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Petrodollars Begin Recycling in Asian Markets — Strengthening Relations with Middle Eastern Countries

The Future for Japanese ODA loans: More Advantageous Conditions, More Effective Assistance
Applying Japan's Development Experience and Expertise

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JAPAN BANK FOR INTERNATIONAL COOPERATION

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The Growing Importance of Islamic Finance

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The popularity of Islamic finance is rising. Holdings of petrodollars have increased dramatically because of the rising crude oil prices over the last few years, and it is now estimated that assets managed by Islamic financial institutions worldwide are worth as much as US$400 billion. Islamic finance conforms to Islamic law (Shari'ah), and this relatively new type of financing method has expanded rapidly from the Muslim world to international financial markets.

As part of Japan's response to these new trends, the Japan Bank for International Cooperation (JBIC) is moving forward on a number of fronts, conducting research in Islamic finance, collecting relevant information, examining the potential of specific petrodollar recycling programs, and promoting cofinancing programs with Islamic financial institutions. By showing initiative in this field and promoting the recycling of petrodollars in Asian markets, Japan will contribute to economic development in Asia, strengthening the international competitiveness of Japanese corporations as a result.

1. Islamic Financial Markets Today

Essential Features of Islamic Finance

Today's Islamic finance has roots that go back to around 1980, when Islamic financial instruments were used primarily in Malaysia and Bahrain to promote the acquirement of relatively small assets such as motor vehicles, precious metals and housing. Islamic finance is based on Shari'ah (Islamic law), which in turn is based on teachings in the Qur'an, the sacred book of Islam. Islamic banking practices prohibit the financing of businesses violating religious precepts (for example, alcohol, gambling and hog farming), the taking of interest, and speculation. Lenders and borrowers conduct transactions in real assets and share the resulting profit or loss. (See pages 7 and 8 for a further explanation of Islamic financing methods.)

Expansion into Global Markets

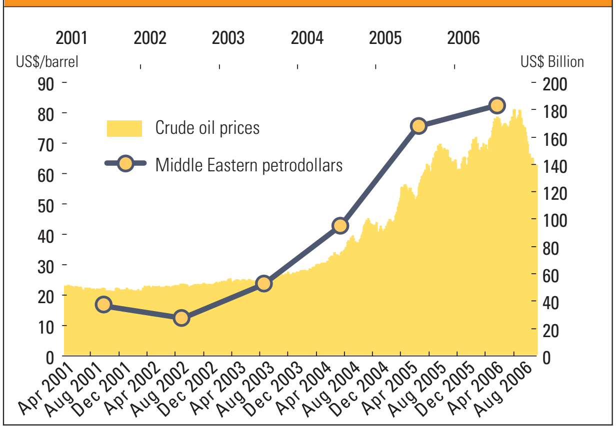
Islamic finance slowly but surely gained momentum and experience in the 1980s. Its opportunity for large-scale expansion came at the beginning of this century, after the issuance of Islamic bonds (*sukuk*) and the development and promotion of markets for trading in these bonds. Governments and government institutions in Muslim countries, notably Bahrain and Malaysia, have launched major *sukuk* issues, and even the World Bank has raised funds through *sukuk* in Malaysia. Malaysia and Bahrain are currently the two largest centers for the Islamic financial market — in Malaysia, where the government takes an active role in Islamic finance, Islamic financial assets are now about 10% of total assets. Islamic financial services are now offered in more than 75 countries by more than 250 financial institutions. Assets under management are growing at annual rates of between 10 and 15%, and, according to different estimates by the International Islamic Finance Forum, are worth either upward of US$260 billion or upward of US$400 billion.

This rapid expansion has been driven by the growing investment needs of Middle Eastern oil producing countries awash in petrodollars as a result of the steep global rise in crude oil prices. Meanwhile, other countries, mainly in the West, have stepped up efforts oriented toward Islamic finance, eager to welcome new investment capital. In the 1980s, the U.K. gained successful experience in the global recycling of petrodollars through eurodollar markets. Britain envisions the City of London as the gateway for Islamic finance, and recently, with this goal in mind, it wasted no time in granting commercial banking licenses to banks that specialize in Islamic financial services. Parallel to this development, U.S. financial institutions established financing subsidiaries in Bahrain in the 1990s, and this spurred the entry of major international commercial banks into the world of Islamic finance.

The Globalization of Islamic Finance

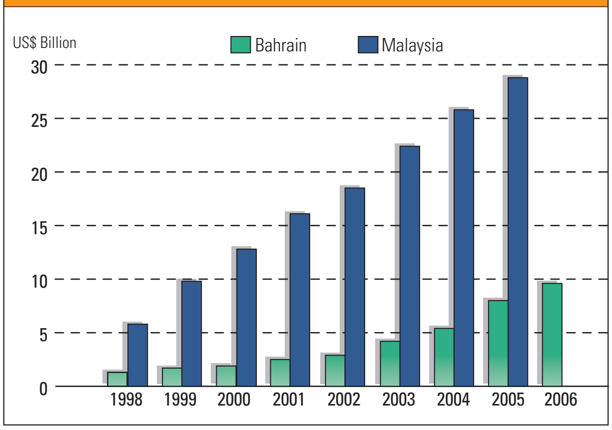
With Islamic finance now strengthening its presence in international finance, there is a growing need to ensure transparency, harmonize standards for such services (which have unique features originally developed to serve local markets), and ensure concordance with conventional financial systems. To promote these goals, in 2002 the central banks of a number of Muslim countries were the main participants in the establishment, as founding members, of the Islamic Financial Services Board (IFSB). Hopes are high that these goals will be met through the efforts of organizations such as the IFSB. (For further information on the IFSB, see pages 4 and 9.)

Crude oil prices and Middle Eastern petrodollars, 2001-2006



Source: Datastream, Bloomberg. Graph compiled by JBIC.

Islamic financial assets of the banking sector, Bahrain and Malaysia, 1998-2006



Source: Bank Negara Malaysia (Central Bank of Malaysia) and Bahrain Monetary Agency
Note: 2006 data for Malaysia not available.

2. Recycling Petrodollars in Asian Markets: The Part JBIC Plays in Japan's Initiative

The Flow of Petrodollars into Asian Markets

Ramifications from the terrorist attacks in the United States in 2001 led to a stronger tendency among Middle Eastern oil producing countries to invest their petrodollars in their own region. But by the following year those petrodollars were once again being recycled to an increasing degree — although indirectly — in Western securities markets, which were viewed as places where continually expanding assets would be managed effectively. But there are now signs of a growing eagerness to invest in Asian markets where the potential for future economic growth appears strong, and this tendency is especially prevalent in Malaysia, which is energetically promoting Islamic financial practices. The challenge is to seize every opportunity to recycle those petrodollars in Asian markets, and to use their potential to effectively promote economic and social development in Asia.

