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MOVING BEYOND GRANTS: QUESTIONS ABOUT AUSTRALIAN INFRASTRUCTURE FINANCING FOR THE PACIFIC

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A. Introduction

Over its more than 40 years of existence, Australian official financing for development has been provided nearly entirely in grants, through the foreign aid program.

Last year, a major break with the past was signalled by Morrison's 8 November 2018 Townsville speech "Australia and the Pacific: a new chapter."

The speech, written to respond to a perception that Australia was being out-muscled by China in the Pacific, announced two major new initiatives. The first was the creation of the Australian Infrastructure Financing Facility for the Pacific (AIFFP), costed at $2 billion, which will "use grant funding combined with long term loans to support high priority infrastructure development." The second was an increased role for Efic, Australia's export credit agency: "an extra $1 billion in callable capital and a new more flexible infrastructure financing power."

"Australia and the Pacific: a new chapter"
Morrison's 8 November 2108 Townsville speech

The Pacific region is estimated to need US$3.1 billion in investment per year to 2030. So today I'm pleased to announce two major new initiatives that will help address the infrastructure needs of the Pacific region.

The first is the creation of an Australian Infrastructure Financing Facility for the Pacific (AIFFP).

This $2 billion infrastructure initiative will significantly boost Australia's support for infrastructure development in Pacific countries and Timor Leste.

It will use grant funding combined with long term loans to support high priority infrastructure development.

This will also enable these projects to leverage broader support. It will invest in essential infrastructure such as telecommunications, energy, transport, water and will stretch our aid dollars even further.

The second major announcement I'm making today is the Government will ask Parliament to give Efic, Australia's export financing agency, an extra $1 billion in callable capital and a new more flexible infrastructure financing power to support investments in the region which have broad national benefit for Australia. It's in our interest that's why we need to do it.

These new measures will enhance Efic's ability to support Australian SMEs to be active in their region. Working with the support and aid that we are putting into the region. Private capital, entrepreneurialism, open markets are crucial to our mutual prosperity. These are our beliefs, these are values, they are shared with the Pacific and we stand with those who share our beliefs and values.

In this report, we provide background to and understanding of these announcements, as well as an initial assessment of their implications. The questions we ask are: ○ What do these announcements mean?

- What are their implications for the aid program and for Australian Official Development Assistance (ODA)?
- How do they compare to what other countries are doing? ○ What issues do these announcements raise?
- What options does the government have in implementing these announcements, and what recommendations can be made in this regard?

B. What do these announcements mean?

Chinese lending and aid to the Pacific came under intense media scrutiny throughout 2018, ever since the then Minister for International Development and the Pacific, Concetta Fierravanti-Wells, made a statement in January 2018 accusing China of engaging in debt trap diplomacy. In June last year, the Australian government scrambled to offer the Solomon Islands an alternative after it became aware that its government had awarded the contract for constructing an internet cable to the Chinese communications giant, Huawei. The Australian government subsequently offered to build both the Solomon Islands cable and a new cable to PNG using grants taken from the aid budget. Given that cables generate a commercial return, this use of grant funding to build the cables could be considered wasteful. The provision of loans (as had originally been arranged when the ADB was involved) would have been more appropriate.

The decision to announce a loan facility from the Pacific came after considerable pressure was placed on the government. Within a context of concern about China's rising influence in the region, the government was accused in the media of benign neglect, and, by some, of having focused the aid program excessively on governance at the expense of critical infrastructure. A number of Pacific island leaders also referred to Canberra's inattention to infrastructure (and excessive focus on "soft" assistance) when explaining why their governments had sought Chinese loans.[2] Within the bureaucracy, a feasibility study was instituted to examine the usefulness of a loans facility that could be used to development infrastructure (possibly along with other uses).

It was Labor that first announced it would set up an infrastructure fund for the Pacific if elected. The announcement that Labor would "actively facilitate concessional loans and financing for investment in … vital nation-building projects through a government-backed infrastructure investment bank" left many unanswered questions, but signalled Labor's intent clearly enough. The announcement constituted a significant change in policy for Labor, which had only earlier in the year signalled its intention to focus the aid program on its traditional priorities of health, education, gender and climate change. That Scott Morrison's announcement of an Australian Infrastructure Financing Facility for the Pacific was made a mere week after Labor's statement makes it clear that the shift to concessional financing for the Pacific has bipartisan support. Given this, we can assume that the AIFFP will survive any change in government (though perhaps with adjustments).

While the AIFFP announcement was no surprise, Morrison's Efic announcement was. There had been several calls within the development sector for the establishment of an Australian Development

[2] Dame Meg Taylor made this remark when speaking to Australian policy makers at a Lowy Institute event in Canberra in May 2018. Vanuatu government officials have made similar remarks. [3] Jim Adams, Bob McMullan, and Clay O'Brien.

Finance Institution (DFI),[3] but no advocacy that we are aware of, in the sector or outside of it, for an expansion of Efic's role.

Few details are on the public record, but the sections below provide our understanding of what the two announcements will or could mean.

(a) The Australian Infrastructure Financing Facility for the Pacific (AIFFP)

This is what we know about the AIFFP (including from DFAT's website):

- $1.5 billion in non-concessional loans. The interest rate for these loans has not been announced. The Australian government can borrow at about 2% (for ten-year bonds). How much of a risk premium will be added is unclear. Given the non-negligible sovereign risk, it could be substantial, though below what countries can borrow from commercial sources. Fiji has recently borrowed from world markets at 6.3%, and PNG at 8.4%.
- $500 million in grants. It is not clear to what extent this is new money for the Pacific, or includes funds already allocated for Pacific infrastructure. Different projects in different countries may be backed by different combinations of grants and loans.
- Projects will not be tied to purchases from Australian companies.
- There is also no indication yet that the Facility will be situated outside of DFAT. It will be "managed by the Department of Foreign Affairs and Trade".
- The AIFFP will be open to co-financing opportunities with the World Bank and ADB, and the private sector.
- It will invest in "high priority infrastructure … including in areas such as telecommunications, energy, transport, water and other essential infrastructure." It will support growth, genuine needs, and the priorities of the Pacific, and also invest in Timor Leste.
- It will be operational by July 2019.

