

ENTER THE
DRAGON

Australia, China, and the New Pacific Development Agenda

This is a joint report between the Jubilee Australia Research Centre, Caritas Australia and the University of New South Wales.

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Glossary of terms

ACFID	Australian Council for International Development
AIFFP	The Australian Infrastructure Financing Facility for the Pacific
AIIB	The Asian Infrastructure and Investment Bank
ADB	The Asian Development Bank
AusAID	Former administering agency of the Australian aid program
BRI	The Chinese Belt and Road Initiative
CDC	Commonwealth Development Corporation- Britain's DFI
DFAT	The Department of Foreign Affairs and Trade (Australia)
DFI	Development Finance Institution: A development institution that makes loans and/or equity investments to private sector institutions
DIFF	The Development Import Finance Facility. An Australian mixed grants and loan facility jointly operated by Efic and AudAID in the 1980s and 1990s
Efic	The Export Finance and Insurance Corporation: Australia's export credit agency
FDI	Foreign Direct Investment
IFC	The International Finance Corporation: The World Bank's private sector development arm and the world's largest DFI
ODA	Official Development Assistance
OECD	The Organisation for Economic Co-operation and Development
OECS	Organisation of East-Caribbean States
PICs	Pacific Island Countries
SOEs	State Owned Enterprises

Executive summary

This report is written as a response to the proposed Australian Infrastructure Investment Fund for the Pacific (AIFFP), a \$2 billion facility that intends to combine \$500 million of aid grants with \$1.5 million of loans. The intended administrative body for the program is Efic - Australia's Export Credit Agency. The AIFFP was announced in November 2018 by the Morrison Government as a the financial arm of a renewed Australian commitment to the Pacific, otherwise known as the 'Pacific step up.' Legislation that would empower Efic to be the principal administering agency for the AIFFP is currently before the Australian parliament.

The report aims to examine the various motivations or justifications for the AIFFP, the institutional mechanisms that could be used to deliver it, and other questions pertinent to the program, such as the vulnerabilities of Pacific nations that should be taken into account, as well as the type of development model this program appears to be promoting. A summary of the report's findings are:

The Australian aid program

Australia is still the largest aid donor in the Pacific region. The Australian contribution to Pacific aid is currently approaching the \$1.3 billion mark. Despite an increasing amount of Chinese aid to the region in recent years, Australia still gives as much as all other bilateral and multilateral donors combined. It is true that this might change if the 2017 Chinese \$3.5 billion commitment to rebuild PNG's road network were to become a reality. But if that were to happen, China could feasibly overtake Australia as the number one Pacific donor without any new Australian commitments. If the \$500 million grant portion of the AIFFP were instituted, it would either involve cuts to countries outside the Pacific, or it would involve a reallocation of around 40 per cent of the Pacific aid budget.

China

China has long been active in the region, but

since 2011, China has substantially increased its aid and investment in the region, including significant amounts of aid to Fiji and to PNG. It has also given moderate amounts (around \$100m) to Samoa, Vanuatu, Micronesia, and Tonga. It has become the second largest bilateral donor in the Pacific, but its official development assistance program is still well behind Australia's at present. This increase is in line with a general growth in financial engagement with countries of the Global South. A good portion of Chinese aid has been for infrastructure purposes, but China has also engaged in other aid priorities such as agriculture, government and civil society, health, and education. The volume, scope, and implications of Chinese aid in the Pacific have varied significantly from country to country.

Many have pointed out how the Pacific step up program is predicated on the the strategic motive of countering growing Chinese influence in the Pacific, and there is good reason to believe that this is indeed a major factor. But in doing so, the Australian government would become similarly guilty of politicising aid. Canberra would also run the risk of further exacerbating the governance woes of its Pacific neighbours by inadequately prioritising local needs and perspectives, and pushing disgruntled Pacific countries even closer to China. Part of the reason for why Chinese aid and investment have been able to gain traction in the Pacific stems from perceptions of Australian 'neo-colonialism' and 'interference' in the domestic affairs of these Pacific Island nations on the one hand, and of strategic neglect on the other.

Infrastructure

Despite calls from some Pacific leaders and outside actors for more Pacific infrastructure, there is yet to be produced a complete and context-specific assessment of the infrastructure needs of Pacific Island nations individually and collectively. The only assessment that has been done by the ADB suffers from serious shortcomings, largely to do with the methodology used.

Moreover, statements by the Pacific Island Forum's General Secretary indicate how the PIF Secretariat would like any new fund to be consistent with its own Pacific Resilience Fund and for the Secretariat to have a role in assessing any potential infrastructure projects that may result.

Institutional questions

Were the AIFFP to give mixed grants/concessional loans to government agencies and be administered by Efic, it would essentially be a recreation of the Development Import Finance Facility or DIFF scheme, whose main years of operation were from 1983 to 1996. Although the intended details about the AIFFP are not yet known, the national content requirements for the AIFFP do not appear to be noticeably different from the 'tied aid' nature of the DIFF program. This report has detailed the major problems with the DIFF scheme, including a supply-driven approval process, a bias for large infrastructure projects, a preference for middle-income countries, and a tendency for debt creation.

An alternative model involving the creation of a Development Finance Institution (DFI) for the AIFFP, tasked with giving loans to the private sector, is equally questionable on two grounds. First, the external debt to export ratios of many of the target countries suggest that even loans to the private sector could place pressure on valuable foreign exchange reserves. Second, there is no evidence that any of the DFIs have contributed to broad-based growth and poverty alleviation, and it is questionable whether they are a suitable model for small-island states as found in the Pacific.

Vulnerabilities

Because of the debt profiles and ecological vulnerabilities of the Pacific nations, a new institution that loans to government agencies in foreign currency would be inappropriate. While some countries might be able to manage loans denominated in their own currencies, a grant facility would be much more suitable and avoid the problem of preferential treatment for certain countries.

The growing severity of storms, floods, and rising waters due to climate change is an additional

factor that is further contributing to sovereign debt distress in the Pacific, and it can reasonably be expected that this trend will continue.

Another issue, when considering the appropriateness of a debt-creating mechanism denominated in foreign currencies and focused on driving the development of (hard) infrastructure, relates to how countries may be tempted to engage in practices harmful to the ecological balance both on land and in Pacific waters. Unsustainable forestry, mining, and fisheries practices may increase, putting even more strain on already fragile ecosystems.

Alternatives

The AIFFP is premised upon a growth-based development model, at a time when there is considerable evidence to show how no clear, 'one-size-fits-all' recipe for creating economic growth exists, especially for the small-island nations of the Pacific. There is, however, a great deal of evidence on how to reduce poverty, although it is hard to see how the AIFFP is best designed for this purpose.

An approach that focused on livelihoods and resilience would instead focus on developing Pacific agriculture, on which the vast majority of the Pacific people depend, as well as on making countries climate resilient in the face of the ever-increasing frequency and severity of storms, floods, and other natural disasters that result from climate change.

Conclusions

This report concludes that the AIFFP would shift the Australian aid program away from its grants basis, which has been one of its key strengths and points of differentiation. The Efic/AIFFP loan system would be creating exactly the kind of opaque, self-interested, supplier-driven loan system for which the government is criticising the Chinese.

Combined with emerging evidence from other parts of the world of how Chinese financial support might not necessarily impede the effectiveness of grants and loans from Western donors, Chinese manoeuvres in the region should not be treated as a direct provocation or 'premeditated' threat to Australia. Canberra's

responses to China and its Pacific step up thus need to take into careful consideration how Australia could end up harming Pacific development interests in the long-term, as well as its bilateral economic relationship with China, through this proposed ‘infrastructure offensive’.

Although no one is questioning that the Pacific needs development, or even that the Pacific nations would benefit from the delivery of relevant infrastructure, more pertinent questions are: what type of development does the Pacific need most, what types of programs, including infrastructure, will best serve this need, and what is the most appropriate and effective means for Australia to develop these programs? The AIFFP, as currently constituted, is not an answer to any of these questions.

The report therefore recommends that no further steps be taken to progress the AIFFP until after the upcoming Federal election, until a more complete and public assessment of infrastructure needs in the Pacific is done, and until a more complete and thorough investigation of the appropriate mechanisms for an infrastructure financing program can be explored. This assessment should include in-depth engagement and consultations with Pacific nations, the Pacific Island Forum Secretariat, and civil society groups both in Australia and the Pacific.

Introduction

On 8 November 2018, Australian Prime Minister Scott Morrison, in a speech at the Lavarack Army Barracks in Townsville, Queensland, announced a raft of measures intended to signal a ‘new chapter’ between Australia and the Pacific. The measures, which have since become known as the ‘Pacific step up’, included an increase in Australian defence commitments in the Pacific in the form of, for example, the establishment of a new mobile training team and more navy deployments to the Pacific. There would also be greater Australian police and security commitments, such as a new police training facility and a security alumni network for senior police, civilian and military leaders who participate in the Defence Cooperation Program. Notably, the announcement mentioned the opening of new diplomatic missions in Palau, the Marshall Islands, French Polynesia, and the Cook Islands, as well as a commitment to improve access for Australian television programs within the region.¹

However, the details in the speech that received the most attention were the financial measures. Two new initiatives were announced: first, the establishment of a new \$2 billion Australian Infrastructure Financing Facility for the Pacific (AIFFP); and second, measures to increase the capacity of Australia’s export credit agency, or Efic, to finance infrastructure programs in the region that are deemed to have a ‘broad national benefit’ to Australia.² ABC called the infrastructure bank the ‘centrepiece’ of the announcement, noting that the Coalition Government had until now been widely accused of ‘failing to take the region seriously’.³

Several commentators have observed how Shadow Prime Minister Bill Shorten had also indicated the ALP’s intention to do something similar a week before in a speech at The Lowy Institute. Recognising how ‘our neighbours in the Pacific are looking for partners to help them build infrastructure,’ Shorten announced that he would like to see Australia develop a ‘government-backed infrastructure investment bank’ for this purpose.⁴

Labor may have floated the idea of some sort of

infrastructure fund for Pacific nations before the Coalition, although this may simply have been an attempt by the ALP to beat the government to the punch. As expected, the government has progressed with its attempt to move forward with increasing Efic’s ability to finance infrastructure programs. On the 13 February this year, the government introduced legislation whose primary purpose was to increase Efic’s general ability to support infrastructure finance; it did, however, have the secondary purpose of creating a role for Efic in financing infrastructure in the Pacific. The new Efic legislation passed the lower house on 21 February 2019 and, at the time of writing, has been referred to the Senate Foreign Affairs, Defence and Trade Legislation Committee.