The Positive Role Japan Can Play

The Japanese government, now interested in the potential of Islamic finance, is collaborating with the Financial Services Agency, the Bank of Japan and JBIC to promote stronger relations with IFSB and to obtain more information on Islamic finance. It is important that Japan make optimum use of its experience, knowledge and credit-worthiness to establish ties with countries such as Malaysia that aim to become global Islamic financial centers. By promoting Islamic finance in the Asian market as a whole, Japan would encourage Middle Eastern petrodollar investors to recognize the advantages of Asia as an investment destination.

JBIC: Becoming Japan's Expert on Islamic Finance

(1) JBIC: Becoming Japan's Center for Information on Islamic Finance

Japan is home to the largest financial trading market in Asia, but it has almost no experience in Islamic finance. As a first step to changing this, JBIC is gathering information and conducting research on Islamic finance while strengthening its relations with relevant institutions. It frequently shares information with the IFSB, which was established in 2002. The IFSB recommended that JBIC join it as an Observer Member, and in January 2007 JBIC became the first Japanese financial institution to do so. JBIC's observer status permits it to attend IFSB meetings and access Islamic finance information compiled for members. Observer status therefore offers extremely valuable opportunities to explore and develop financing programs using Islamic funds.

(2) Seminar on Islamic Finance Held at JBIC Headquarters

The IFSB and JBIC organized a Seminar on Islamic Finance in January 2007 to facilitate Japanese understanding of the Islamic financial services industry. The two-day seminar, held at JBIC headquarters, was the first of its kind in East Asia. After keynote addresses by the IFSB Secretary General and the Governor of the Central Bank of Malaysia, specialists spoke on subjects such as the supervision and regulation of Islamic finance, legislation, market perspectives, and Islamic financial services in Japan. Seminar participants filled the hall and asked pertinent questions.

Left: The Governor of the Central Bank of Malaysia, speaking at the seminar. Below: The seminar was very well attended.

KEY WORDS
Keys to understanding Islamic finance

Islamic Financial Services Board (IFSB)
One of the IFSB's functions is to explore ways to harmonize rules and standards governing Islamic finance. It was inaugurated in 2002 by institutions in Muslim countries, most located in the Middle East. The Secretariat is in Malaysia. There are currently 20 full members, many of them central banks of Muslim countries. There are 15 associate members, including the International Monetary Fund and the World Bank. JBIC is one of 90 observer members.

Petrodollars
Surplus foreign currency assets that have their source in the net petroleum profits of oil-producing countries.

(3) JBIC To Share Information with Private Financial Institutions

Japanese financial institutions do not yet have experience with Islamic finance, so they are not very familiar with its distinctive approach.

It is customary for financial institutions that conduct Islamic financial transactions on a regular basis to establish advisory boards composed of Islamic legal scholars to help them ensure that their methods and systems conform to Shari'ah. But Japanese financial institutions have had little opportunity to come in contact with Islamic legal scholars, because of their lack of experience in Islamic finance.

Therefore, in May 2006 JBIC established a Shari'ah Advisory Group composed of Islamic legal scholars. This was the first such step taken in Japan. JBIC has signed Memorandums of Understanding (MOUs) on business cooperation with private financial institutions who are convinced that Islamic finance offers significant business opportunities. Under the MOUs, Islamic Finance Study Groups will be held when appropriate, to disseminate the knowledge gained from the Shari'ah Advisory Group.

(4) JBIC Making Tangible Progress on Introducing Islamic Finance

JBIC co-hosted the Seminar on Islamic Finance in early 2007, and has signed a Memorandum of Understanding on Islamic finance with the Central Bank of Malaysia.

JBIC is considering issuing Islamic bonds (*sukuk*) after conducting studies, in order to promote the development of Islamic finance in Asia and better serve local capital needs. The Central Bank of Malaysia leads the Islamic finance sector in Asia, and the stronger cooperative relationship that JBIC has now established with the Bank is highly significant.

JBIC intends to continue gaining and sharing knowledge and concrete experience in matters of Islamic finance, so that it can better contribute to the further development of Islamic financial services in Asia and the recycling of petrodollars within Asia.

Cooperation Will Lead to Mutual Understanding Between Muslim Societies and Japan

Muhammad Imran Usmani, Ph.D.,
Member of the JBIC Shari'ah Advisory Group, and member of the Shari'ah Board of the Meezan Bank (Pakistan)

I believe that the Islamic community from the East to the West has warmly welcomed the interest shown by the Japanese government, Japanese governmental institutions, especially JBIC, Japanese financial institutions, and Japanese enterprises and individuals in Islamic Finance.

Islamic finance relates to all financial activities which are conducted in accordance with Islamic Law, known as Shari'ah. The most unique characteristic of Islamic finance is that all products offered by Islamic financial institutions must be Shari'ah compliant through review by a Shari'ah Advisory Board which is established in each Islamic financial institution. Although it is possible that interpretations of the Shari'ah by Shari'ah Advisory Boards may be differ amongst Islamic financial institutions, the Islamic finance community is making efforts to harmonize the interpretation of the Shari'ah amongst Islamic financial institutions and also to harmonize that common interpretation of the Shari'ah with conventional finance.

A feature which distinguishes Islamic finance from conventional finance which I would like to most emphasize is that conventional banking prices money (in the form of interest), whereas Islamic finance prices goods and services which promotes entrepreneurship, wealth creation and economic well-being. The profit and loss sharing and partnership models featured in Islamic finance products means that financial institutions become investors rather than creditors which encourages a fairer distribution of wealth in the society which is also representative of true productivity.

I hope that Japanese institutions and enterprises will become more interested in Islamic finance as the future cooperation between Islamic and Japanese financial institutions will lead to a deeper understanding and appreciation of the societies which they represent, and also opportunities to create wealth which will be mutually beneficial.

Islamic Finance Study Group

JBIC established the Islamic Finance Study Session in May 2006, after signing Memorandums of Understanding to that effect with private financial institutions (Sumitomo Mitsui Banking Corporation, Mizuho Corporate Bank and Bank of Tokyo-Mitsubishi UFJ).

3. Projects Cofinanced with Islamic Finance Partners

JBIC's Experience with Islamic Finance in Middle Eastern Projects

Fulfilling its role as a policy-oriented financial institution mandated to harmonize Japan's external economic policies with its economic cooperation programs, JBIC has offered financial assistance to many projects in different parts of the world. A number of investment projects and large infrastructure projects in which Japanese corporations have participated have recently been cofinanced with Islamic finance partners, particularly in the Middle East. This shows that, even in cases of direct corporate participation, Islamic finance is taking on greater importance in the world of international finance.