In some ways, the AIFFP appears similar in its design to the Australia Indonesia Partnership for Reconstruction and Development (AIPRD) established after the Boxing Day Tsunami. This was $1 billion, a mix of loans and grants, a one-off, and was managed by DFAT. There are some important differences though: the AIPRD was equal parts loan and grant (not three-quarters loan as in the case of AIFFP); the AIPRD loans were highly concessional, with no interest charged and a repayment period of 40 years; and bidding on AIPRD projects was restricted to Australian, NZ and Indonesian companies.

There is much we don't know about the AIFFP. How transparent it will be, what its terms and conditions will be are questions to which no definitive answers are available. We don't know whether AIFFP will take over responsibility for all DFAT-funded infrastructure projects in the Pacific, though this would seem to make a lot of sense.

Because the AIFFP loans will not be concessional, they will not be counted as ODA. The grants will be. How much aid will have to be cut to make room for the $500 million of AIFFP grants depends on how quickly these grants are disbursed, and whether they include existing infrastructure commitments. Given that the Pacific has moved to the top of Australia's aid priority list, it seems likely that there will be cuts in aid to Asia to finance the additional grant component for the AIFFP. It remains to be seen whether the establishment of the AIFFP will also entail budget cuts to other sectors in the Pacific.

(b) Efic

Every developed country has an export credit agency which provides loans, guarantees and insurance to help national businesses export. Efic is Australia's.

The Morrison Efic announcement consists of two parts. The government's decision to increase Efic's callable capital is dramatic: its callable capital is currently $200 million; this will be increased to $1.2 billion.
Callable capital are funds that are not paid up but are available if needed. Essentially, the government undertakes to bail Efic out to the extent of the callable capital if it runs into difficulty. Like any such arrangement, the call is expected never to have to be made; and if it is made, it is the end of the organisation. The callable capital is nevertheless valuable as it enables Efic to borrow greater amounts at lower interest rates – since its creditors know that the government is standing behind it.

Efic manages risk by requiring adherence to prudent capital adequacy ratios. As per its latest annual report, Efic requires a ratio of cash capital (that is, excluding callable capita) to risk weighted assets of at least 8%, and a ratio of capital (including callable capital) to risk weighted assets of at least 16%. (p. 53). Actual ratios in 2017 were 17.6% on a cash capital basis and 25.2% if callable capital is included, that is, way above what Efic itself judges to be adequate. In other words, Efic already has too much capital. If there was no change to its risk weighted assets ($2.7 billion in 2017-18), then, upon the implementation of the announced callable capital increase, its capital adequacy ratio would increase to 62% (2.7/1.674). Let's say Efic wants to keep its capital adequacy ratio at 25%. Then its risk weighted assets would have to increase from $2.7 billion to $6.7 billion.

Where will Efic find an additional $4 billion of financing opportunities? There are a number of restrictions on Efic lending. They are not allowed to lend if private sector financing is available, and they are meant to focus on small and medium enterprise lending. As recently as 2013, Labor withdrew $200 million in capital from Efic. While this was subsequently reversed by the Coalition (in 2014), it nevertheless is hardly the context in which one would expect such a large increase.

Efic is minimally involved in the Pacific. According to the 2017-18 annual report, Efic exposure is $2.6 billion. Of this, $387 million is to the Pacific, about 15%. $273 million of this, or over 70%, is to one project, the PNG LNG project.[3]

At face value then – given that Efic's prime role is to help Australian companies, given that it has little exposure to the Pacific, and given that it seems to be in no need of capital – the Morrison announcement of a dramatic capital increase for Efic seems odd in the context of a speech about stepping up engagement in the Pacific.

An explanation is given by Morrison's undertaking that Efic will be given a "new more flexible infrastructure financing power to support investments in the region which have broad national benefit for Australia." This has been fleshed out through legislation put forward to the Australian parliament in February 2019, specifically the Export Finance and Insurance Corporation Amendment (Support for Infrastructure Financing) Bill 2019. Under this Bill, Efic's mandate is to be expanded to

[3] The PNG LNG project was approved by Efic under the so called "National Interest Account". These are projects that the Efic is directed to engage in by the Minister, and which are guaranteed separately by government.

cover overseas infrastructure projects. Any overseas infrastructure project that can be shown to be of direct or indirect benefit to Australia will be eligible for funding. Benefits to Australia are defined extremely broadly. According to the Bill's explanatory memorandum, they include: "the involvement of Australian companies in infrastructure projects, as well as future and indirect benefits for Australia or Australians, such as greater Australian participation in supply chains, access to new markets for Australian businesses, more Australian jobs, payments, dividends or other financial proceeds from overseas to Australia, or stronger relationships with our regional partners, especially in the Pacific." Efic will effectively be allowed to fund *any* overseas infrastructure project.

For any project that it does fund, EFIC has to act in such a way as is "likely to result in the maximum Australian benefits" (Section 5 of the 2019 Bill). As the Minister's second reading speech clarified, Efic "will be required to maximise Australian participation in overseas infrastructure projects."

Even with this new infrastructure mandate, it is unclear that Efic requires an increase in callable capital of $1 billion, which will allow it to do another $4 billion of financing. However, the Minister's speech indicates that Efic is near its single-country limit for PNG.[4] More lending to the Pacific, both to support infrastructure and perhaps to support major resource projects, may require an increase in callable capital to avoid hitting individual country or project exposure limits.

There are no ODA implications of the Efic reforms. Up until 1996, Efic was used to manage the Development Import Finance Facility (DIFF), an aid-supported so-called "mixed credit" program. Under DIFF, companies were given a mix of export credit and aid funding to implement projects approved by both developing country governments and AusAID. Clearly, DIFF had ODA implications. But these announcements purely relate to export credit; there is no ODA component.