The primary impact of the legislation would be to increase Efic’s callable capital by \$1 billion on its Commercial Account—a significant increase, from \$200 million to \$1.2 billion. (‘Callable capital’ is a banking term to be distinguished from ‘paid in capital’). This increase in ‘callable capital’ does not simply mean that Efic has another billion dollars to lend. Traditionally, Efic has tended to have about half callable capital and half paid in capital. Given that Efic is required to maintain a capital adequacy ratio of 16 per cent, if this basic ratio were to be continued, a one billion increase in callable capital would enable Efic to take on new loan exposures of several billion dollars.⁵

There are two points to make about this \$1 billion increase in Efic’s callable capital for infrastructure projects. First, it is required to take place on Efic’s Commercial Account. This is Efic’s regular account on which it conducts the vast majority of transactions. It is an account that Efic operates without involvement of the government and for which the loan terms and interest rates are not very different than those offered by a commercial bank. Second, there is no mention in the legislation which specifies that Efic’s increase in infrastructure lending on its commercial account needs to go to Pacific nations. Indeed, in the second reading speech, the infrastructure needs of the Asia-Pacific region were given as much emphasis as the Pacific infrastructure needs.

The second reading speech also explained that: ‘Efic will have the lead where there are stronger commercial prospects as Efic’s financing will be on a commercial basis.’⁶ It is therefore hard to see that any more than a small proportion of these new Commercial Account funds will go to Pacific nations. It is much more likely that bankable projects with typical repayment terms will be hard to find in the Pacific island states, Timor-Leste and PNG.

However, the legislation also creates a role for Efic to participate in the AIFFP as well by giving Efic the power to administer AIFFP loans. The details, therefore, of the AIFFP, and how Efic’s new power will be ‘applied in our region,’ will be laid out in a new Statement of Expectations, if the Efic Amendment Act passes through parliament and becomes law. The government has announced that the AIFFP will be a \$2 billion fund, and, that \$500 million will be taken from the aid budget to help finance this. It is not clear yet where the other \$1.5 billion will come from, but it would seem likely that Efic, as administrators of the program, will be responsible for coming up with it by accessing the capital markets.⁷

In summary, the course that the government is pursuing is not to set up a new Pacific Infrastructure bank, as proposed by the ALP and Mr Shorten. Rather, the government is proposing to use Efic to significantly increase its commercial lending to infrastructure projects, possibly by many billions of dollars, although much of this increase is unlikely to go to the Pacific. Second, Efic, acting in some sort of coordination with DFAT, will administer a \$2 billion concessional loan program which is directed at Pacific Island nations, PNG and Timor-Leste.

The appropriateness of Efic to administer and indeed, to be involved with a Pacific infrastructure fund has been questioned, most particularly by Stephen Howes, the Director of ANU’s Development Policy Centre. Howes listed four major concerns: (1) the risk that this mechanism will push unsuitable projects; (2) that the mechanism will be independent of the domestic policy context; (3) the Efic focus on promoting Australian exports render it unsuitable; (4) that it creates an overly complex architecture.⁸ Adding to these criticisms are that, according to the way that the government presented the bill to parliament, the bill seems designed to support the

development of fossil fuel infrastructure projects such as the controversial PNG LNG project.⁹ For a more detailed critique of the Efic reforms, the submissions to the Senate Inquiry into the legislation by Jubilee Australia and others go into these matters in more explicit detail.¹⁰

However, this report is not specifically concerned about the proposed Efic legislation. As already mentioned, the primary intention of the legislation is to increase Efic’s commercial infrastructure loans generally—not specifically for the Pacific. The nuts and bolts of how Efic would participate in a concessional loan-oriented AIFFP are presently unclear, but clearly a secondary consideration as far as the legislation goes.

What this paper is concerned about is the question of a new infrastructure fund for the Pacific. As explained above, this is something that both major parties are committed to. It therefore seems likely that after the upcoming election some sort of Pacific infrastructure mechanism will happen, it is just the type of mechanism that remains opaque. The Morrison Government intends to somehow use Efic, but the ALP’s position on such a mechanism is currently unclear.

Motivations for the AIFFP

A Pacific Infrastructure Fund using concessional loans therefore is an idea that enjoys widespread political support both inside and outside parliament. So, where has the idea come from? What are the arguments that have been used in support of it? What are the critiques? And, importantly, are there any precedents for anything like this, both in Australia and overseas?

The principal argument used by proponents of this overall project has been that the Pacific is, indeed, in serious need of new infrastructure. As the joint announcement that accompanied Morrison’s speech of 8 November, said: ‘Better economic infrastructure in Pacific nations will contribute to stronger growth, not only in their countries but across our region, including in Australia.’¹¹ According to Bill Shorten: ‘Our neighbours in the Pacific are looking for partners to help them build infrastructure.’ And Stephen Howes agrees, saying: ‘The Pacific needs infrastructure.’

With the announcement of the new Efic

legislation, more detailed claims about the Pacific's need for infrastructure have been forthcoming from both sides of politics. The number most cited—indeed, the only number cited—comes from research by the Asian Development Bank (ADB). In its 2017 report: *Meeting Asia's Infrastructure Needs*, the ADB calculated that the Pacific region will need US\$46 billion in infrastructure investment between 2015-2030, or US\$3.1 billion per year.¹² The US\$3.1 billion figure has since been cited by Assistant Secretary Mark Coulton in his second reading speech for the Efic bill, and by Shadow Trade Minister Jason Clare in his speech about the legislation.¹³ The Department of Foreign Affairs and Trade's webpage about the AIFFP also cites the US\$3.1 billion figure.¹⁴

Equally talked about, especially by commentators and analysts, is that the government has announced this move in order to assert its leadership role in the region. Although it is not always explicitly stated, the assumption behind the geostrategic argument is that, in developing its own Pacific loan program, China is getting the jump on Australia in our own backyard.

The geostrategic rationale for a Pacific infrastructure fund is tied to the argument that Australia needs to act as a leader in this region. In the Prime Minister's words:

This is our patch. This is our part of the world. This is where we have special responsibilities. We always have, we always will. ... We are connected as members of a Pacific family. My Government, the Government that I have the privilege to lead is returning the Pacific to where it should be – front and centre of Australia's strategic outlook, our foreign policy, our personal connections, including at the highest levels of government.¹⁵

China is not mentioned here. But despite attempts by both Mr Morrison and Mr Shorten to downplay the China connection, Chinese economic influence in the Pacific the major subtext to the announcement.¹⁶ Media commentary and headlines at the time specifically talked about the China factor.¹⁷ This interpretation is not unwarranted when we consider that the new US BUILD Act, on which this initiative is at least partly based, was itself created as a response to Chinese investment in Africa (see section 4.2).¹⁸ Indeed, although China has a long history of economic engagement with the Pacific, it is only

in more recent years that the volume and scope of Chinese aid and investment in the region has come to attract more intense scrutiny, sparking deep-seated security concerns within Australian policy circles. As discussed later, China could now overtake Australia's position if it were to follow through with recent aid pledges

Aims and structure of this report

The overall aims of this report are three-fold. The first aim is to examine the debates that have informed both the arguments for and critiques against a loan-based infrastructure fund for the Pacific. **Part I** examines the current state of the Australian aid program in the region, both in itself and in the context of other bilateral aid programs. **Part II** looks more deeply at one of the issues at the crux of discussions surrounding Australia's step up in the Pacific—that is, the role that China is currently playing in the region, especially with respect to its aid program. In particular, it considers where Chinese aid has been invested and with what impacts, whether China has developed a coherent Pacific strategy, and how Australia ought to respond.

Part III explores the other questions at the heart of all this: what are the Pacific's infrastructure needs? How reliable are the current dollar projections for Pacific infrastructure? What assumptions are they based on? And what are Pacific nations themselves calling for when it comes to infrastructure?

The second aim of this report is to explore the institutional framework into which such a proposal might fit. At the time of writing, the structure of a Pacific infrastructure fund remains somewhat unclear. **Part IV** identifies two basic models which the Pacific infrastructure fund could take, and their precedents both in Australia and overseas.

The third aim of the report is to take a step back and look at the macro issues through which this policy debate may be viewed. **Part V** looks at the particular vulnerabilities facing the Pacific nations that are pertinent when designing a new aid program there, with a particular emphasis on the vulnerabilities arising out of sovereign debt and from climate change. **Part VI** discusses such issues as what type of development is suitable for the Pacific, and are there alternatives to the AIFFP as it is currently being proposed?