In the Middle East and the Persian Gulf region, conventional and Islamic financial systems are often blended to support project financing schemes. There is every reason to assume that this type of blend will continue to be used for major infrastructure projects there, such as petrochemical and LNG plants, power generation facilities and desalination plants.

Bahrain: Buyer's Credit for a Public Petroleum Company (2005)

In response to the worldwide trend toward tighter environmental regulations, the Bahrain Petroleum Company (BAPCO) decided to purchase advanced environmental conservation equipment from Japan, primarily a desulphurization unit, in order to lower its refinery's diesel fuel sulfur content to 10ppm, a level that meets the environmental standards of advanced countries.

JBIC extended buyer's credit to BAPCO for a loan for JGC Corporation to export the equipment as a set. This was the first direct loan commitment that JBIC provided Bahrain. The loan was arranged so that revenues from the sale of petroleum products are set aside for the purpose of repayment, thereby avoiding the need for a loan guarantee from the Bahrain government. Funds required for the construction and equipping of the environmental conservation project were procured using the Islamic financing tools of overseas financial institutions, and this has created a model for programs cofinanced with Islamic financial instruments.

BAPCO refinery

Saudi Arabia: Project Financing for an Oil Refining and Petrochemical Project (2006)

Saudi Arabia's Saudi Aramco, the world's largest petroleum company, and Sumitomo Chemical Co., Ltd., have decided to establish a refining and petrochemical company called PETRORabigh with equal capital investments. The new company will acquire and improve an existing Saudi Aramco oil refinery, and construct new facilities for the production of refined petroleum products and petrochemical products such as polyethylene. JBIC is providing Saudi Aramco and PETRORabigh with loan in project financing.

The project financing, the first from JIBC to Saudi Arabia, will support that country's efforts to diversify its petrochemical industry, give added value to its petrochemical products, and create more jobs. Use of Japan's advanced technology will ensure the stable, low-cost production of products at a time when crude oil prices are spiraling upward. The project financing will promote friendly relations between both countries, and represents a cofinancing arrangement that involves Islamic financial resources from overseas financial institutions.

PETRORabigh oil refinery and petrochemical plant

What is Islamic finance?

Islamic finance is also called Shari'ah-compliant finance, because its financial and commercial affairs conform to Shari'ah (Islamic law). These financial services abide by two major sources of inspiration: the Qur'an (the sacred book of Islam), and the Sunna (practices and traditions from the time of the Prophet Muhammad). Islamic finance is practiced by Muslims in the Islamic world, of course, but it is also expanding as an international financing practice in the global market.

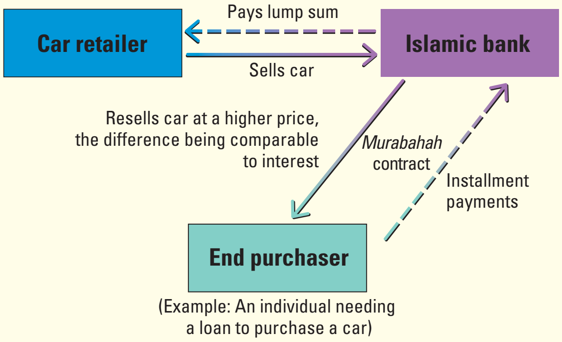
The most distinguishing features of Islamic finance are: (1) *riba* (interest) is prohibited; (2) profits and losses are shared by the capital provider and the entrepreneur; (3) transactions are backed up by material, not intangible, assets; and (4) financing for businesses violating religious precepts (for example, alcohol or gambling) is prohibited.

Islamic financing methods

Typical contractual arrangement: Cost-plus loan (*murabahah*)

This method, applied since the early days of Islamic finance, is often used for individuals acquiring a relatively small material asset, such as a car or house. In Islamic finance, about 70% of all capital management schemes follow this method.

A similar method, called *istisna'a*, is applied when there is no material asset at the time of the contract (for example, a house purchased before it is built).



Islamic financial instruments for project loans

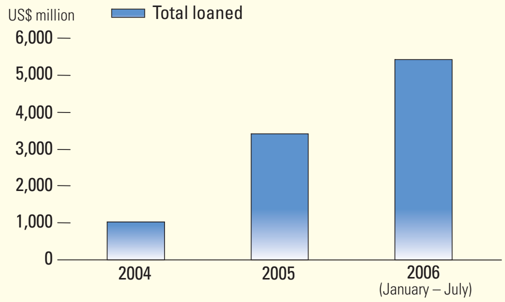
Global Islamic Project Loans (IPLs)

IPLs use Islamic finance methods to finance a project.

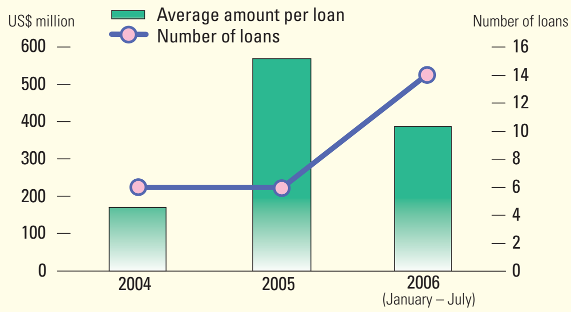
IPL financing has soared recently — the total amount provided in the first seven months of 2006 exceeded the total value of loans in 2004 and 2005. The number of loans is also increasing sharply. Contrasted to this, the average amount of loans provided during 2006 was less than for 2005, thereby actually demonstrating again that IPLs are gaining favor.

Project financing through IPLs is often a blend of Islamic financing with conventional financing methods. It is anticipated that cofinancing with an Islamic finance component will rise even higher, especially for private-sector water and power producers (IWPP*) in the Middle East and Persian Gulf region.

IPLs: Total amounts, 2004 – July 2006



IPLs: Average amount per loan, 2004 – July 2006



* An IWPP (Independent Water and Power Producer) builds and operates power generation and water desalination plants on its own, and sells the electricity and water.

Sukuk: Islamic bonds

In the past, Islamic financial services handled relatively small transactions with individual consumers, but since the beginning of this century they have expanded rapidly due to the issuing of sukuk bonds. *Sukuk* permit the raising of large amounts of capital, and *sukuk* transaction markets have been developed to promote the dispersion of investment risk. Islamic finance has expanded tremendously as a result.

Sukuk are issued in the same way as conventional bonds. Their basic difference is that the procured capital is used in accordance with Islamic finance methods, and is not used for business operations that would violate Muslim teachings.