While we have dealt with the two initiatives separately above, they are related. According to the Minister's second reading speech, the EFIC reform:

> … will complement the new Australian Infrastructure Financing Facility for the Pacific, which is commonly known as the AIFFP. Efic will have the lead where there are stronger commercial prospects, as Efic's financing will be on a commercial basis. The AIFFP will boost Australia's support for infrastructure development in the region by combining loans with grants on a caseby-case basis. The bill will also enable Efic to assist with the timely implementation of the Australian Infrastructure Financing Facility for the Pacific by administering the AIFFP loans. The government will detail how Efic's new power will support the AIFFP and be applied in our region, including the Pacific, under a new statement of expectations.

This paragraph raises two issues. The first is the division of labour between Efic and AIFFP, with its suggestion that "Efic will have the lead where there are stronger commercial prospects." But the Minister's speech also makes reference to "sovereign borrowers," implying that Efic will lend to governments. Once the loan is on the government's book, it is hard to say that the project is commercial. The other issue is the role of Efic is managing the AIFFP. According to the Minister, Efic will administer the AIFFP loans. This is very unclear. What does it mean to administer the loan? In the case of loans mixed with grants, who will administer the grants?

[4] Though given that most lending to PNG is under the national interest account (for the PNG LNG project), which are guaranteed separately, how close PNG is to its limit requires further investigation.

In summary, it is far from clear what the division of labour will be between AIFFP and Efic, and what role Efic will play in managing or supporting AIFFP.

C. What are other countries doing?

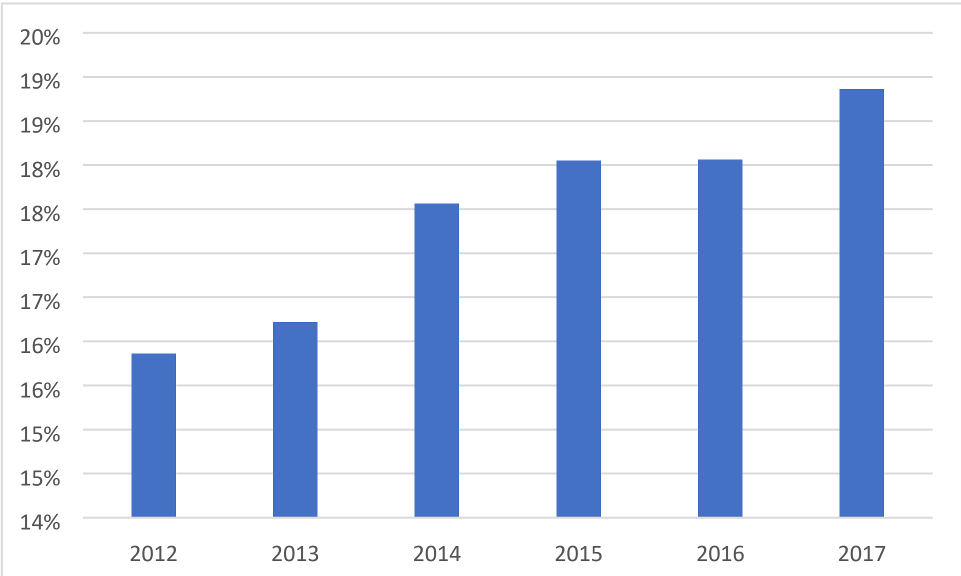
Many other Western countries are active in the private sector, lending and infrastructure space as part of their international official financing, but they largely take a different approach to the one just announced for Australia.

Countries which go beyond grants typically undertake one or more of the following: (a) concessional loans, mainly for infrastructure; (b) support for the private sector in developing countries through a mix of non-concessional lending, equity and guarantees; and (c) non-concessional export credit loans. We deal with these separately with respect to OECD (rich) countries, followed by a brief discussion of China's approach, which is different again.

(a) Concessional loans for infrastructure

Concessional lending is included in ODA calculations. It is significant and increasing. The share of loans in total (gross) Official Development Assistance has increased from 16% in 2012 to 19% in 2017. In absolute (nominal) terms that represents a growth of 39% in loans, as against only 12% in grants. Three of the top five donors are big lenders: Japan has a loan-to-gross-ODA share of 62% in 2017, France 39% and Germany 20%.

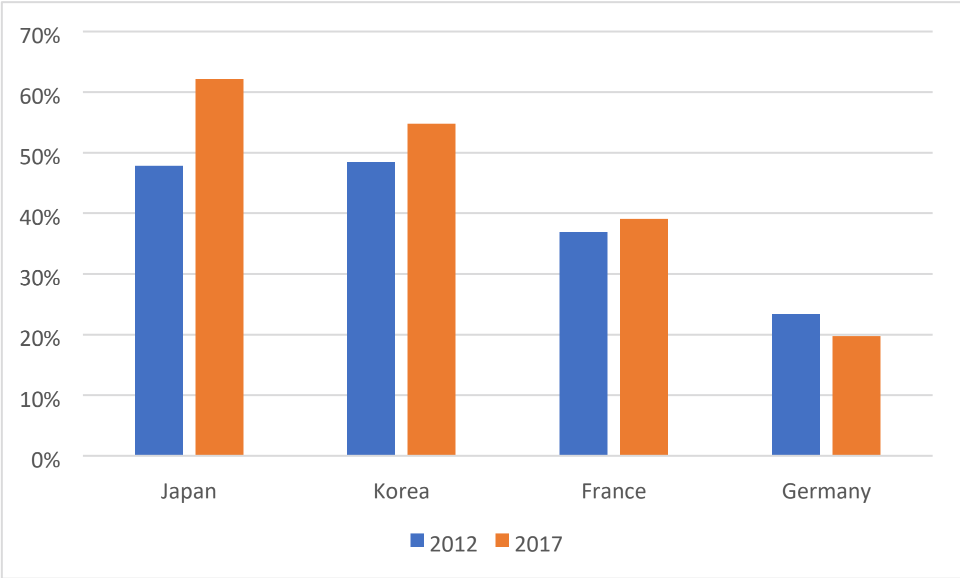
Figure 1. The share of loans in total Official Development Assistance



Source: OECD ODA statistics

The importance of loans is growing for Japan and Korea, is stable for France, and declining for Germany.