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Part 1: The Australian aid program

1.1 Summary of the current aid budget

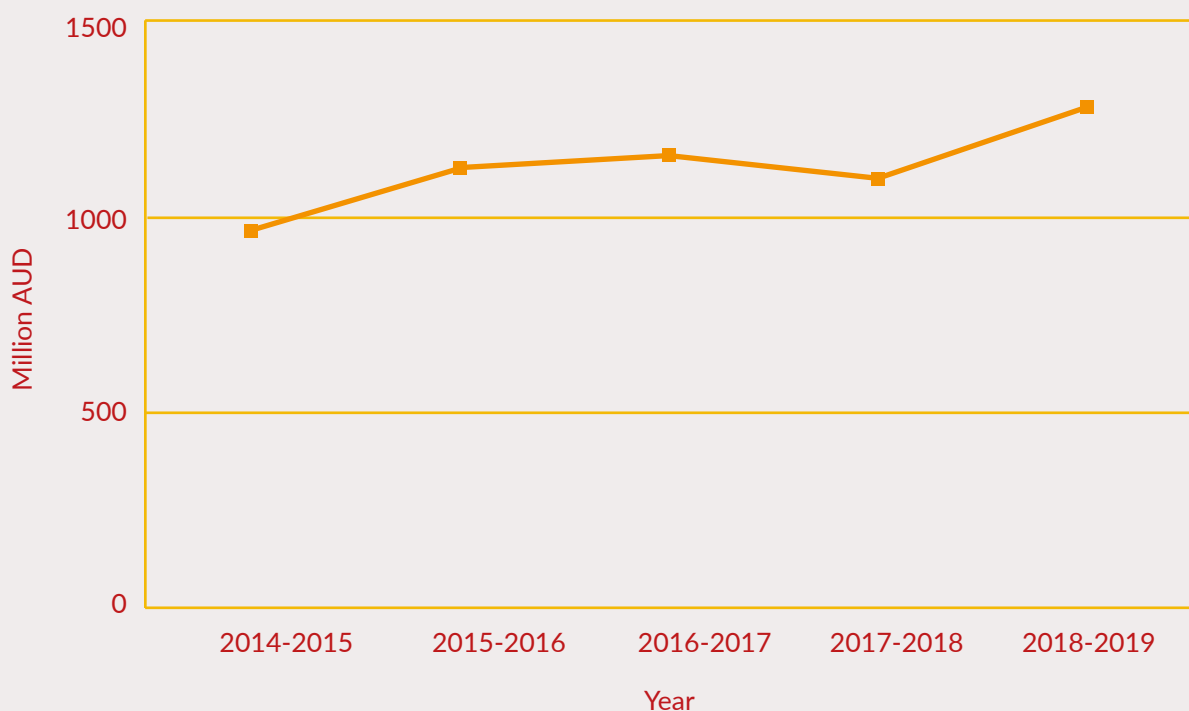
Released on 8 May 2018, the 2018-2019 Australian foreign aid budget devoted approximately \$4.2 billion¹ to commitments in Official Development Assistance (ODA) around the world.² From this figure, approximately \$1.3 billion was allocated to Pacific Island states, the highest amount ever allocated to the region. This is a smallish increase from previous years (see figure 1.1. below).³

Australia's eleven Bilateral Pacific Partnerships for Development comprise 79.9 per cent, or \$1,038.7 billion, of the total ODA allocation, for 2018-2019. The recipients of these bilateral agreements are Papua New Guinea (since March 2016), Tonga (Dec 2016), Samoa (Dec 2016), Vanuatu (Dec 2016), Nauru (Apr 2017), Solomon Islands (Jun 2017), Tuvalu (Mar 2018), Federated States of Micronesia (Jun 2018), Republic of Palau (Jun 2018), Republic of the Marshall Islands (Jun 2018) and Kiribati

(Sep 2018).⁵ Papua New Guinea has been the largest recipient of Australian bilateral aid between 2018 – 2019 with \$572.2 million in commitments, followed by the Solomon Islands at \$187 million, Vanuatu at \$62.3 million and Fiji at \$58.1 million.⁶ However, due to the breadth of these individual agreements, it will be outside of the scope of this paper to summarise and analyse the budget allocations and priorities for each state. Hence, the following sections will focus specifically on the Pacific Regional Development Program.

DFAT's Pacific Regional Aid, which makes up the remaining 21 per cent of the Pacific aid allocation, aims to materialise a 'secure, stable and prosperous' Pacific.⁷ It complements extant bilateral aid agreements by focusing on developing the region as an integrated, holistic entity and addressing the potential deficiencies of a purely bilateral approach. To achieve this vision of economic stability and prosperity, DFAT has

FIGURE 1.1: AUSTRALIAN AID TO THE PACIFIC⁴



delineated four main objectives for its regional assistance program for 2015-2030: ‘economic growth’, ‘effective regional institutions’, ‘healthy and resilient communities’, and ‘empowering women and girls.’ It is worth mentioning that these four objectives have been cogent with the 2030 Sustainable Development Goals outlined by the United Nations, also released in 2015.⁸

The breakdown of bilateral versus regional aid can be seen graphically in figure 1.2 below.

The Pacific aid program may be divided into six categories (see percentage breakdowns below in figure 1.3).

The government’s desire for increased economic integration is promoted through Australia’s ‘Aid for Trade’ Program and the Pacific Agreement on Closer Economic Relations (PACER), with the aim inculcating economic growth through integration with Australia.¹¹ Also falling into the Infrastructure and Trade program is the governments the Pacific Private Sector Development Initiative (PSDI) amounting to \$34.0 million from 2013 – 2019. The current focus is on improving access to financial services in households, improving competition, assessing business legislation to allow greater capital flows and empowering women. The ANZ

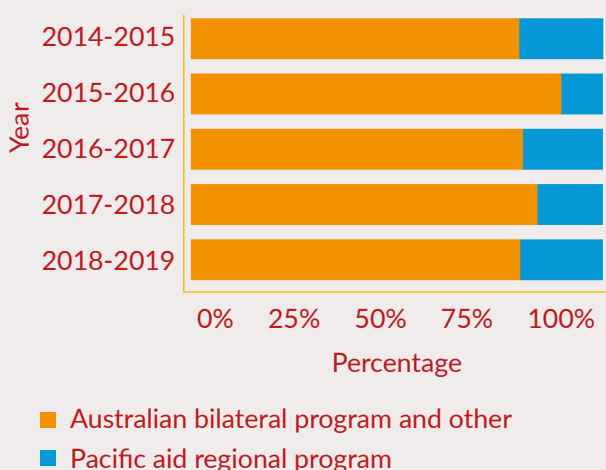
Bank (since Feb 2015), and Westpac Bank (since Sep 2014) are some of the corporations which have been contracted to provide technical assistance, market access and microfinance loans to small to medium sized enterprises (SMEs). The cruise liner Carnival Australia has been another major private sector partner (since 2013).

Developments in education and training are another important part of the aid program. Some of the mechanisms include supporting the University of the South Pacific Partnership program, amounting to \$70 million from 2014 – 2019, and Stage II of the Australian-Pacific Technical College, amounting to \$240.6 million at the end of 2018. Moreover, the government has also pushed for a Partnership with Educational Quality and Assessment, which totalled \$2.13 million by the end of 2018.

DFAT investments also focus on improving agriculture and fisheries sectors in the Pacific. The ‘sustainable commercial and subsistence fisheries’ program, for example, has allocated \$45 million in commitments from 2015-2018.

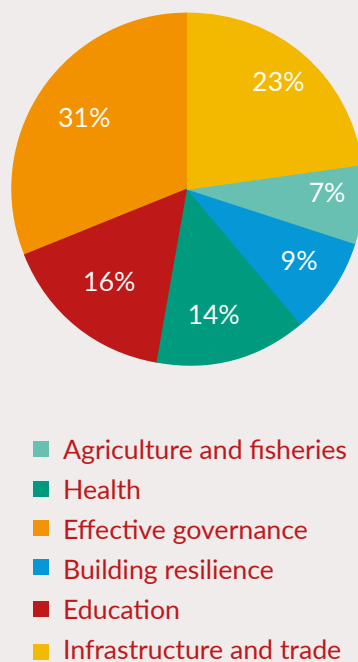
Another stated aim of the aid program is to improve governance and help build effective regional

FIGURE 1.2: AUSTRALIAN BILATERAL VS REGIONAL AID PROGRAM



Source: DFAT⁹

FIGURE 1.3: PACIFIC AID BUDGET BY CATEGORY



Source: DFAT¹⁰

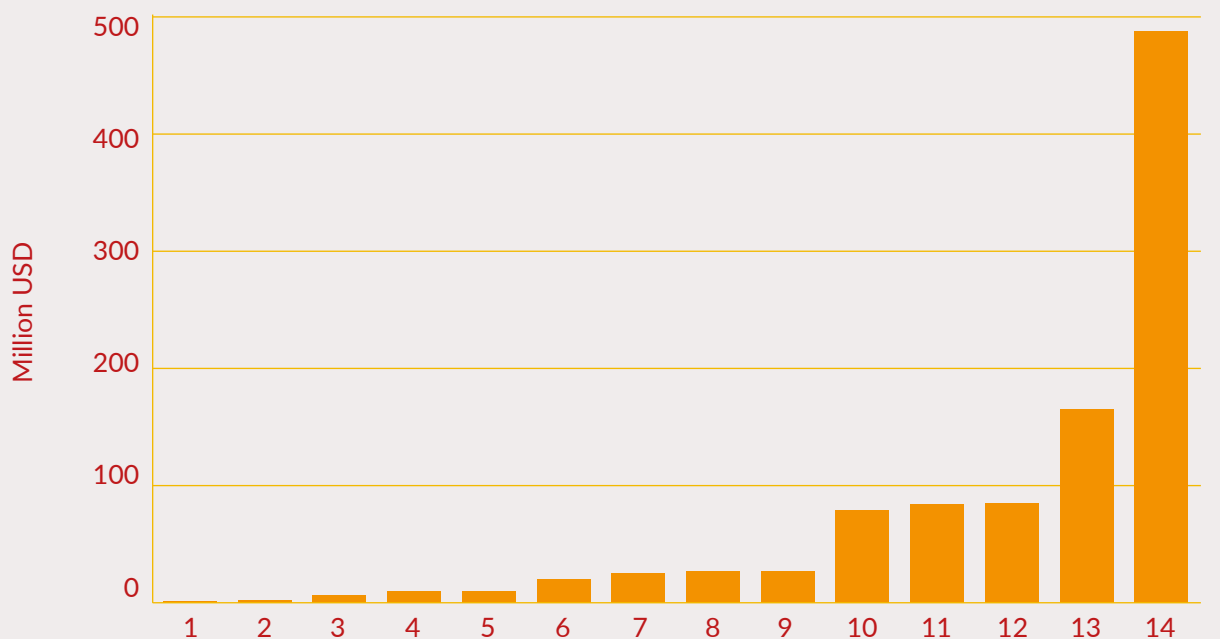
institutions (Effective Governance). In recent years, this agreement has included strategies such as funding the Pacific Islands Forum Secretariat (PIFS) (\$21.6 million in 2014 – 2017), the Secretariat of the Pacific Community (SPC) (\$81.2 million 2014 – 2017), and the Pacific Leadership Program. These initiatives had collectively aimed to develop greater 'institutional and human capability in public finance' and stronger 'public sector capacities, transparency and accountability'.