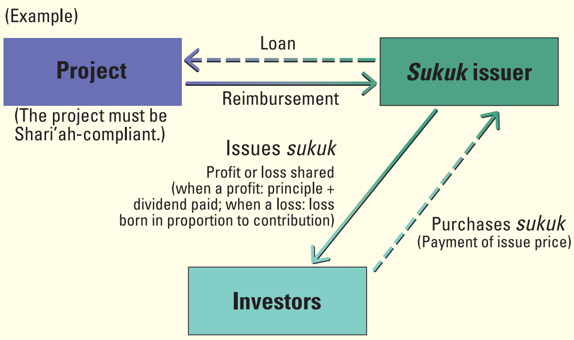
Generally, the procurement of capital through *sukuk* issues is done in combination with a capital management method such as *musharakah* (partnership financing) or *ijara* (lease financing). *Sukuk*-related payments must be made either under a transaction agreement or as part of an investment scheme involving material assets.

Typical financial structure for *sukuk* (I)

Musharakah: Equity participation where profits and losses are shared

Under the *musharakah* form of money management, capital is procured by issuing *sukuk* and then used for an investment project specified beforehand by the issuer.

If the project yields a profit, it is distributed among the investor partners at pre-agreed ratios. If the project yields a loss, it is borne by the investors in proportion to their capital contributions.



Typical financial structure for *sukuk* (II)

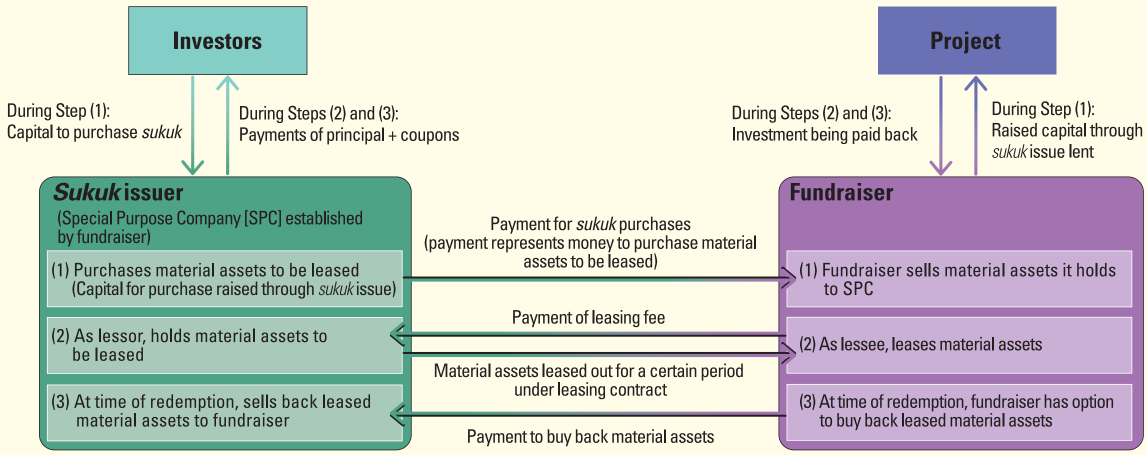
Ijara: Lease-and-sell method

* A Special Purpose Company (SPC) is established for the purpose of raising funds. The fundraiser sells material assets to the SPC (for example, a building held by a financial institution), then establishes a new leasing arrangement with the SPC.

* The SPC issues *sukuk* backed up by this transaction, thereby raising capital. The SPC purchases and holds the leased assets, and allocates leasing income in the form of dividends (corresponding coupons) to the investor.

* The fundraiser allocates capital procured through the SPC to finance the project.

* When the *sukuk* are redeemed, the fundraiser has the option of buying back the assets from the SPC, with the SPC allocating the money received from this sale to the investors.



GUEST OPINION

ISLAMIC FINANCE: AN INTEGRAL COMPONENT OF THE GLOBAL FINANCIAL SYSTEM

Professor **Rifaat Ahmed Abdel Karim**,
Secretary General, Islamic Financial Services Board (IFSB)

Islamic financial services is without doubt rising to greater prominence in the global financial system, and over the last decade or so has rapidly extended beyond predominantly Muslim emerging economies to major developed economies. This growing significance demonstrates the viability of Islamic finance as a basis for financial intermediation that supports economic growth and national development.

While initially developed to fulfill the needs of Muslims, Islamic financial services have now gained universal acceptance, and the appreciation of their potential has motivated international financial institutions to venture into this fast expanding market. Financial institutions now offering Islamic financial services are constantly developing and innovating Shari'ah compliant products to suit market demands. While it can be seen as a significant and positive development in the global financial system, this extreme growth poses a major challenge both to regulators and international inter-governmental organisations that are entrusted with the task of monitoring the soundness and stability of the financial systems in various jurisdictions, and to the market players themselves.

The two fundamental challenges facing the Islamic financial services industry are to ensure that the industry operates (1) as an integral part of the international financial system; and (2) on a sound and stable basis.

The integration of the Islamic financial services industry into the global financial system will to a large extent be facilitated by high quality prudential standards which, while complementing existing international standards, also address the specificities of Islamic finance. We believe that the IFSB has a significant role to play in promoting and facilitating this integration.

Role of the Islamic Financial Services Board

The IFSB was officially inaugurated on 3rd November 2002 with nine founding members — the Central Banks of Bahrain, Indonesia, Iran, Kuwait, Malaysia, Pakistan, Saudi Arabia and Sudan as well as the Islamic Development Bank. Malaysia, the host country of the IFSB, has enacted a law known as the Islamic Financial Services Board Act 2002, which gives the IFSB privileges and immunities that are reserved for international organisations and diplomatic missions.

The membership of the IFSB (as at March 2007) is 126 organisations comprising regulatory and supervisory authorities, international inter-governmental organisations such as The World Bank, International Monetary Fund (IMF), Bank for International Settlements and Asian Development Bank as well as market players and financial institutions operating in over 22 jurisdictions.

It is worth noting the increased interest in the Islamic financial services industry, especially from non-traditional Muslim markets. In the past year, we admitted regulatory authorities and financial institutional members from Japan, Hong Kong, Singapore, Germany, Turkey and the United Kingdom. Japan Bank for International Cooperation joined the IFSB as an Observer member in January 2007.

Since its inception, the IFSB has issued three standards and guiding principles for the Islamic financial services industry focusing on Risk Management, Capital Adequacy and Corporate Governance. Two further standards on Supervisory Review Process and Transparency and Market Discipline are scheduled for adoption by the IFSB Council by end of 2007. They are currently being issued as exposure drafts, as part of a public consultation process. The IFSB is also working on three new standards and guidelines on Special Issues in Capital Adequacy, Governance of Investment Funds and Corporate Governance in Takaful Operations.

In developing its standards and guidelines for the Islamic financial services industry — broadly defined to include banking, capital markets and insurance - the IFSB does not attempt to reinvent the wheel. Rather, it compliments the standards and guidelines issued by its international counterparts.