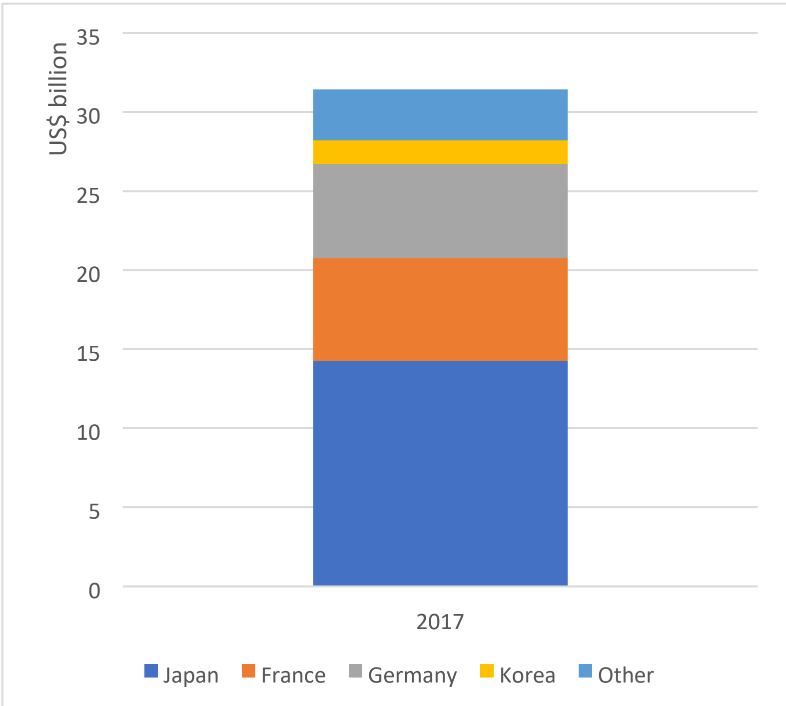
Figure 2. The share of loans in total ODA by major lending country



Source: OECD ODA statistics

Japan is by far the biggest lender, and is responsible for 45% of the world's concessional loans. France and Germany between them are responsible for another 40%.

Figure 3. Concessional lending in 2017



Source: OECD ODA statistics

There are two architectures used by countries that disburse their ODA in part via loans. One is the integrated model. Both Japan and France charge the one institution to provide the bulk of their loans *and* grants. In Japan, the responsible entity is JICA, the Japan International Cooperation Agency, and in France, it is FDA, the French Development Agency.

The other model is the separated or articulated one. In Germany, GIZ is responsible for most of the country's grants, and KfW for the concessional loans (as well as other functions). An agency in the country's Ministry of Foreign Affairs coordinates. Likewise in Korea, KOICA, under the Ministry of Foreign Affairs, is responsible for grants, and the Economic Development Cooperation Fund within the Export-Import Bank of Korea, and under the guidance of the Ministry of Finance is responsible for concessional loans.

We are not aware of a comparative literature on this topic. Arguments can be made for and against both models. Interestingly, Japan moved about a decade ago from the articulated to the integrated approach. (Loans were formally with the Japan Bank for International Cooperation (JBIC), but were shifted to JICA in 2008.) In other words, Japan before 2008 had a model very similar to Korea's today.

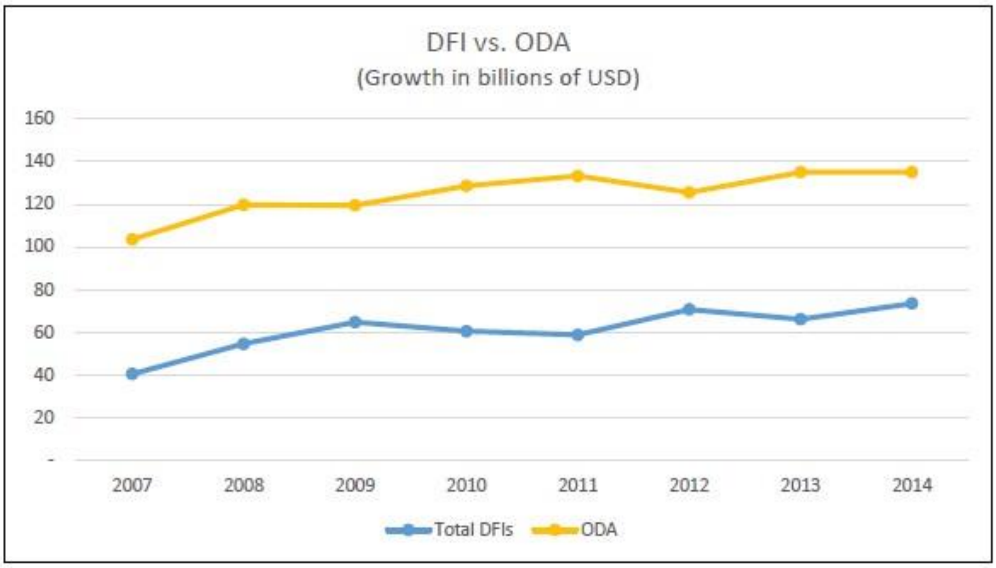
What interest rates are normally charged by these concessional lenders? Terms and conditions often vary, but, for example, Japan's standard rates for least developed countries are highly concessional: 40 year repayment period, 10 year grace period, interest rate of 0.01%. Korea's rates appear to be the same. Germany's and France's concessional interest rates are more difficult to come by. They are reported to be higher.[5]

(b) Support for the private sector in developing countries

Financial support for the private sector is typically provided mainly through a dedicated agency, known as a Development Finance Institution (DFI). Every major European donor has a DFI. In addition, the US has OPIC (now being reformed), and Japan JBIC, both of which have DFI functions. Most recently Canada created a DFI, DevNet. DFIs typically benefit from government capital, but operate in a non-concessional manner. DFI operations are on the rise, both in absolute terms, and relative to ODA. The figure below illustrates.

[5] In 2012, there were criticisms that France and Germany were claiming to lend concessionally (and were according to official ODA) definitions, but were in fact lending on commercial terms. Since then, the definition of concessionality has been tightened. France and Germany claim to be lending on a genuinely concessional basis. Their share of lending to total ODA has stabilised or declined since 2012 (see earlier graphs).