The government also has several initiatives targeting health in general and building resilient communities. These include support for the Pacific Community's Public Health Division Strategic Plan, costing up to \$20 million between January 2018 and December 2020, a partnership with the World Health Organisation (WHO) amounting to \$0.5 million at the end of 2018, and the Australia Pacific

Climate Partnership, which will amount to \$75 million in investments by 2022.

Lastly, the government has sought to empower women at a regional level through the 'Pacific Women shaping the Pacific' program, which aims to 'improve the political, economic and social opportunities of Pacific women' in the region. It seeks to achieve this by working with individual state actors, NGOs, the private sector, and United Nations agencies. The program is expected to receive a total investment of \$320 million by 2022. This is supplemented by efforts to 'improve reproductive rights' through multilateral programs such as the UN Joint program for Reproductive, Maternal, Newborn, Child and Adolescent Health (\$9 million in 2015 – 2019), Working for Sexual and Reproductive Health and Rights (SRHR) (\$4.5 million in 2015 – 2018) and the World Bank's

FIGURE 1.4: COMPARISON OF PACIFIC AID DONORS



- | | |
|---|--|
| 1 Sweden | 8 United Nations development programme |
| 2 Green Climate Fund | 9 New Zealand |
| 3 India | 10 Asian Development Bank |
| 4 International fund for agricultural development | 11 EU Institutions |
| 5 Unicef | 12 World Bank Group |
| 6 Taiwan | 13 China |
| 7 The global fund to fight aids, tuberculosis and malaria | 14 Australia |

Source: Pacific Aid Map, The Lowy Institute

Pacific Facility IV Trust Fund, worth \$5 million in investments (2018–2022).

Aid Program Performance Reports by DFAT have shown changes in the composition of the Regional Development Program. In recent years, the goal of ‘Economic Growth’ has received slightly less funding. Between 2015 and 2016, projects that aimed at enhancing economic growth amounted to 47.4 per cent, increased to 58 per cent in the 2017 – 2018 period. This year’s budget for ‘economic growth’ is at 46 per cent. ‘Building Effective Institutions’, on the other hand, has grown to 33 per cent, a large increase from 22 per cent in 2017 – 2018, which is perhaps a result of ‘amber’ ratings on their progress for the last five years. The objectives of ‘Healthy and Resilient Communities’ and ‘Empowering Women and Girls’ have remained static, showing increases of only around 0.5 – 1.5 per cent.

1.2 Comparison with other aid donors

Despite the recent talk about China, Australia still dominates all other bilateral and multilateral donors in the Pacific aid scene. As figure 1.4 demonstrates, in 2017, Australia gave as much as all the other donors combined. China was the next largest donor, followed by the World Bank, the EU and the ADB.¹²

It is interesting to compare Australia’s aid program with that of other traditional Western donors such as New Zealand, Japan and the European Union.

New Zealand

The New Zealand Ministry of Foreign Affairs (MFAT) releases their ODA budget every three years. Their most recent release under the Ardern administration was for the 2018 – 2021 allocation. It reported a total of NZ\$1131.0 million to the Pacific Development Cooperation, comprising nearly 60 per cent their total ODA budget.¹³ From this figure, NZ\$256.69 million was devoted to the Pacific Regional Program, while the remaining NZ\$874.31 million was allocated to bilateral programs, a ratio that mirrors that of Australia. From New Zealand’s aid allocation, we see a similar and balanced approach to funding. This is expected as Australia and New Zealand have expressed a close commitment to the 2030 Sustainable Development Goals. However, we can deduce two key differences: 1) New Zealand has delineated

more specific areas for its investment plans, which have been made more explicit than our own aid funding, and 2) New Zealand’s Pacific ODA to GDP ratio is significantly lower. The latter difference is anticipated as New Zealand has a lower economic capacity to give foreign aid.

Japan

Latest reports indicate that Japan spent \$128.06 million in the Oceania/Pacific region from 2015–2016,¹⁴ as part of an estimated \$1.8 billion in total financial assistance from 2006–2016.¹⁴ Japan’s total commitment is significantly lower than Australia’s commitments, both in nominal volume and in proportion to GDP. Furthermore, it is worth noting that Japan has employed an almost exclusively bilateral approach, in contrast to the Australian distinction between Pacific partnerships and the ‘Regional Aid Development Program’. Perhaps as a response to the creeping influence of Beijing in the region, the Japanese ODA to the Pacific is characterised by a stronger emphasis on transport infrastructure and economic development through bilateral means. Prime Minister Shinzo Abe has also focused on climate change issues in the region, to which he had addressed with a “sense of urgency”.¹⁵

The European Union

€800 million or approximately \$AUD1.1 billion in EU funds were dedicated to the region from 2014 - 2020.¹⁶ From this €800 million, €166 million is devoted to the Regional Indicative Programme (RIP), an initiative comparable to Australia’s regional Pacific Aid Development Fund. Structurally, this is similar to the New Zealand and Australian approach to funding, with 21 per cent dedicated to holistic regional efforts, while the remaining 79 per cent focused on bilateral and multilateral accords. The EU has indicated three main priorities: 1) Regional Economic Integration 2) Sustainable Management of Natural Resources and the Environment and the Management of Waste, and 3) Inclusive and Accountable Governance and the Respect of Human Rights. Understandably because of their distance and other regional interests, the European Union has dedicated significantly fewer financial resources to the region in terms of total volume and proportion to GDP.¹⁷

Multilateral Programs

Apart from the bilateral donors, there are of course

multilateral donors such as the World Bank and the ADB. As Howes and Dornan have pointed out, the World Bank and the ADB have been scaling up their commitments on the Pacific, over the 2018-2020 period, and their combined investment is now over the one-billion dollar mark, which is essentially double that of the previous three-year period. This increased capacity is partly as a response to increased support for World Bank and ADB programs from donors like Australia.¹⁸

Apart from lending to specific projects, the World Bank and the ADB also coordinate a number of regional capacity-building and technical assistance programs. A prime example is the Pacific Regional Infrastructure Facility (PRIF). Begun in 2008, the PRIF is a coordination facility that aims to provide technical assistance, research and knowledge products on major infrastructure issues concerning Pacific Island countries. Australia's (DFAT), New Zealand's (NZMFAT), the European Commission (EC), the European Investment Bank (EIB) and the Japan International Cooperation Agency (JICA) are also members.

Another example of a multilateral initiative is the World Bank's Pacific Resilience Program (PRF). The PRF was launched in 2016 as part of the Bank's aim to build resilience against climate change in the Pacific. The project was approved in June 2015 and is expected to end November 2020. The total project cost is about US\$9.47 million with US\$ 3.68 million already committed. Samoa has been one of the countries where the program has been active.

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Part 2: China in the Pacific

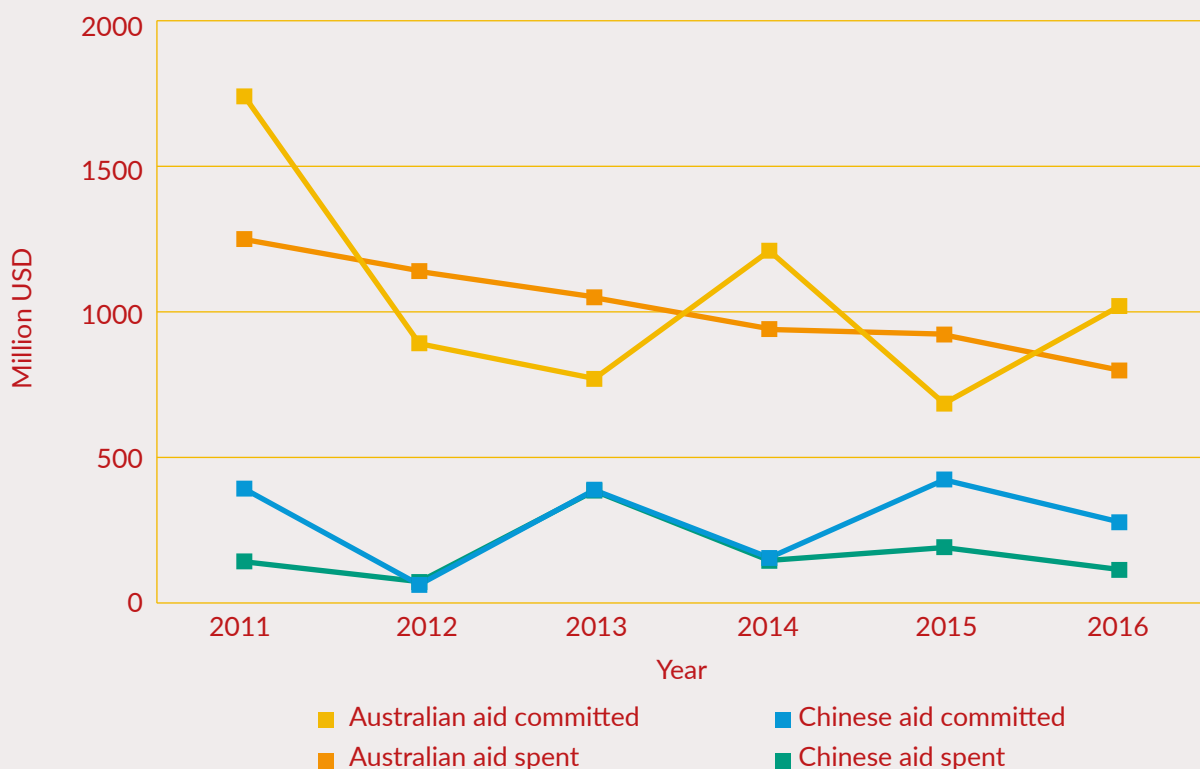
2.1: Chinese aid and investment in the Pacific

China's engagement with the Pacific has evolved over time: from a focus on competing with Taiwan for diplomatic recognition and securing access to offshore natural resources, to a more interests-based approach that emphasises profit-making and the expansion of commercial opportunities for its industries (some of which are faced with slowing demand at home). Nevertheless, Chinese efforts to consolidate their diplomatic and economic presence in the Pacific have become increasingly manifest since the 2000s—a trend marked by the organization of the first China-Pacific Island Countries Economic Development and Cooperation Forum in 2006. In parallel, Chinese development assistance to the region, which is characterised by a combination of grants and concessional loans, has dramatically grown over the past decade.