It has to be noted that similar to other international standard-setting organisations, the IFSB does not have the power to enforce the implementation of the standards and guidelines it promulgates. In this respect, the IFSB endeavours to develop high quality standards and guidelines while working together with regulatory and supervisory authorities in member countries as well as other relevant international organisations to conduct awareness programmes such as workshops and seminars so as to facilitate the implementation of its standards and guidelines.

Cross-Sectoral Approach to Supervision of Islamic Financial Services

The scope of financial services for the IFSB includes banking, capital markets and takaful segments of the Islamic financial services industry. While each sector is constantly innovating and developing new Shari'ah compliant products and services, the role of the IFSB is to assist and facilitate the industry to operate on a sound and stable basis.

The forthcoming IFSB Summit on 15 - 16 May 2007, which will be held in Dubai, will focus on "The Need for A Cross-Sectoral Approach to the Supervision of Islamic Financial Services". The Central Bank of the UAE is hosting the Summit, and it will be held under the Royal Patronage of the His Highness Sheikh Mohammed bin Rashid Al Maktoum, Vice President and Prime Minister of the UAE and Ruler of Dubai. Among the distinguished chairpersons and speakers who have confirmed their participation are the Managing Director of the IMF and the former Prime Minister of New Zealand together with 12 Governors of Central Banks and Chairmen of Securities and Insurance Commissions. The Summit will discuss alternative regulatory structures for effective supervision, the relevance of a cross-sectoral approach of supervision for Islamic financial services, the approach from the standard-setters' and market players' perspectives as well as challenges and opportunities that lie ahead for cross-sectoral supervision.

The 4th IFSB Summit aims to facilitate constructive discussion and exchange of ideas on an approach which may prove relevant at a time many stakeholders are watching further developments within the industry, developments that will further the position of Islamic finance as an integral part of the global financial system.

Potential benefits of JBIC's proposed *sukuk* issue

JBIC is considering issuing *sukuk* (a type of bond) in Malaysia. If it does so, we hope that Japanese government institutions and private companies will actively explore ways to use the *sukuk* market as a way to raise funds.

The proposed *sukuk* would be the first ever issued by a government or government institution of a G8 country, and would represent an important step toward the involvement of Islamic financial services in the global financial system. International credit rating institutions would probably assign a sovereign credit rating of AA or even higher to quality *sukuk* issued by a Japanese government institution. It is expected that repeated issues would establish global benchmarks, Islamic capital markets would secure a stronger position for themselves in Asia, and the day would soon come when petrodollars would be recycled within the Asian market.

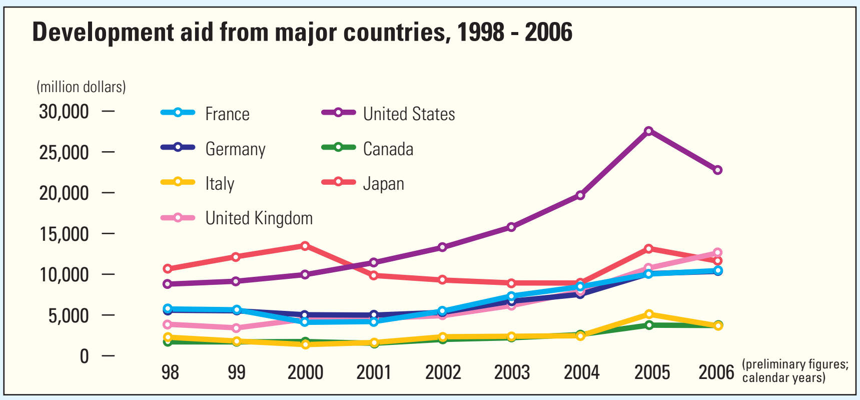
(The above text is an article submitted by Professor Karim in the end of March 2007, with the addition of some of his remarks at the January 2007 Seminar on Islamic Finance.)

FOCUS

The Future for Japanese ODA loans:
More Advantageous Conditions, More Effective Assistance
Applying Japan's Development Experience and Expertise

The environment in which Japan's Official Development Assistance (ODA) programs operate is dramatically changing. The world's assistance needs are greater, as is evident from the challenges posed by the United Nations' Millennium Development Goals (MDGs), and developing countries still have strong expectations of Japan. The Japanese government, however, is now in a difficult fiscal situation, and Japan's ODA has slipped from second to third place. Meanwhile, South Korea, China and other emerging donors have arrived on the scene. These and other changing trends are affecting international assistance. The best approach for more impressive Japanese ODA is to fully utilize the experience and expertise gained through its own development, and through its development assistance programs.

Japanese ODA loans through the Japan Bank for International Cooperation (JBIC) must offer even more advantageous conditions and be even more effective, in order to better contribute to sustainable development and the self-help efforts of recipient countries. JBIC promotes the development of both infrastructure and social sector, and is strengthening its ties with the Japan International Cooperation Agency (JICA) and other organizations that are active in development assistance.



Source: OECD Development Assistance Committee (DAC), 2007 press release

Photos: Delhi Mass Rapid Transport System Project (India)

Japanese ODA loans: Optimizing Japan's Experience in Its Own Development and Its Assistance Programs

Infrastructure Projects for Economic Development

The fourth Tokyo International Conference on African Development (TICAD-IV) will be held in 2008 in Tokyo, and right after that Japan is scheduled to host the G8 Summit in Hokkaido. For these reasons, too, attention is already focusing on 2008 as the year of official development assistance (ODA).

Japan's ODA programs began in 1954, and have since provided assistance in the form of technical cooperation, loans, and grants facilitating the advancement of developing countries. Aid from Western countries has tended to prioritize direct assistance to the poor through, for example, health and medical programs. On the other hand, Japan, while also offering this type of assistance, has focused its energies on economic growth through Japanese ODA loan support for the construction and improvement of socioeconomic infrastructure. This approach raises living standards and reduces poverty in recipient countries. Japanese ODA loans and other forms of assistance provide backup support for the self-help efforts of developing countries, especially in Asia, and it is often said that they have played a key role in the "East Asian miracle" of economic development seen today.