Figure 4 DFI transactions and ODA flows



Source: Savoy, Carter and Lemma (2016).

DFIs not only provide loans, indeed lending in some cases is not their primary modality. In the UK 78% of CDC financing is via equity. About half of the commitments made by European DFIs are either equity or quasi-equity (Savoy, Carter and Lemma, 2016, p.18). The inability to invest in equity was one driver for the recent reforms of OPIC in the US.

(c) Export credit agency financing for infrastructure

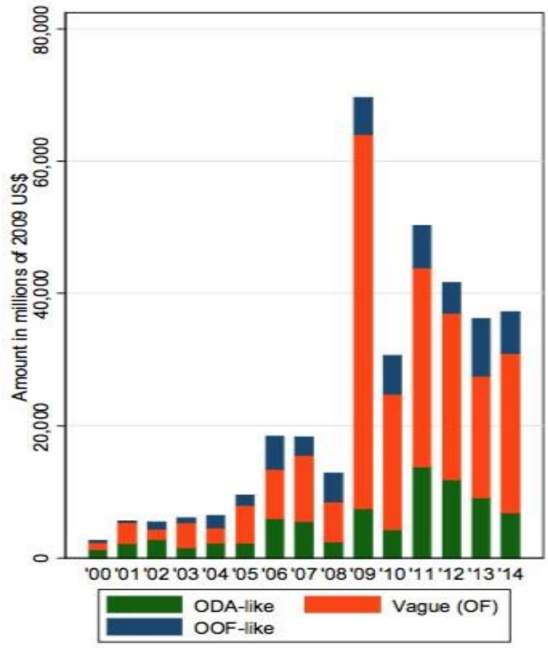
Export credit dwarfs concessional loans and DFI transactions. One estimate of just nine ECAs is that they provided $488 billion in export financing support in 2013. The primary job of any export credit agency is to promote its country's exports. If a country produces equipment used in infrastructure (e.g. power turbines, trains), then naturally an ECA starts supporting infrastructure. As this note explains, ECAs may provide financing either for the manufacturer of the equipment or, in the case of project financing, for the purchaser. When the financing is for the purchaser, it is on the basis of an understanding that there will be benefits for the home country in terms of supply decisions.

We are not aware of other countries adopting legislation such as that proposed for Efic. However, infrastructure clearly is a priority for other ECAs. For example, UK Export Finance notes in its 2017-18 Annual Report that it made its "largest ever direct loan to an African government supporting the construction of Kabaale Airport in Uganda." (p.15)

(d) Chinese financing for infrastructure

China uses all of the instruments managed above. However, as it is not a member of the OECD, it not required to report how much of its development financing is concessional, and how much is nonconcessional. The graph below shows both how much Chinese official finance has increased, and how much the uncertainty is over its concessional status.

Figure 5 Chinese Official Finance, 2000-2014



Source: Dreher, Fuchs, Parks, Strange & Tierney 2017, p.43. ODA-like projects are provided at levels of concessionality that are consistent with the ODA criteria established by the OECD-DAC. Other-Official Flows-like (OOF-like) projects are insufficiently concessional to qualify as ODA. Other finance-like (OF-like) projects represent official financial flows whose concessional status is unsure.

D. Issues

Both the AIFFP establishment and the Efic reforms raise a number of questions, especially in the context of the international comparisons provided above. We discuss them in turn

(a) AIFFP

Reliance on non-concessional loans. As far as we are aware, all countries that provide a dedicated infrastructure lending facility do so on a concessional basis, with the funding being ODA eligible as a result. Certainly this is the case for the big infrastructure lenders examined in the previous section: Japan, Germany, France and Korea.

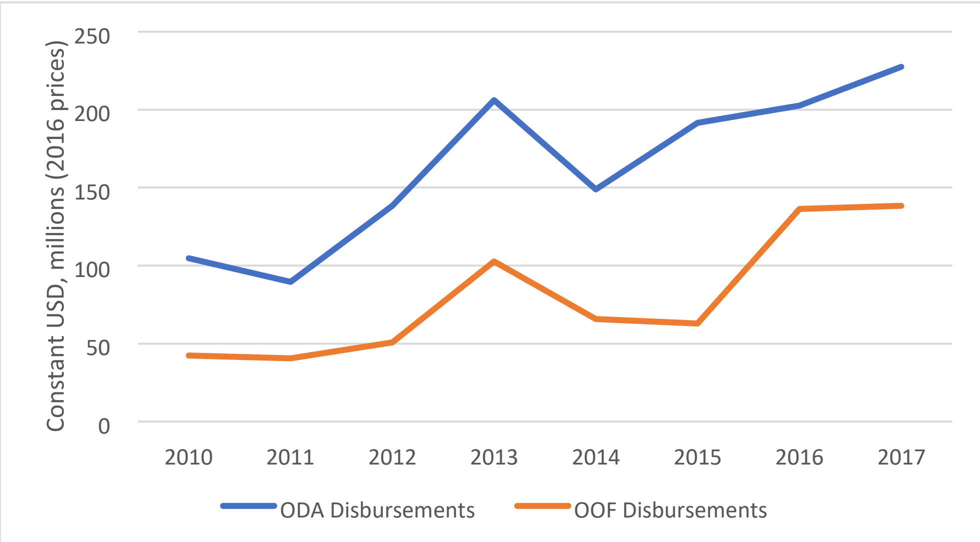
The only other time that Australia has provided infrastructure loans was also on a concessional basis, namely with the post-tsunami loans, when Australia lent $500 million to Indonesia for roads and schools at a zero interest rate. It is not clear why Australia has taken such an unusual and different approach this time.

Countries normally provide non-concessional loans for infrastructure through either an export credit agency or a DFI. But AIFFP loans will, unlike an ECA, give no preference to Australian companies and, unlike a DFI will only be for infrastructure (possibly also social infrastructure such as buildings in the health and education sectors). According to a recent CSIS and ODI report (Savoy, Carter and Lemma 2016), only 29% of total investments by European DFIs are directed towards infrastructure.