Owing to the secrecy surrounding aid figures, it remains difficult to ascertain the exact degree to which Chinese loans and payments have been tied to resource or equity deals, and by extension, the extent to which they are ultimately geared towards China's own national priorities. To this extent, this report remains grateful to the Lowy Institute for amassing a great deal of data about Chinese loans in the Pacific region.

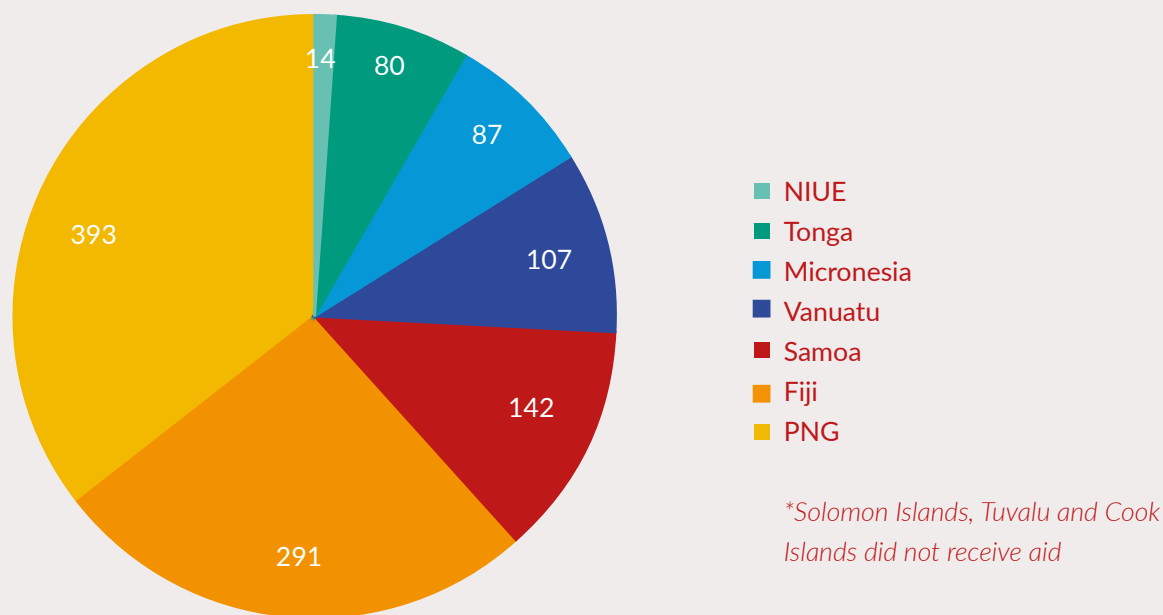
What the data reveals is that between 2011 and 2018, the Chinese Government provided an estimated US\$1.26 billion in aid to Pacific Island countries, of which over US\$840 million was committed to funding a spate of transport schemes. Although this accounts for only around 8 percent of the US\$14.51 billion in actual aid spending from all donors between 2011-2018, the prospect of China transforming into the Pacific's largest donor is now very possible. As noted in the preceding section, while Australia remains

FIGURE 2.1: CHINESE VS AUSTRALIAN PACIFIC AID 2011-2016 (MILLION USD)



Source: Data collated from the Lowy Pacific Aid Map¹

FIGURE 2.2: CHINESE PACIFIC AID PROGRAM PER COUNTRY (MILLION USD) ²



Source: Lowy Pacific Aid Map

the largest donor to the Pacific in terms of actual money spent, China is poised to overtake Australia’s position if it were to follow through with a 2017 pledge to deliver US\$4 billion worth of aid to the region - most of which relates to an ambitious \$3.5 billion road-building project in Papua New Guinea.³ The figure above illustrates the breakdown of the Chinese aid program to the Pacific by country. Sectoral breakdowns for some of the largest recipients are represented in more detail in Appendix 1.

China’s increased engagement in the Pacific should not be seen in isolation from its persistent efforts to deploy a ‘charm offensive’ and the opening of its chequebook to other regions. Following President Xi Jinping’s announcement of the multi-billion-dollar Belt and Road Initiative (BRI) in 2013, Beijing has demonstrated a capacity as well as willingness to assume stronger leadership in shaping the global economic order. In particular, the Asian Infrastructure Investment Bank (AIIB), which was founded in 2016, is positioned as a key financier of BRI-related infrastructure projects across the Asia-Pacific and elsewhere

in the world. Existing alongside China’s major policy and commercial banks (i.e. the CDB and China Exim Bank), as well as other multilateral development banks like the New Development Bank,⁴ the AIIB’s establishment thus heralds the continued growth of Chinese infrastructure investment across the developing world. The BRI also reflects, more broadly, the emergence of China’s hybrid approach to financing ODA that combines traditional aid in the form of grants with zero-interest and commercial finance (the latter in the guise of concessional loans). Between 2000 and 2014, of the US\$362 billion spent on foreign aid and loans by China, 21 per cent is estimated to have been spent on grants, with the rest being loans. As widely noted, the majority of Chinese ODA does not fit with the criteria of ‘development assistance’ as set out by the OECD’s Development Assistance Committee (DAC).

Both the BRI and AIIB represent a continuation of Beijing’s long-term focus on cultivating soft power and supporting its companies to ‘go global’—the latter being a policy that has been in place since the 1990s.⁵ Here, infrastructure

development has served as a popular entry-point for Chinese companies to overseas markets. Supported by the Chinese Government's diplomatic and economic clout, large state-owned enterprises (SOEs) have been notably active in backing a range of infrastructure from roads and railways to hydropower dams, industrial facilities, and government buildings, all the while learning the commercial 'rules of engagement' as relative latecomers to the global market.

Even so, compared to other regions like Africa and Southeast Asia, where China has invested heavily,⁶ the overall scale of Chinese financing in the Pacific is still generally smaller, in effect suggesting how the Pacific might still not rank too highly on China's foreign-policy agenda.

2.2 Contextualising Chinese money

Reminiscent of the concerns raised in other developing regions such as Africa, South Asia and Latin America with respect to the geopolitical influence of Chinese money, the debates surrounding China's economic engagement with PICs continue to centre on the question of what motives and intentions underlie Beijing's Pacific strategy. 2017 saw fears of China's economic power and, specifically, its 'no strings attached' aid program becoming linked to the country's purported 'expansionist' ambitions in other domains: China Merchant Port Holding's (a Chinese state-owned enterprise) recent acquisition of a 99-year lease for Hambantota Port in Sri Lanka⁷ seems to lend credence to forewarnings that a similar fate might await Vanuatu's Luganville Wharf. Should Vanuatu be

unable to service the debt, then the government might have to propose to Beijing a similar 'debt-equity swap'.⁸ Australia's competing proposal against China's Huawei Technologies Group's bid to build undersea internet cables for the Solomon Islands and Papua New Guinea—for which the Pacific Infrastructure Fund is expected to help pay—may stem from concerns of possible cyber-interference if the Chinese were to gain access to the Sydney landing station.⁹

Although the view of China as a 'rogue donor'-cum-investor has been challenged by Chinese and Western commentators alike, the so-called China Threat thesis, which reached its popularity peak back in the 1990s, continues to cast a long shadow over Australia's policy responses to China today. Despite being framed as an initiative to assist Pacific nations in meeting their development needs, it is clear that Canberra's step up in the Pacific and the AIFFP's announcement serve a dual purpose: to check Beijing's regional infrastructure drive and counter its perceived assertiveness in Australia's 'natural' sphere of influence. This geostrategic overlay also aligns with the United States' evolving policy towards China and the Indo-Pacific, which sees the Pentagon seeking to increase US military presence in the Pacific.¹⁰

It is possible, however, to overestimate the extent to which Chinese aid has a geostrategic rather than a traditional economic motive. Commercial interests frequently factor in Chinese decisions to provide ODA or invest in an infrastructure project as prominently as political considerations. At a time when Chinese SOEs and private companies are increasingly 'going out' in order to establish

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themselves within the global market, the motivation behind ODA or FDI projects can oftentimes be driven from the ‘bottom-up’ by the corporations involved - that is, by a desire to turn a profit and gain market access in a certain country. China is thus acting just like any other aid donor, and current security concerns may be overstated. Studies are nonetheless revealing how Chinese aid, aside from its stated purpose of promoting socio-economic development in recipient countries, does tend to have a secondary objective of supporting Chinese exports or market-rate loans that Beijing wants to see repaid (as the loans will have, in turn, been borrowed from the capital market). As a result, Beijing rarely forgives debt from concessional loans due to bureaucratic constraints and a fear of setting a risky precedent among borrowers. In this way, Chinese aid and commercial investments are intimately linked.

That said, China does appear to have a Blue Pacific engagement strategy. However, the strategy is not especially well-defined or especially coherent, as some Chinese observers have admitted, beyond the common references to ‘win-win cooperation’ and a ‘friendly’ desire to assist the PICs in their development.¹¹ Beijing continues to deny claims that it is seeking to systematically expand its military influence in the region—a claim that has also found support among some in Australia’s security circles. A lack of policy coherence and coordination on this matter would not be surprising given that China’s foreign policy is inherently omnidirectional,¹² being based on a multilayered and fragmented decision-making process. Indeed, inconsistencies found in Chinese foreign policy are broadly reflected in the implementation issues that continue to bedevil the BRI. In contrast to perceptions of the BRI as a linchpin in a new Chinese grand strategy, the reality of the BRI’s on-the-ground implementation provides a less coherent picture, with its policy conceptualization remaining equally vague. Nearly a decade on since its announcement, Chinese policymakers and pundits still struggle to make sense of what the BRI should look like in practice.¹³

None of this is to say that increased Chinese engagement in the region is entirely unproblematic, or that there are not valid causes for concern about the continuing rise of China as

a major geopolitical and economic power in the region.

