : profit-sharing	- PPP _D : concession with public guarantees - Pure concessions
	- Civil works - Single-payment outsourcing contracts	- PPP _E : classic PPP with recurrent public payments
	Low	High
	Contract enforcement by courts	

Financial structures for economically sound transportation projects

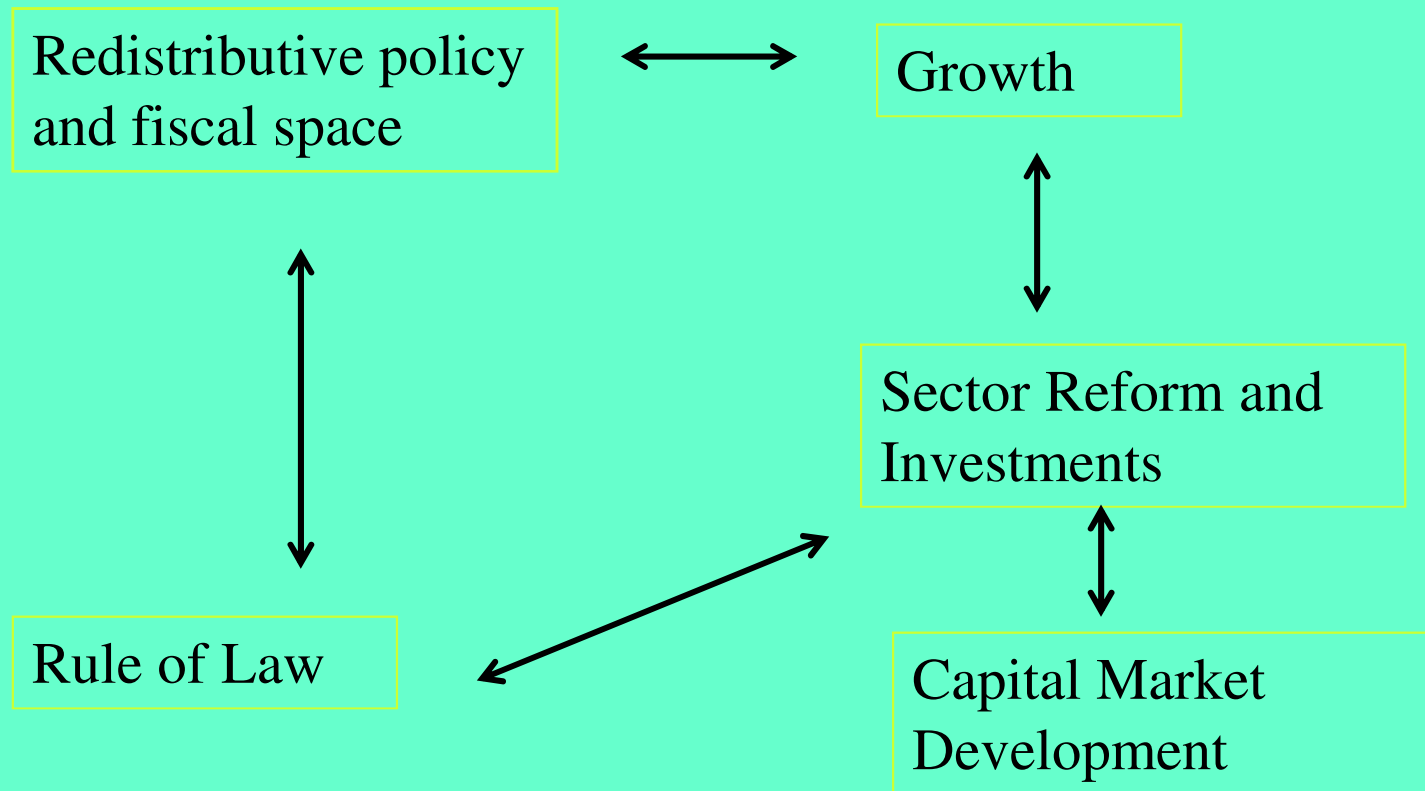
Case 2: LOW fiscal space credibility

(+) Private profitability (-)	- PPP _A : profit-sharing	- PPP _A : profit-sharing - Single-payment outsourcing contracts
	- PPP _B : public/community procurement (matching); evaluate tax earmarking	- PPP _C : concession revenue supplemented by land use rights
	Low	High
	Contract enforcement by courts	

Can reforms become sustainable?

- A long-term, evolutionary, incremental approach to reach infrastructure reform sustainability
- Effort *inside* the sector to increase reform quality and public support must not diminish
- However, a purely sector approach does not suffice, given distrust in government and the pervasiveness of inefficient redistribution
- *Coordinate* sector measures with advances in (i) redistributive and fiscal policy; (ii) rule of law; (iii) capital market development

Can reforms be made sustainable?



Where are We?

- The need of infrastructure financing is clear
- The commitment of Government bond development is strong
- However, will the government find and keep the **right mix** between the public sector and private sector financing? Or it might be tempted to give preference to the first one?
- In LAC we see that in large part Governments are committed to fiscal discipline and are attempting to move towards the **optimal mix**. However, this is valid for large countries (e.g., Mexico, Brazil).
- Small countries? Will we have a two speed LAC? This is a big challenge

Looking Forward

- Reforms take time and perseverance even if you have “big bangs”
- Government: Enabling environment + Leadership + Continuity + Doing the right things and attack the roots
 - Institutional, Political, Administrative and Judicial stability
 - Stop the pendulum between public and private sector in financial markets
- Growth and competitiveness are complementary and instrumental to reach better standards of living

Challenges for Governments and IFIs

- How to combine political leadership and empowerment to *start* change in expectations
- How to ensure permanence of results to *consolidate* expectations
- Tactical advice for sector reform meanwhile: press for measures that *self-reinforce* in the right direction; avoid overwhelming institutions with duties beyond their capabilities

IDB in Latin American and Caribbean Markets

Five Pillars of the IDB's approach to infrastructure and capital market development

1. Institutional support through capital market development initiatives and infrastructure financing
2. Government Debt management and bond issues as a building block of capital market development
3. Contributing to the development of local currency financing as *issuer* (e.g., Finance Department) and as *lender* for domestic capital markets development (e.g., PRI);
4. Local currency financing to the public sector;
5. Efficiency of State owned banks

Key Messages

- LAC needs to spend more on infrastructure
- LAC needs to spend better
- Governments remain at the heart of the infrastructure challenge
- The private sector can contribute, but only if the region builds on the lessons of the last decade
- Investments in infrastructure have to be regarded in an holistic fashion