More Attractive Conditions, More Effective Assistance — Without Overburdening Japanese Taxpayers

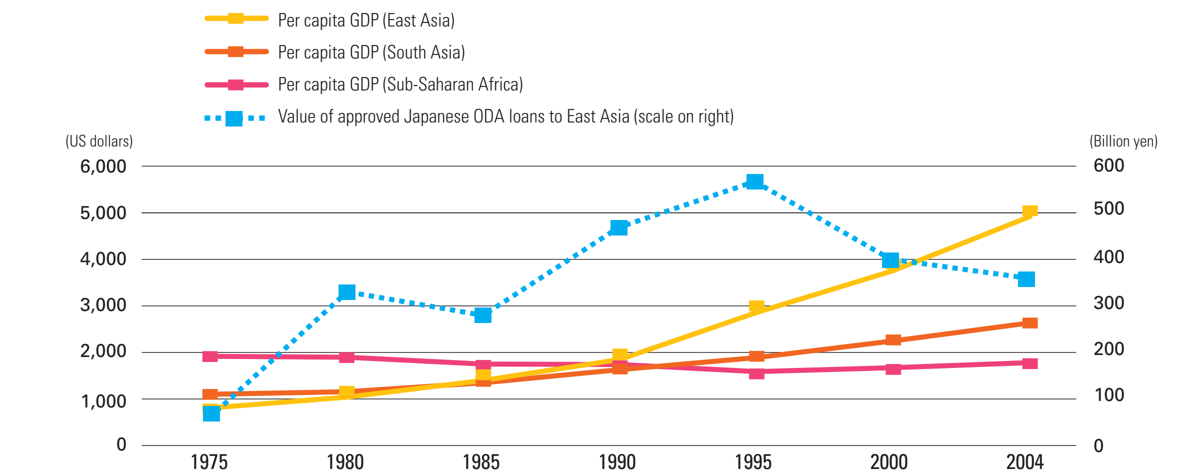
Reports indicate that despite years of continued development assistance, about 1.2 billion people worldwide still live on less than a dollar a day — a figure that represents one-fifth of all humanity.

The UN Millennium Development Goals (MDGs) are inspired by the Millennium Declaration adopted in 2000, and set down specific actions and targets, including the eradication of extreme poverty. The Goals are extremely ambitious, and more assistance is required to achieve them.

Japan's ODA was the highest in the world during the 1990s, but began shrinking in 2000 due to the difficult fiscal situation faced by the Japanese government. On the other hand, developed countries in the West scaled up their assistance budgets, spurred on by the 2002 UN International Conference on Financing for Development in Monterrey, where it was affirmed that developed countries would need to double their ODA for the MDGs to be achieved. Japan's ODA fell behind that of the United States, and in 2006 slipped again to third place, behind that of the United Kingdom as well. The OECD Development Assistance Committee (DAC) released estimates indicating that if present trends continue, Japan's ODA will fall to fifth place in several years. International development assistance is seeing other significant changes as well, notably the entry of emerging donors such as South Korea and China.

Japan depends on other countries for much of its energy resources and food, and its corporations are pursuing businesses around the world. For these reasons, too, it is crucial that Japan promote global stability and maintain friendly relations with other countries. In pursuit of these goals, Japan needs to fulfill its due role in development assistance. More attractive and more effective assistance programs that place a lighter burden on the Japanese people will become important "to help ensure Japan's own security and prosperity," an objective stressed in Japan's ODA Charter. Japanese ODA loans are potent instruments for achieving these aims. There are indeed causes for optimism, since Japan implements the programs with experience and expertise gained through its own economic development and through the successful assistance projects carried out for years in Asia.

Role of Japanese ODA loans in East Asia's economic development



Effective ODA loans to Facilitate Developing Countries' Own Initiatives

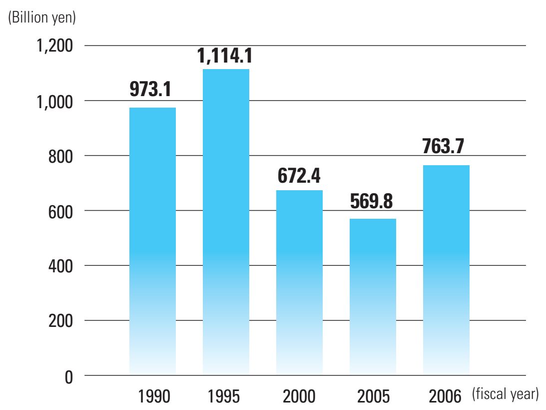
Solid Results in Many Fields

The basic philosophy behind Japan's assistance is support for self-help efforts that depend on the initiative of developing countries themselves. Japanese ODA loans are financing instruments, of course, but they are also an expression of respect for the self-help endeavors of other countries, and they represent practical support measures that embody Japan's experience and expertise.

Japanese ODA loans provided through JBIC have roots going back to 1958, and since then Japan has built up, primarily in Asia, a wealth of development support experience in many sectors, including electric power, transportation, telecommunications, irrigation, water supply and sewerage systems, and environmental protection.

These programs have clearly been a factor in the strong economic growth and impressive reduction of poverty in Asia. JBIC employs a wide range of process-related tools, from project formation to post evaluation, and will use the experience and skills it has gained in the field to make these tools even more useful and practical, and to prioritize efforts to raise the capacities of developing countries. JBIC continues to be involved in policymaking, human resource development and sustainable initiatives fostering citizen participation in developing countries, while strengthening its ties with JICA, which is mandated to link capital aid cooperation with technical cooperation beginning in 2008, and with local governments, universities, NGOs and other organizations.

Value of Japan's approved ODA loans, 1990 - 2006



Japanese ODA loans: Effective Use in More Parts of the World

The Japanese government intends to implement ODA projects strategically at a time when it faces a difficult fiscal situation. Within the government, discussions are continuing on how Japan can improve the quality of its ODA projects while at the same time meeting the international commitment made at the G8 Summit in Gleneagles in 2005 to increase the value of ODA assistance by US$10 billion over the subsequent five years. Policy-related matters discussed during a January 2007 government meeting on overseas economic cooperation included the increase in the number of donor countries, facilitating Japanese ODA loans through faster decision-making and implementation processes, and seamless ties linking the efforts of JICA and JBIC in the field.

Against this backdrop, JBIC substantially increased the value of newly committed Japanese ODA loans for fiscal 2006 by 34% over the previous year, to 763.7 billion yen.

At 84.3%, Asia still accounts for a major share of Japanese ODA loans. Africa dramatically increased its share over fiscal 2005 from 8.9 to 14.9%, with total loan value jumping from 50.7 billion yen to 113.7 billion. This increase was due to a number of factors, including: (1) Tanzania received its first Japanese ODA loan in 25 years, after achieving strong results from its many years of structural reform aimed at resolving debt issues; and (2) private sector assistance financing involving the participation of the African Development Bank. In addition, two Sub-Saharan countries, Namibia and Mozambique, have recently been added to the list of Japanese ODA loan beneficiaries.

In Asia, JBIC will continue to support infrastructure projects, which have tremendous capital needs, and will enhance its support for countries in Sub-Saharan Africa. JBIC also intends to carefully promote ODA projects in countries in other parts of the world where expectations for economic development are high, using the expertise it has gained through support programs in Asia, and showing consideration for each country's circumstances and respect for their self-help efforts, all the while accurately ascertaining what types of assistance are truly required.