There is, of course, the popularly-held view that roads and ports constructed by the Chinese ultimately lead ‘to nowhere’ in both a figurative and literal sense, considering how their concessional nature could worsen debt distress.¹⁴ Beijing is typically, albeit debatably, portrayed as a ‘malevolent’ donor, responsible for providing rogue aid that perpetuates bad governance and political opacity not just in the Pacific, but also in other industrialising regions. Here, Chinese spending in Africa and the particular practice of reserves-backed lending (also known as the ‘Angola model’)¹⁵—of which the US\$3 billion-loan secured by Ghana against its petroleum revenues in 2010 constitutes an example—are often leveraged as a case in point. Moreover, the negative socio-economic and ecological repercussions of Chinese infrastructure schemes of low quality and/or dubious utility consistently cast a doubtful light over the benefits generated from Chinese-backed projects. An oft-cited example of the classic Chinese white elephant is a hospital in Luanda, Angola, which within a few months of its opening was in imminent danger of collapse.

In the Pacific context, the practical necessity of so-called white elephant projects like the construction of a US\$12 million, six-lane road (known as Independence Boulevard) in Port Moresby have proven contentious. These questions of utility have, in turn, underscored the tendency for Chinese aid to be politicised. One is reminded here of how Tonga signed a Belt and Road memorandum of understanding and had its onerous loan payments deferred for five years shortly thereafter.¹⁶

The issue of debt has equally served as another constant cause for concern.¹⁷ Considering how six PICs (Kiribati, Marshall Islands, Tuvalu, Micronesia, Samoa, and Tonga) are already at high risk of debt distress, observers have warned of how Chinese concessional loans for large-scale and expensive infrastructure projects, like the Luganville Wharf and PNG’s prospective High Priority Economic Road Project have the potential to exacerbate this situation—if they are not already doing so—due to the limited ability of PICs to service these large debts.¹⁸ That said, China is yet to officially become the main lender

to the region, holding approximately 12 percent of total debt owned by the PICs.¹⁹ And with the exception of Tonga, Samoa, and Vanuatu, where Chinese lending is estimated to comprise 56, 38 and 35 percent of their debts respectively, Chinese loans currently account for less than half of lending in any single PIC.²⁰

Despite the Chinese Government's most recent announcement of the China International Development Cooperation Agency (CIDCA) as its new foreign aid agency tasked with coordinating, enhancing the efficiency of, and strategic planning for the country's 'development cooperation', China's aid program still presently lacks adequate oversight mechanisms to manage and monitor impact. Its aid strategy also continues to be frustrated by a fragmented policymaking process and bureaucratic complexity, as reflected in the well-known rivalry between the Ministry of Foreign Affairs and the Ministry of Commerce in carrying out this strategy. As such, even though the combination of grants and concessional loans allow for larger-scale financing in countries with an infrastructure deficit, the implications of this mode of financing remain largely obscure and seem to vary on a case-to-case basis.

In view of these issues, and especially considering the volume of money to be invested into the AIFFP, how Canberra perceives and responds to Chinese presence in the Pacific warrants careful consideration. Australia might find itself overreacting to China and, in so doing, risk jeopardising its bilateral economic

relationship with Beijing. In fact, some Chinese commentators view the Pacific step up as part of a bigger US-led attempt to 'contain' China, with editorial pieces in the state-run Global Times reacting sharply to Australia's 'reinvented' role in the region. One, in particular, posed the following question to the Pacific nations: 'Does it feel bizarre if the richest guy in your neighborhood, who has been ignoring and snubbing you for the past 10 to 20 years, suddenly turns up at your doorstep, trying to flatter and offering sumptuous gifts?'²¹

It also warrants note here that China is not the only player in the region about which Australia might be concerned. Taiwan, for one, has long been active in the region, competing with China for diplomatic recognition through payment of bilateral aid. Unlike China, the Taiwanese have provided aid mainly in the form of grants as opposed to concessional loans; even so, this has not prevented controversy. Most famously, then Taiwanese Minister of Foreign Affairs James Huang became entangled in the disappearance of US\$30 million, which was reportedly given to two brokers as 'foreign aid' to the PNG government on the condition that the country switch its recognition from Beijing to Taipei.²² Similarly, concerns have been raised in relation to the involvement of Malaysian companies in the region's palm oil sector that poses serious social and environmental challenges for countries like PNG. This is, of course, not to mention the track record of Australian firms investing in problematic resource schemes, of which the troubled Gold Ridge Mine in the Solomon Islands

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comes to mind.

In sum, the geostrategic threat posed by China's presence in the Pacific should not be exaggerated. While China is not a traditional aid donor, the most important concerns that we might have about its aid and investment in the region are not terribly different from the concerns that Australians might have about the behaviour of other countries, including our own. These types of concerns--white elephant infrastructure projects, 'boomerang' aid, investment focused on resource extraction, loans that are debt-creating--are discussed in more detail in the ensuing sections.

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Part 3: Pacific infrastructure needs

3.1 Infrastructure projections

As explained in the introduction, the ADB report Meeting Asia's Infrastructure Needs has been at the centre of many of the justifications for the AIFFP. Although the ADB is the only institution to quantify infrastructure projections by dollar value, other groups have made general statements about the need for infrastructure. For example, Tom Perry, team leader for Pacific communications at the World Bank, said: 'Additional support and investment in critical infrastructure will benefit the Pacific, particularly given the scale of need for infrastructure'.¹ Similar sentiments were expressed by group called the Pacific Investment Forum in a paper to the Pacific Forum Economic Ministers Meeting (FEMM) in April 2018. The paper made the following statement: 'In the Pacific, it is well-acknowledged that the infrastructure gap is large and expanding. It is a severe barrier to growth and development in both developed and emerging economies. In the face of demand for access from investors and a pressing need of governments to secure funding for infrastructure development, bridging the gap has become ever more urgent.'²

For its part, the ADB's core emphasis appears to be on infrastructure's ability to fuel economic growth, which allows greater economic and human development: 'One of infrastructure's most dramatic benefits is on the poor, allowing access to better health and educational services, improving living conditions, and fostering greater social and economic mobility.'

A closer look at the ADB estimates is therefore necessary.

The ADB report estimates that US\$26 trillion of

infrastructure investment will be needed from 2016 to 2030 (US\$1.7 trillion per year) in Asia and the Pacific. Estimated infrastructure needs in the Pacific ranged from US\$42 to US\$46 billion, or US\$3.1 billion a year. This accounted for a higher share of national GDP than other regions. The estimate includes additional costs associated with climate change adaptation. The annual infrastructure investment estimate is much higher than previous estimates made by the ADB using a similar methodology in 2009. This is both due to the updated estimate including climate adaptation and there having been faster than projected growth in the region.

Infrastructure demand/supply projections were based of a cross-country panel regression model of how a country's infrastructure stock relates to factors hypothesized to drive (or proxy) the demand/supply for infrastructure.³ Using the regression model and future estimates of factors assumed to drive and/or proxy infrastructure stocks, projections were then made of the likely level of infrastructure each country would need from 2016 to 2030 (according to infrastructure type). The estimated cost of future infrastructure for a country could then be estimated by multiplying the volume of infrastructure by its assumed price, or 'unit cost' (after also accounting for the cost of maintaining aging infrastructure). To account for the cost of mitigation and climate proofing, baseline infrastructure cost estimates were then inflated. With the level of cost varying according to the type of infrastructure (see Appendix 2 for more detail about the ADB's methodology).

However, the applicability of the ADB's projections is open to question on a number of counts. First, the accuracy of the estimates for

The ADB report estimates that \$26 trillion of infrastructure investment will be needed from 2016 to 2030 in Asia and the Pacific.

PICs are reliant on a variety of factors, including its ability to model the infrastructure stocks of PICs; the accuracy of the projections of factors thought to determine/proxy cross-country infrastructure stocks; the appropriateness of the unit costs and assumed asset depreciation rates to PICs; and the representativeness of the infrastructure path of other Asian nations to the development path of PICs. In other words, a model is only as good as its assumptions are reliable.

Finally, the study completely elides the question of the advantages of infrastructure investment vis-à-vis other forms of assistance or aid, such as health, education, governance, agriculture extension programs. It therefore does not consider what economists might call the ‘opportunity costs’ that may come from an overly-strong emphasis on infrastructure over the provision of other goods.

Beyond these general critiques, there is the further question of how applicable the ADB model may be to Pacific nations in particular. First, the report’s lack of cost estimates for individual countries, reporting of confidence intervals, statistical outputs and sensitivity tests, makes it difficult to speculate as to the applicability of the approach for PICs. However, given PICs face starkly different challenges due to their geography, demographics, location and economies of scale, it is not clear how the methodology would provide accurate estimates for PICs. Moreover, given many of the ADB’s member countries are significantly larger than PICs, it is plausible that the model has picked up economies of scale and infrastructure network effects not

available to many small-island economies.⁴ Second, the ADB cost estimates were reported to be highly variable, resulting in the median being selected. While a reasonable approach, this may suggest the final estimate is highly sensitive to changes in the underlying cost assumptions. It is plausible that in many cases the costs of asset depreciation, climate mitigation and climate proofing will be higher in PICs. For example, while Pacific Island Nations had their estimates for road infrastructure inflated by one third to account for the higher infrastructure costs, it is not clear whether this has also been done for other sectors.⁵ This, again, might influence the applicability of the estimates to PICs.

Third, although the model attempts to account for cross-country differences, it appears to ignore political and institutional factors. This practically may influence how factors in the model influence a country’s investment stocks, thereby undermining its accuracy for PICs. For instance, higher levels of corruption may reduce the stock of roads (all other things constant).

Following from this, there are enough questions about the ADB report’s methodology and general approach to question its use in isolation as a justification of the need for a new Pacific infrastructure program. A more compelling case for new Pacific infrastructure would need to be premised on the needs and development priorities of specific Pacific countries. An in-depth report that assesses and calculates these specific needs is something that, at this point, is yet to be produced.

There are, therefore, enough questions about the ADB report’s methodology and its general approach to question it being used in isolation as a justification for the need for a new Pacific infrastructure program. A more compelling case for new Pacific infrastructure would need to be premised on the needs and development priorities of specific Pacific countries, something that at this point is yet to be produced.

The proposed PRF is a new facility to enable be more equipped to respond to the unique challenges of these small developing island countries. In particular, it should assist in dealing with natural hazard risks and the need to adapt to climate change.