High degree of non-concessionality. While individual projects will be backed by varying amounts of loan-grant combinations, overall the AIFFP is mainly non-concessional: three quarters nonconcessional loan[6] and one quarter grant. By contrast, the funding provided after the Tsunami to Indonesia was much more concessional. Using current DAC definitions, the loan itself which was for infrastructure had a grant equivalence of 94%.[8] And 50% of the total funds provided were grants. The tsunami loans were not for post-tsunami reconstruction. They financed infrastructure (schools and roads) across Indonesia. Given the Pacific's less successful growth record, lower growth prospects, and higher level of debt distress (see below) it is unclear why Indonesia was given a much more concessional deal than is being offered to the Pacific.

Awash in money. For the last decade or more, a key Australian strategy has been to expand the presence of the multilaterals on the Pacific. This has been done by (a) subsidising the operations of the multilaterals in the Pacific and (b) supporting increased lending resources for the Pacific. This has been a successful strategy, and both the World Bank and the ADB are scaling up in the Pacific. Both ODA and non-concessional lending (Other Official Flows, or OOF in the graph below) are more than double what they were seven years ago (see Figure 6).

Figure 6. Annual ADB and World Bank disbursements in the Pacific over time

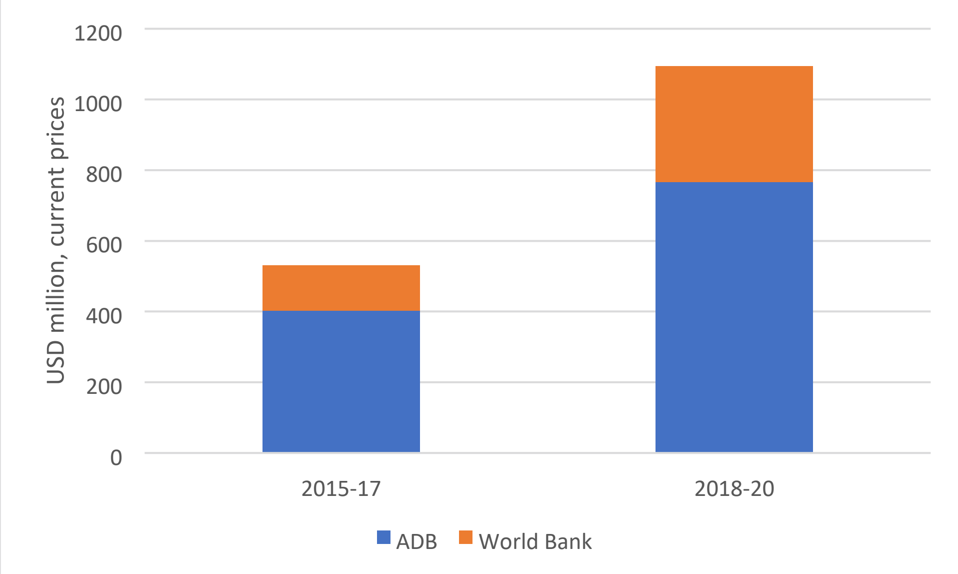


Source: OECD ODA statistics

Moreover, these increases appear set to continue. Figure 7 below compares commitments in the past three years with those projected for the next three. This is an increase from about one half to just one billion US dollars.

[6] One could argue that the potentially low interest on AIFFP makes it concessional relative to commercial borrowing. However, as with the case of World Bank loans, to be concessional, being cheap is not enough; the loans have to be "concessional in character", that is, there has to be an element of subsidy. [8] We use the interest rate of 7% suggested by the DAC for lower-middle-income countries.

Figure 7. ADB and World Bank commitments, past and planned



Source: ADB, World Bank, own calculations and estimates.

The World Bank and ADB are only two finance providers to the Pacific. Aid and lending from China is more difficult to estimate, but is clearly growing. Fox and Dornan estimate that Chinese debt makes up 12% of the total for the Pacific, compared to 21% for the multilateral banks. Chinese debt is a more important source than the World Bank and ADB for Fiji, Vanuatu and Tonga, and a similarly important source for Samoa.

Then there is an increasing amount of funding related to climate change also available for the Pacific.

With all this official financing, does the Pacific need more funding from Australia? Or should we be focused more on the downside of this tide of funding heading for the region? Can the Pacific absorb all this assistance? Or will the prospect of easy money undermine the prospects for reforms?

Can the Pacific afford to borrow more? Debt stress is on the rise in the region (Figure 8). In 2008, only one Pacific island country out of seven with a rating was rated as having a high level of debt distress. In 2017, it was five out of 12.

Figure 8. Number of countries by IMF/ADB debt distress rating category – Pacific Islands and Timor Léste

Source: Fox and Dornan.

These ratings reflect neither high nor in general rising debt-GDP ratios (in fact, by global standards they remain low). Only Vanuatu shows a sharp increase in its government debt/GDP ratio in recent years. Rather, the worsening ratings reflect in large part a better understanding of the vulnerability of Pacific economies, and therefore their limited ability to take on debt. Pacific island economies are undiversified, have little to no growth, and are highly vulnerable to natural disasters. With the possible exceptions of Fiji and PNG, they are simply unable to take on large amounts of finance without also exposing themselves to considerable risk.

A result of this is that very few Pacific island countries are able to borrow on non-concessional terms. Only Fiji and PNG have access to non-concessional International Bank for Reconstruction and Development (IBRD) finance. Both countries are also the only Pacific ones to have borrowed from international capital markets, albeit at relatively high prices.

All this raises questions about the ability of the Pacific to absorb more debt, and in particular to absorb more non-concessional debt. In turn, this raises further questions about the largely nonconcessional nature of the AIFFP.

Worsening the neglect of maintenance. Perhaps the biggest problem in the Pacific when it comes to infrastructure is the neglect of infrastructure maintenance. The Pacific suffers from a "build, neglect, rebuild" syndrome. In principle, there is nothing to stop the infrastructure facility from lending or granting for maintenance. In practice, countries are reluctant to borrow for maintenance, even though maintenance often has a much higher return than new builds. Given that three-quarters of the AIFFP is loans, it is likely that the majority of the AIFFP will be used for new builds, and will therefore intensify the build-decay-rebuild syndrome. This will need to be managed carefully by the aid program, which has to date had a reasonably good record of focusing on maintenance.