KEY WORDS

Keys to understanding opportunities to make ODA loans more advantageous and effective

Millennium Development Goals (MDGs)

The MDGs were inspired by the United Nations Millennium Declaration issued at the UN Millennium Summit in September 2000. The following year, they became shared development targets for the international community in the 21st century. The MDGs set specific quantifiable targets to be achieved by 2015 in eight thematic areas, including eradication of extreme poverty and hunger, achievement of universal primary education, improvements in healthcare and medical treatment, and environmental sustainability.

Recent Practices Using Japan's Development Experiences

Partnership with Local Governments and Universities

Case Study 1: India — Hussain Sagar Lake and Catchment Area Improvement Project

— Tie-ups with Hikone City and the University of Shiga Prefecture to use their experience and know-how in lake water purification

Hyderabad, the capital of the state of Andhra Pradesh in southern India, is attracting worldwide attention as a center for software development. Companies there are contributing to the development of systems for Japanese corporations as well. Against this backdrop of economic development, the water quality of Hussain Sagar Lake in the center of the metropolitan area has deteriorated, creating a need for improved sewage treatment facilities.

In the 1960s, Lake Biwa in Shiga Prefecture, Japan, was polluted by industrial and household wastewater and the inflow of pesticides and fertilizers. Citizens joined hands with the local governments of Hikone City and the prefecture to improve water quality, and eventually succeeded in halting the pollution. Capitalizing on this shared experience, international associations in Hyderabad and Hikone formed a partnership that was augmented through grass-root exchanges, creating opportunities for Hikone to demonstrate to Hyderabad the experience and know-how it had gained by improving Lake Biwa's water quality.

Hussain Sagar Lake in Hyderabad is in urgent need of measures to improve water quality

Hyderabad is experiencing dramatic economic growth

In 2005, JBIC partnered with Hikone City and the University of Shiga Prefecture to hold a workshop in Hyderabad and demonstrate this experience and know-how to local people involved in the issue. In March 2006, JBIC decided to provide an ODA loan for the Hussain Sagar Lake and Catchment Area Improvement Project, and in May 2006 people from Hyderabad participated in training sessions in Hikone. The collaboration is ongoing.

Case Study 2: China — Trainees from China

—Tie-ups with Yamaguchi University, Shimane University, Shimane Prefecture, Fukuoka City and Kita Kyushu City

Japanese ODA loans for China now prioritize human resource development and environmental projects in the interior, since the more coastal areas have seen greater economic development. The support is widespread, encompassing not only improvements in physical facilities but also the human resources, inviting trainees to Japan and sending experts to China through tie-ups with local governments and universities.

One such endeavor, the Inland Higher Education Project in Guizhou Province fostered a tie-up between Yamaguchi University in Japan and a university in Guizhou Province. This led to the creation of a human resources development program for environmental education, which will form the basis for an environmental education handbook for senior high school students in Guizhou. The Yamaguchi prefectural government plans to invite government officials and senior high school teachers from China to attend a training session that it will organize.

As part of the Ningxia Water Environment Improvement Project, Shimane University provided backup for local research into the use of reclaimed wastewater and the development of a related training program. When the project reaches the implementation stage, the governments of Shimane Prefecture, Fukuoka City and Kita Kyushu City plan to invite trainees from China to examine water conservation measures and the use of reclaimed wastewater in Japan.

Exchanging ideas at a Chinese university specializing in science and technology: participants in a human resources development project

Tokyo International Conference on African Development (TICAD)

These international conferences are held in Tokyo under the co-organization of the Japanese government, the United Nations, the Global Coalition for Africa (GCA), and the World Bank, to examine policy guidelines on African development. The first Conference was held in 1993, and the fourth is scheduled for 2008.

Private Sector Assistance Loan under the joint initiative titled Enhanced Private Sector Assistance for Africa with the African Development Bank

At the G8 Summit in 2005, then-Prime Minister Junichiro Koizumi announced a joint initiative with the African Development Bank (AfDB), entitled Enhanced Private Sector Assistance (EPSA). Under this initiative, Japan is able to provide ODA loans to the AfDB up to a limit of 11.5 billion yen, to be used to foster local small and micro enterprises and private financial institutions.

Case Study 3: India — Gujarat Forestry Development Project Phase 2

—JBIC joins forces with the University of the Ryukyus and Okinawa Prefecture for mangrove reforestation and conservation

The mangrove swamps in the coastal regions of the state of Gujarat in western India are the second largest in the country. Mangroves protect shores from wave and tidal erosion, but in Gujarat, 79% of the mangrove cover has deteriorated. In 2007, a reforestation project financed with an ODA loan from Japan was launched with local citizen participation to restore mangrove swamps, raise local incomes and improve the environment.

During the project formation stage, JBIC partnered with the University of the Ryukyus and the Okinawa prefectural government to organize workshops for organizations in Gujarat, to demonstrate Japan's know-how and experience in planting and protecting mangroves. This expertise holds promise for a successful outcome to the project.

Workshops in India offer guidelines in mangrove swamp conservation

Infrastructure Projects Applying Japan's Advanced Technology

Case Study 4: Vietnam — Ho Chi Minh City Urban Railway Construction Project

—Taking advantage of the advanced technology of Japanese companies

In Ho Chi Minh, Vietnam's largest city, traffic is becoming heavier as the economy grows. This has created serious problems, especially a sharp increase in traffic accidents, road congestion and air pollution, all factors hindering socioeconomic development.

Traffic is heavy in Ho Chi Minh City, Vietnam

To promote Ho Chi Minh's economy and improve the urban environment, JBIC has agreed to provide Japanese ODA loan for the Ho Chi Minh City Urban Railway Construction Project, which envisages high-speed operations on underground and elevated track for Line 1 (from Ben Thanh to Suoi Tien). This is the first full-scale urban railway project in the country, and because Japan's rail technology is expected to be introduced, Special Terms for Economic Partnership (STEP) will be applied.

The advanced technology of Japanese companies in the railway sector will be used for this project in response to Vietnam's request, as it has for other urban rail projects financed through Japanese ODA loans. The positive results of such projects can already be seen in Bangkok, Thailand and Delhi, India.

JBIC is transferring Japan's advanced technology to Vietnam through strong support of other projects as well, including highly efficient electric power plant technology, and environmental protection technology to halt pollution.