3.2 Pacific nation perspectives

Many Pacific Island leaders have not been silent about their desire for more infrastructure. As discussed in Part II, despite the existence of competing views regarding the political strings that may be attached to Chinese aid, a number of Pacific Island leaders have released a flurry of statements about the need for infrastructure in the wake of China's Belt and Road Initiative and Beijing's commitment to invest more in the region's infrastructure and overall economic development. In an interview with Xinhua news agency, Samoan Prime Minister Tuilaepa Sailele Malielegaoi talked about the 'vast market' which the BRI was opening up, whereas PNG Prime Minister Peter O'Neill noted how the BRI will be 'able to open up markets and improve the standard of living for our people.' Jerry Agus, chief executive officer of PNG Tourism Promotion Authority, has likewise remarked on how infrastructure is very important for Pacific Island countries, and how 'without infrastructure, you cannot do anything. Our (geological) environment is very unforgiving. We need roads, airports, bridges.'⁶ Tonga's Prime Minister similarly observed that his nation was 'exceedingly grateful' for development assistance from Beijing after the 2006 riots and the two countries would continue to discuss solutions for repayment through 'friendly consultation.'⁷

The AIFFP announcement has equally stimulated discussion from Pacific leaders. The Deputy Prime Minister of Cook Islands, Mark Brown, told the ABC that the Australian initiative would provide 'viable alternatives to what Pacific countries have been turning towards over the last years to non-traditional development partners', and that 'for us to be able to have the choice with the

increased presence of both Australia and New Zealand in the Pacific can only be good for the Pacific countries'⁸ Papua New Guinea's Deputy Prime Minister Charles Abel says his nation is also happy to see Australia's attention focused on the Pacific: 'Our general view [is] that Australia also needs to step up—they need to maintain their presence and influence in the region as well'.⁹

It is in this way that Pacific nations, such as Vanuatu, are leveraging Chinese and Australian strategic and economic interests to promote their own infrastructure development. One instructive example of this is evident from when a US\$20 million investment from Huawei to construct a communications network for Vanuatu reportedly prompted a million-dollar commitment from Australia to fund telecommunications regulation and management.¹⁰

The Secretary General of the Pacific Islands Forum (PIF), Dame Meg Taylor, aptly summarises the Pacific nations' desire for infrastructure in a speech about China's impact in the Pacific as follows:

Indeed, if there is one word that might resonate amongst all Forum members when it comes to China, that word is access. Access to markets, technology, financing, infrastructure. Access to a viable future. ... To a large extent, Forum Island countries have been excluded from the sorts of financing, technology and infrastructure that can enable us to fully engage in a globalised world. Many countries see the rise of China and its increasing interest in the region as providing an opportunity to rectify this.¹¹

Nevertheless, Dame Taylor also moderated these general observations about the need for infrastructure with a number of caveats. She warned about the dangers of playing one donor

against another, instead extolling the virtues of partners ‘working together for the benefit of the region’. To this end, Taylor seemed to suggest that the AIFFP should support the PIF Secretariat’s own priorities, specifically the Pacific Resilience Facility (PRF):

As I have said before, I would offer that channeling such assistance through the Pacific Resilience Facility is one of the many appropriate options for strengthening our will to drive our own pathways toward resilient development.¹²

The proposed PRF is a new facility aimed at assisting PICs in dealing with natural hazards and the climate change adaptation. Additionally, the proposed PRF aims to help lower the costs of emergency response and relief, as well as recovery and reconstruction, by building stronger and better infrastructure. The PRF’s five strategic objectives are to: strengthen the collective financial resilience of PICs against natural hazard risks in the Pacific region; provide cost-efficient and contextualised financing options for resilient development projects in the Pacific; encourage capacity development in national climate and disaster risk budgeting and financing; strengthen strategic partnerships with key development partners to harness collective support for disaster preparedness in the PICs; and encourage capacity development in national climate and disaster risk budgeting and financing through strengthened public financial management in the Pacific region.¹³

Dame Taylor noted that the PRF could also be used to establish common regional criteria to help its members assess investments. Here, it could operate as a sort of monitoring and regulation mechanism for infrastructure quality that can help to ensure standards are met for environmental, social and cultural protection.¹⁴

Ensuring that any infrastructure developed will be focused on meeting the needs of climate change resilience is clearly a key concern for Taylor and the PRF. Mark Brown has similarly echoed Taylor’s concern about the need to focus on climate change, explaining how the Cook Islands would like see climate change issues ‘more accurately clarified’ by Australia, as ‘For us the climate change issues are significant, they’re at the front and centre of any development initiative in the Pacific island countries’. He went on to say that ‘we welcome engaging more with Australia to see

what further commitment Australia will provide, not just in the infrastructure fund but also in their contributions towards the effects of climate change’.¹⁵

In summary, despite the enthusiasm amongst some Pacific leaders for some infrastructure, there also seems to be an acknowledgement that 1) the infrastructure needs to fit in with more pressing priorities and fears around climate change, 2) there is as yet lacking a process for assessment of the viability and disarability of individual projects.

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Part 4: Institutional questions

There are two major forms that a Pacific Infrastructure vehicle might take. First, a loan facility, either using Efic or some other agency, that makes concessional loans. Second, a Development Finance Institution, or DFI, which lends money and invests in the private sector—either companies based in Pacific nations, or through private equity investments targeted at the Pacific. We will now consider them in turn.

4.1 Concessional loans and the DIFF program

If designed as a loan facility, the AIFFP would disburse concessional loans (or loans blended with grants) to Pacific government agencies and/or commercial enterprises, in response to development projects endorsed by Pacific governments. As Howes and Dornan have pointed out, concessional loans are an increasing prominent instrument in foreign aid, growing from 16 to 19 per cent of aid allocations in the five years up to 2017. Japan, German, France and Korea are some of the nations that tend to utilise this method.¹

Prima facie, such a concessional loan facility would look very similar to the axed Development Import Finance Facility (DIFF). DIFF was an Australian Government scheme principally operating between 1983 and 1996 (it was created a few years earlier). DIFF was intended to open up new foreign markets for Australian exporters while at the same time assisting the ‘development needs’ of importing countries. Recipient governments were offered Efic loans partially supported by aid grants to fund the delivery of services by Australian companies, mainly in the transport, telecommunications, energy and extractive industries sectors.

The model proposed by the current Efic legislation before parliament appears to share institutional, financial and conceptual features with the DIFF program. Institutionally, both DIFF and the AIFFP appear to be some sort of coordinated program between Efic and the Australian agency responsible for the aid program (AusAID in the case of the DIFF scheme, DFAT in the case of the

AIFFP). Financially, both combine grant aid and capital borrowed by Efic to create ‘blended loans’ that are highly concessional (i.e. lower interest rates, long grace periods, some of the finance facilities would have a grant component and a loan component). DIFF financing was on average a 35:65 blend where 35 per cent grant component from the aid budget, and 65 per cent loan from Efic’s balance sheet. (From 1987 onwards, new rules required that low income countries—admittedly a minority of countries receiving DIFF aid—receive a grant element of at least 50 per cent).² Given that we know how the AIFFP will be a \$2 billion annual program with \$500 million in grant aid, it seems reasonable to assume that the average facility could be closer to a 25:75 blend.

Conceptually, both programs appear to be motivated at least partly to benefit Australian businesses. DIFF was a classic ‘tied-aid program’, where an Australian exporter or company was delivering the goods or services being purchased by the developing country. The AIFFP also appears to have similar features when it comes to Australian benefit, although there is some doubt about this. The legislation currently before parliament indicates that the extra \$1 billion in callable capital to Efic for infrastructure needs to meet Efic’s national content requirements. It therefore seems reasonable to assume that such a ‘national content’ requirement will also apply to AIFFP financing as well. What remains somewhat unclear, however, is whether Efic would necessarily have to apply its national content requirements to participate in AIFFP loans. If, for example, all AIFFP loans were to fall under Efic’s National Interest Account, it may be that the national content requirement could be waived for a broader definition of national interest (for example, national security). However, given the lack of clarity about how the AIFFP would work, this is just speculation at this point.

The potential similarities between the AIFFP and the DIFF program requires further analysis. In 1996 the DIFF program was discontinued when the Howard Government came in, ending the 13 years of Labour government under which the DIFF had flourished. There were several critiques

levelled against the DIFF program. One critique emphasised by the incoming government was on economic grounds, that the DIFF was actually doing more harm than good to Australian business. This attitude was pithily summed up by the soon-to-be Treasurer Peter Costello who, during the build-up to the 1996 election, reportedly described DIFF as a 'subsidy paid to domestic business'.³ During the subsequent Senate Inquiry into DIFF, Howard Government Senators agreed. Mentioning Treasury estimates that DIFF-Efic packages averaged out at 40 per cent of total project financing, the Senators concluded in their minority report that: 'there appears to be little economic advantage in engaging in a subsidy war with other larger economic powers'.⁴

The remaining complaints against DIFF related to its impact on the recipient countries, and in both cases, there was an alignment between the position taken by the incoming conservative government and members of the Australian aid community. A second critique rested on the question of the so-called 'supplier-driven' nature of the program, wherein, it was said, projects were driven more by the needs of exporters than those of the developing countries who were recipients of the projects. There was some acknowledgment of this problem even before the scheme was scrapped. In the early years of the program, it seems that many or perhaps most of the projects were initiated not by the recipient country but by the exporter. The Indonesian National Planning Board complained in 1992 that suppliers were convincing ministries to 'take what was on offer' (this is significant given that Indonesia was the largest recipient of DIFF loans).⁵

In 1992, a review saw a series of 'improvements' made to the scheme.⁶ 'Suppliers' (i.e. companies), could only choose from a list of projects that had at first been submitted to AusAID (then known as AIDAB) by recipient governments, and could indicate to AusAID which proposals were of 'low-priority'.⁷ By 1995/96, the administrators of the scheme claimed that due to these improvements, 85 per cent of the DIFF projects were initiated by the recipient governments 'and not by commercial interests'.⁸ However, it is not even clear that this rule change really made much difference to the supplier-driven nature of DIFF. Certainly, Treasury did not think so. In its evidence to the 1996 Senate Inquiry it said that 'the supply-driven nature of DIFF means that it is focussed on projects that are