Neglect of policy reform. Morrison's AIFFP announcement harks back to old, discredited, but still common, "financing gap" arguments for donor support. The Pacific region, it is said, needs $3.1 billion per year up to 2030. So Australia, as "partner and friend" will provide $2 billion. Leave to one side the lack of clarity as to over how many years the initial $2 billion fund will be spent and the question of the robustness of the $3.1 billion ADB estimate. The fundamental issue is that infrastructure funding and performance are not determined by external financing availability but domestic policy. There is no mention of policy in either the PM's speech or the DFAT elaboration.

There are several factors that make us wary of the risk that insufficient attention will be given to the critical issue of infrastructure policy. One will be the pressure to disburse $2 billion dollars. Another is the evident desire to compete with China. China avoids asking for policy reforms. It just funds.

The third and most worrying source of concern are the precedents set so far. The two 2018 projects which are most likely to portend the shape of the AIFFP are the PNG-Solomon Islands cable and the PNG energy access project. Both have been characterized by early announcements, and a complete lack of any policy agreements. As far as we are aware, Australia has no agreement with either PNG or Solomon Islands as to how the cable from Sydney will be used once it comes on-shore, and whether arrangements governing its use will be monopolistic or competitive. There are certainly serious concerns in PNG that the cable will not be available to all internet service providers on an equal basis. These concerns are heightened by (a) the lack of any announced agreement on this issue; and (b) the fact that the cable owner, Dataco, is being merged with the state-owned utilities, PNG Telkom and Bmobile/Vodafone. Likewise, the key issue with the PNG energy access announcement (made late last year at APEC) is whether access will be extended through the grid or off grid. Extension through the grid will require Australia to work with the inefficient and financially weak PNG Power. Off-grid and mini-grid extensions open up private sector options. There is no indication which options will be favoured, but the PNG government has indicated that the primary route will be the former.

The multilaterals to their credit have a practice of only announcing loan packages once they have an agreement in place with the recipient government, an agreement covering policy as well as project issues. Even with this, the Banks struggle to get required policies in place. The tendency of Australia to announce projects first and worry about policy later is likely to make it even less likely that a conducive policy environment will be created. There is a real risk that the AIFFP legacy will be one of more debt combined with poor policy leading to poor outcomes.

Local content and skills transfer. A common complaint in the Pacific regarding aid funded infrastructure projects, and aid more broadly, is that too little effort is made to employ or transfer skills to Pacific island workers. This criticism is directed most forcefully toward Chinese-funded projects, but it is also applied to Australian aid projects. Addressing the criticism by employing more Pacific islanders in infrastructure works, and by focusing on skills development, such as though linking project experience with TVET training, should be an obvious focus for Australia. But such outcomes will only be achieved if contractors are contractually obliged to achieve them.[7] The default strategy for contractors will usually be to minimise cost and risk by not focusing on skills transfer and by employing existing staff, which generally means employing workers from outside of the Pacific.

[7] This is discussed in more detail in this 2016 ADB report and this Devpolicy blog by Richard Curtain.

Lack of transparency. There are risks that the AIFFP will suffer from a lack of transparency. Information about the two predecessor projects discussed above (the submarine cable and PNG electrification) is almost completely absent. And funding information about the AIFFP was regarded as too sensitive to be included in the MYEFO.

Corruption. Corruption is endemic to the Pacific, and is especially bad in PNG. The risks to the aid program of fraud are removed by not actually handing grants to recipient governments. But when countries take out loans, they want to actually implement the projects, since they are responsible for repaying the funds. A different approach, such as insisting on implementation removed from Pacific island government, is likely to meet with resistance. Either way, for Australia to reduce the risks, it will need to implement additional safeguards.

Environmental and social impacts. Infrastructure projects are complex, often with social impacts, such as displacement, and environmental impacts, in the case of dam construction. How will these be managed? In the case of co-financing, they can be left to the multilaterals involved, but for projects where Australia is the sole or lead funder, environmental and social management will be a major challenge.

Duration. There would seem to be three options. The first is that AIFFP closes once it commits the initial funding envelope. In this case, the initiative could have a life of as short as three years. The second is that it closes once that $2 billion is disbursed. This would take much longer. The posttsunami Indonesian loan took almost ten years to fully disburse. The third is that AIFFP would be open-ended with no closing date, though for it to remain a concessional facility, the grant element would need to be renewed.

Institutional home Where will the facility reside? Its very name suggests that it will simply be a unit within DFAT. So too do public statements, which suggest the initiative will be "managed" by DFAT. Whether it should be more autonomous depends on the anticipated life span of the unit. If it is just a one off, there is little point considering a more permanent home. But if it is going to be around for longer, consideration should be given to alternative arrangements.

Where will the money come from? The non-concessional loans will have no impact on other government spending. Because they don't count against either deficit targets or ODA, there will be no pressure to offset increased loan-funded infrastructure spending against cuts elsewhere. For grants, it is a different matter. Cuts will have to be found to finance the $500 million in additional grant-financed infrastructure. How much depends on how quickly the money will be spent, and whether the grant funding is additional to existing infrastructure spending. Assuming that at least some is additional, then the cuts will either have to come from other sectors in the Pacific, or from other parts of the aid budget. Given the priority the Pacific now has, it is likely that the aid will come from Asia. This is regrettable. It is worth returning to the Independent Review of Aid Effectiveness of 2010, which was the last independent review of the aid program. It rated the case for expansion of Pacific aid at the lowest of its three levels. The Pacific is already highly aid-dependent. Too much aid is distortionary, and DFAT's own statistics show that aid performs worse in the Pacific than in Asia.

(b) Efic

There are four issues with the Efic reforms and legislation.