Support for Disaster Management and Energy Conservation

Case Study 5: Countries prone to natural disasters — Exploring disaster risk management issues

—Discussing Japan's experience after the Great Hanshin-Awaji Earthquake

The world still remembers the tsunamis that caused so much damage after undersea seismic activity off Sumatra in 2004. Japan has built up considerable expertise in mitigating the effects of earthquakes, typhoons, floods, volcanic eruptions and other natural

KEY WORDS

Keys to understanding opportunities to make ODA loans more advantageous and effective

Special Terms for Economic Partnership (STEP)

Although the STEP program requires that equipment and materials are procured from Japanese companies, preferential interest rates, repayment periods and other favorable conditions apply. The loans facilitate the transfer of advanced Japanese technologies and know-how to developing countries.

disasters, and JBIC is teaming up with governments, citizens' groups and NGOs to support disaster risk management and reconstruction.

Villagers taking action to prevent flooding in the Philippines: One activity presented at the seminar on disaster risk management

In May 2007, JBIC held a seminar on disaster risk management in Kobe, Japan, with cooperation from the Kobe municipal government and the Asian Disaster Reduction Center. The keynote speech, given by a Kobe City official, focused on the region's experience after the Great Hanshin-Awaji Earthquake. The speech was followed by discussions and presentations from experts involved in disaster risk management and research in countries prone to natural disaster, including Bangladesh, Pakistan, the Philippines and Indonesia.

JICA and JBIC representatives joined in the panel discussion that examined what kind of assistance is truly necessary for community residents, how government activities can be linked with local community needs, and how important the roles of education for disaster risk management are.

This type of seminar approach is used to expand knowledge in other fields as well, such as energy conservation and pollution prevention.

Tsunami damage in Sri Lanka after a massive earthquake off Sumatra

Making the Most of JBIC's Assistance Experience in Partnership with Other Cooperation Organizations

Case Study 6: Operations agreements with Export—Import Bank of Thailand, Neighboring Countries Economic Development Cooperation Agency and Economic Development Cooperation Fund of the Export-Import Bank of Korea

— Partnerships with emerging donors for more effective support programs

In 2006, JBIC signed memorandums of understanding (MOU) with the Export-Import Bank of Thailand (TEXIM) and the Neighboring Countries Economic Development Cooperation Agency (NEDA), to facilitate more partnering for development of the Greater Mekong Subregion.

The objective of the MOU with TEXIM is to exchange information that will be used when providing cooperative support for Japanese and Thai businesses expanding into the Greater Mekong Subregion (GMS). This will promote investment in the region. The MOU with NEDA will strengthen JBIC's partnership with that organization, which has begun financial cooperation with Cambodia and Laos. JBIC has sent a expert to NEDA to conduct training programs, and assist NEDA as it enhances its organizational capacity, drawing on the expertise JBIC has gained in project implementation and evaluations. JBIC intends to strengthen its ties with TEXIM and NEDA, and will offer effective support for sustainable development, nature conservation and poverty reduction in the GMS.

JBIC has also signed an ODA operations agreement with the Economic Development Cooperation Fund (EDCF) of the Export-Import Bank of Korea. JBIC intends to continue actively promoting partnerships with emerging donors in Asia.

Ceremony marking the signing of an ODA operations agreement with the Economic Development Cooperation Fund (EDCF) of the Republic of Korea

Japanese ODA loan project evaluations

JBIC evaluates all projects to enhance the effectiveness and efficiency of ODA operations, and to ensure full accountability. Post-project evaluations are based on international evaluation criteria. Projects are evaluated on an individual basis, and impact analysis is also made to examine the effect of Japanese ODA loan operations on specific countries and on specific themes. Results of all project evaluations are made public.

Japanese ODA loans: More Advantageous Conditions

The capital needs of developing countries will most likely remain great for many years. For one thing, poverty reduction and other efforts to achieve the Millennium Development Goals will continue for some time in Africa and elsewhere in the world. In addition, developing countries in Asia that are now enjoying economic expansion will require more capital investment to maintain growth rates. The governments of developing countries have limited capital resources, and this means that private investment must be encouraged. To improve the investment climate, there is an urgent need to build institutional systems, raise capacity, improve governance, and develop basic infrastructure. Japan's ODA can play a very important role in achieving these objectives.

To enhance the effectiveness and efficiency of Japan's ODA operations and improve their quality, in the fall of 2008 the Japanese government will integrate JBIC's Overseas Economic Cooperation Operations (which include ODA loan programs), technical assistance operations managed by Japan International Cooperation Agency (JICA), and many of the grant aid programs that now fall under the purview of the Ministry of Foreign Affairs. The "new JICA" will bring all three roles under a single umbrella.

JBIC has partnered with JICA to pursue projects in many sectors in the past, and will put its weight behind the goals driving this integration in order to improve the quality of Japan's assistance and raise the international competitiveness of Japanese ODA. In doing so, JBIC will meet the expectations of the Japanese people, who expect that Japan's aid programs will be carried out under ODA policies and strategies that suit the new age.

Japanese ODA loan Terms Becoming More Favorable

Keiichiro Nakazawa,
Director, Project Development Department

In response to enormous development needs, the Japanese government has confirmed that it aims to increase the aggregate value of Japan's ODA assistance by US$10 billion during the five year period beginning in 2005, and that it will therefore place even greater priority on Japanese ODA loans.

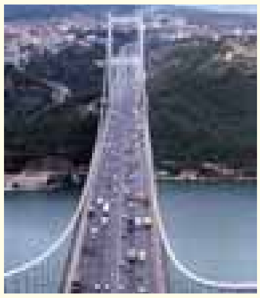
In April 2007, the government of Japan and JBIC began lowering ODA loan interest rates and modifying the fee system to further promote the use of such loans and speed up the project implementation more. The goal here is to promote project implementation by reducing the burden on borrowing countries and levying a commitment charge of just 0.1% per annum on undisbursed amounts of Loans (the portion of approved loans still not disbursed).

Also, the interest rate on consulting services was reduced to almost zero (the rate is now 0.01%). This was done to strengthen the soft component assistance, to ensure a higher level of quality in the projects, and to speed implementation.

Conditions are also better for upper-middle income countries, including substantially lower interest rates, widening the coverage of project candidates, and greater emphasis on ease of use. For example, assistance for earthquake-related measures has been expanded to include disaster risk management and post-disaster recovery measures, and assistance to reduce income disparities in lagging rural regions has been expanded to include measures to raise the living standards of the urban poor. These steps are being taken to promote improvements in social infrastructure.

In addition, interest rates have been made even more favorable for the Special Terms for Economic Partnership (STEP) program, which requires that equipment and materials be procured from Japanese companies as a way to introduce Japan's technology and know-how. On another front, the interest rate on loans to finance emergency post-disaster recovery efforts — a program where Japan's international contributions are much admired — has been reduced to almost zero (the rate is now 0.01%).

JBIC is keen to continue promoting policies such as these, as they will lead to greater use of Japanese ODA loans.



Second Bosphorus Bridge (Turkey) constructed with support from Japanese ODA loan

Cover: Tubbataha Reef Marine Park, the Philippines

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