Undermining good governance. There is a risk that the Efic reforms will give a green light to Australian businesses to push projects in neighbouring countries, including by recruiting local political champions to their cause. The risks are obvious. They are that the better connected rather than the better infrastructure projects will be approved, that good governance will be undermined, and competitive tendering sidelined.

This is not just a theoretical concern. This is exactly how much of China's development financing works (as documented here). As PNG's Deputy Prime Minster Charles Abel has gone on record saying, China's finance is welcome, but the country's way of doing business (that is, as described above) is weakening institutions. We should not be imitating China and further undermining governance in the Pacific by encouraging a supply-side, project-proponent-led, non-competitive approach to infrastructure.

Ignoring policy reform. A second problem with Efic being responsible for overseas infrastructure financing decisions is that, as discussed earlier, what really matters for infrastructure success is not financing availability but the domestic policy framework. If that policy framework is sound, financing will follow. If it's not, no amount of official financing will lead to sustained development. We have already raised this as a challenge for DFAT in managing the AIFFP. It will be a much bigger problem for Efic, which has no capacity to assess the infrastructure policy framework of any country, and no mandate to push for policy reform.

Putting Australia's interests first. The third reason that Efic should not be charged with the job of regional infrastructure development is that its mandate has always been and remains to promote Australian exports and business. The Efic legislation does not mandate tying to Australian producers, but it does require that benefits to Australia be maximised. There is no requirement that competitive tendering be used. This is bad for the Pacific, and bad for Australia's reputation. At fora such as G20 and APEC, we will continue to promote the virtues of open markets and competition. But in practice, we will be putting pressure on potential recipients to maximise Australian content in return for Australian financing.

More broadly, and still more worryingly, we could end up under the Efic legislation supporting projects that are not in the interest of the recipient country. Under the proposed legislation, Efic would be required to show that the infrastructure it planned to support was of benefit to Australia but would not be required to show that it was of benefit to the recipient country. Efic would need to show that the project is commercially viable, but it is all too easy for an infrastructure project, backed by government guarantees or loans or monopolies, to be commercially viable but bad for the country concerned.

Overly complex architecture. Fourth and finally, how will AIFFP and Efic relate in the infrastructure space? The minister's speech says that Efic will take the lead "where there are stronger commercial prospects", but the explanatory memorandum refers to sovereign borrowers, implying that Efic, like AIFFP, will be lending to governments. The minister's speech also talks about Efic "administering" AIFFP loans, but not, presumably, its grants. We run the risk of moving from too little support for Pacific infrastructure to an overly complex architecture.

The main defence of the Efic legislation is that most countries have ECAs and most ECAs lend for infrastructure projects. What then is the big deal? In response to this, note in turn that there is nothing to stop Efic lending now to support an Australian company that has landed an infrastructure deal. But that is quite different to promoting policy and legislation which requires Efic to go out and develop infrastructure lending as part of an initiative to promote development in the Pacific. For the reasons provided above, this is a bad idea.

E. Conclusion

We have four main reservations regarding the Australian Infrastructure Financing Facility for the Pacific.

First, its lack of conformity with international practice is surprising. While there will be some grants to mix the loans with, the basis for reliance on non-concessional loans is unclear.

Second, and related, the very limited concessionality in the initiative is disturbing. The unfavourable treatment of the Pacific compared to Indonesia cannot be justified. The high debt stress of the Pacific, and its limited growth prospects, heighten our concern. It makes no sense for Australia to be offering the Pacific a less concessional package than it offered Indonesia. It makes no sense for Australia to be offering less concessional loans than Korea and Japan.

Third, there are serious risks that the new initiative will not do enough to promote policy reform, and may even undermine those trying to support policy reform, namely the multilateral banks.

Fourth, given the Pacific is already so aid-dependent, and that financing to the Pacific is on a steep upward trajectory, it is questionable whether the Pacific needs another major financing facility.

Our reservations regarding the Efic announcement are even more fundamental. While Efic should not be barred from supporting Australian exporters engaged in infrastructure, such support should not be a major plank of Australian support for the Pacific. The problems identified in the previous section regarding the risks of undermining governance, Efic's inability to promote policy reform, and Efic's mandate to put Australian interests first are too serious to ignore.

Finally, there are issues around management and coordination. It is unclear how Efic and AIFFP will differentiate their roles, and a risk that they will overlap.

While our reservations are deep, our remedies are doable. We accept that AIFFP will be established: given its bipartisan support, this seems inevitable. But it can be improved.

First, make AIFFP concessional. Give the Pacific the same terms that we gave Indonesia. Use this to increase ODA. **Do not cut the aid program.** Since loans (even concessional loans) do not count against the budget deficit target, there is no need to cut aid to "make room" for concessional loans.[8]

Second, commit to only making loans for infrastructure when the policy environment is sound.

[8] If AIFFP is to lend to the private sector, it might want to keep those loans as non-concessional. However, we argue that this should be the function of the DFI.

Third, review the performance of AIFFP after five years before deciding whether to replenish it. Given all the uncertainties, and the ever-increasing amounts of funding heading for the Pacific, it is not clear that AIFFP needs to be a permanent part of Australia's assistance for the Pacific.

There is no similar reason to accept the Efic reforms. Instead establish a DFI. The Efic reforms have not been discussed at all. As noted, Efic can already lend to support Australian business in infrastructure, but it should not become a major part of the Australian effort to support infrastructure in the Pacific. Instead, we would advocate for the establishment of an Australian Development Financing Institution.[9] This would make for a much clearer division of labour, with the DFI supporting the private sector, in infrastructure and other sectors, and AIFFP lending to government for infrastructure, at a concessional rate.

Canada provides an interesting example. Rather than expanding the mandate of Canada's ECA, Canada asked its ECA to establish a DFI, FinDev Canada, which focuses on green growth, agribusiness, and the financial sector under a general mandate to "support the growth and sustainability of businesses in developing markets."

If, however, the government decides to continue going down the track of Efic reforms, then we would recommend that (i) Efic be required to certify that the policy framework for any infrastructure project it supports is satisfactory; and (ii) the requirement that Efic be required to maximise Australian participation be dropped.

[9] See the references in footnote three for more on the advantages of an Australian FDI.