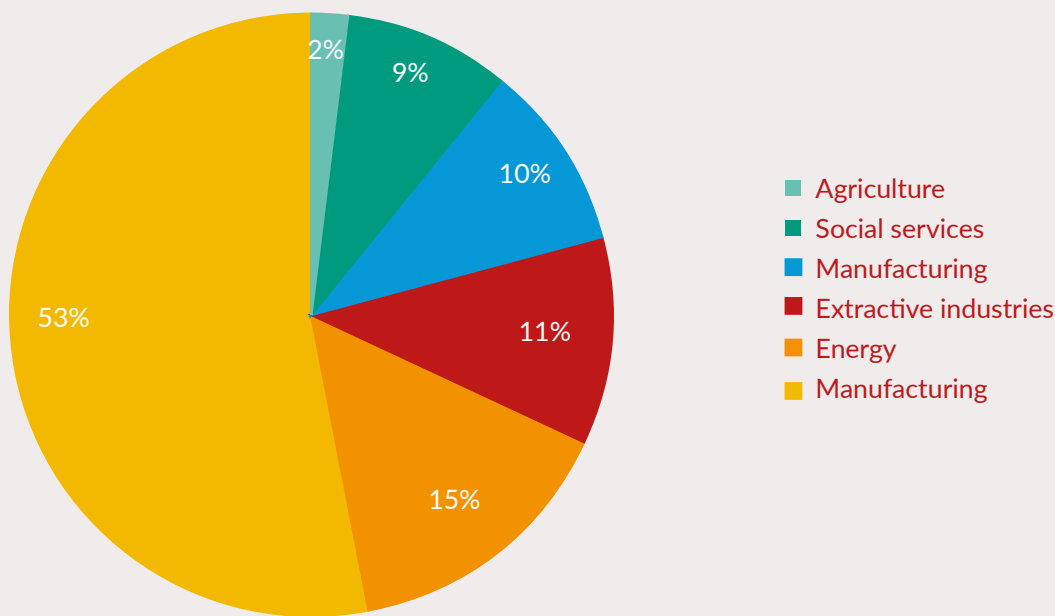
important for Australian exporters, rather than necessarily for recipient countries'.⁹

A related criticism to the supply-driven nature of the program was that DIFF priorities tended to be skewed towards certain countries and sectors, which saw aid priorities depart from what should be the guiding principles of poverty alleviation and sustainable development. From a country point of view, between 1983 and 1996, a full 85 per cent of DIFF funding went to just three countries (46 percent of DIFF funding went to Indonesia, 30 per cent to China and 9 per cent to India). David Burch, in identifying this pattern, argued that this skewed DIFF financing towards countries with a large and growing middle-class and rapid economic growth, and away from countries more in need of actual aid. To further emphasise his point, he reminded readers that these three countries only received 21 per cent of the disbursements under the wider aid program.¹⁰

Figure 4.1 shows the sectoral breakdown of DIFF outlays over the first ten years of the program's operation (but excluding the final two years). Over this period, 53 per cent of DIFF financing went to transport and communications sectors. Energy (15 per cent), extractive industries (11 per cent) and manufacturing (10 per cent) sectors also received support. Social services came next at 9 per cent, and agriculture received a paltry 2 per cent of DIFF financing. Burch, pointing out that aid to social services and agriculture has the greatest impact of reducing poverty and increasing quality of life, argued that these sectoral allocations were 'difficult to justify'.¹¹ The Senate Minority Report echoed these sentiments, arguing that the provision of large amounts of financial assistance to one industry sector contributed to the distortion of aid priorities.¹² It further pointed out that a huge chunk of the DIFF program (\$575 million) went to just 10 companies.¹³

The concentration of DIFF loans is demonstrated by looking at a number of case studies, the most obvious being the \$142 million of DIFF money that went to Australian construction company Transfield.¹⁴ Over the nine-year period between 1984 and 1993, the company received the benefit of approximately one-third of the taxpayer-raised DIFF funds to pursue a joint venture with Indonesian trading partner, PT Bakrie & Brothers, building around 2,500 prefabricated steel bridges in the country.¹⁵ The latter company was owned

FIGURE 4.1: DIFF INVESTMENTS PER SECTOR, 1983-84 TO 1993-94 (MILLION AUD)



Source: Richard Burch chapter
(see endnotes)

by Aburizal Bakrie, a controversial Indonesian Government figure and one of Indonesia's richest men who secured his fortune through his close links to the Suharto regime. He has since been implicated in serious charges of corruption, tax evasion and maladministration.¹⁶

There are other examples of DIFF money going into mega-projects of unclear development benefit. One of these was the \$61.5 million of DIFF funding that went to White-Sydney-based industries for the Pipawar open-cut coal mine in Bihar State in northeast India. The Pipawar project was associated with claims of negative social and environmental impacts, including the displacement of over 2,000 people, many of whom were never compensated for their loss of livelihood.¹⁷ Another mega-project was the Tianjin Urban Project in China, to which \$75 million of DIFF funding was allocated. The question here is whether such a large amount of Australian aid money should have gone to support the development of an already prosperous region instead of other priorities.¹⁸ Together, these three projects made up around half of the total DIFF allocation by dollar value.

Burch questioned whether this bias towards large-scale and capital intensive projects could meet the needs of target groups in developing

countries, on the grounds that they had a major negative impact on the local environment upon which the livelihoods of the poorest depended, and also whether the focus on projects relying on large quantities of imported technology would add much to the provision of indigenous technological capacities.¹⁹ The Australian Council for Overseas Aid (ACFOA—the precursor to ACFID) agreed:

DIFF distorts the type of aid projects supported. Because it basically provides support for the purchase of capital goods, DIFF produces a bias towards infrastructure-type projects (for example, cement plants, coal mines, bridges and aircraft hangers) which rely on economic trickle-down effects to benefit the poor. This is contrary to the prevailing view that to most effectively tackle poverty you need projects which benefit the poor directly (for example, through agricultural development, water supplies and sanitation, rural and adult education).²⁰

Another critique of the DIFF program concerns the question of institutional capacity. One of the main purposes of aid is not just to provide goods and services, but to build and strengthen the capacity of development and governance institutions in the recipient country. If the selection of the projects is overly influenced by outside bodies, and the delivery of the goods and services is also done by these agencies, then the opportunity for those capacities to develop on the ground are impeded.

Once again, Treasury pithily summed up this argument in its analysis of the DIFF program:

DIFF projects are not designed to promote policy dialogue or to assist in the development of institutional capacity in recipient countries. Whatever the merits of individual projects that DIFF may finance, their development impact is inevitably much narrower than is available through other forms of aid.²¹

There was one criticism of the DIFF program that did not receive much airing at the time but should not be forgotten now: this is the fact that it was a debt-creating mechanism. The DIFF aid grants to Indonesia, for example, were, like all DIFF projects, accompanied by Efic loans—loans that were, in the Indonesia case, approximately twice as large as the DIFF grants. These loans, of course, had to be paid back. However, although a middle-income country, Indonesia had, by the 1990s, amassed a huge sovereign debt, which ballooned after the Asian Financial Crisis of 1998 saw a fall in GDP and a devaluation of the Indonesian currency. Much of the external debt was to other bilateral lenders, particularly Japan. Large amounts were also owed to multilateral institutions such as the World Bank and the ADB. Indonesia's sovereign debt to Australia, most of which was amassed through the DIFF program, represented only a small amount of this total.

4.2 A new development finance institution

Although the Efic legislation would suggest that the DIFF program is the sort of model that the AIFFP might follow, there has also been talk of the Australian Government setting up its own Development Finance Institution (DFI). In theory, DFIs are expected to 'maximise profit and development impact in high-risk, underserved and cash-starved emerging markets'.²² The DFI model is seen in multilateral institutions such as the World Bank's IFC. Many OECD countries also have DFIs, such as the British Commonwealth Development Corporation (CDC). DFIs often also invest directly in private equity funds, as with the British CDC.

DIFF loans were often made to commercial enterprises, although it is our understanding that these had to be guaranteed by the respective governments, which is one reason why DIFF loans later became associated with debt problems. Another key difference between a DFI and the

DIFF program is that a DFI could be expected to make greater use of direct equity investments and financial intermediaries.

Policy experts both inside and outside government have referenced or even supported the idea that the AIFFP could be run through a new DFI. An exchange between Frances Adamson, Secretary of the Department of Foreign Affairs and Trade, and shadow Foreign Minister Penny Wong referenced the DFI model, implying that it was something that DFAT was looking at.²³ At a recent ACFID Roundtable meeting, it was suggested that the AIFFP could focus its lending on the private sector rather than to government agencies. The argument was that this would allow the AIFFP to avoid exacerbating the sovereign debt problem in the Pacific. The Development Policy Institute's Stephen Howes and Matthew Dornan have come out explicitly and recommended that Australia set up a new DFI to operate the AIFFP, on the grounds that it would not be debt creating and that it would get around the problem of Efic's lack of institutional capacity and know-how when it comes to international development.²⁴ Cornelia Tremain of the Lowy Institute has also supported the DFI model for Australia.²⁵

Many European countries have DFIs, which were often set up in the post-colonial era as a way for European nations to engage in private sector investment in their former colonies. The first DFI, Britain's CDC, was set up in 1948. For many years, the CDC invested only in private equity funds, but recent changes to its rules now mean that 50 per cent of CDC financing is through private equity and direct loans. The CDC has been criticised on a number of grounds: first, it makes a return of 10 per cent a year (approximately three times more than it is supposed to). Second, it shows a bias towards large economies and investments that meet the needs of the middle-classes in these economies. For example, 65 per cent of its investments go to five countries: India, China, Nigeria, South Africa and Kenya. Finally, many of the companies it invests in use tax havens.²⁶

The US set up the world's second DFI with OPIC. Last year, the BUILD Act replaced OPIC with a new DFI, the IDFC, which will consolidate all private sector financing into one institution. The IDFC does not have a specific sectoral mandate; it does have the mission to focus on areas of market gaps. It will be able to make loans in local currencies

and to non-US businesses.²⁷ The BUILD Act has been specifically justified by its proponents on the grounds that a renewed effort is needed to counter the influence of China in Africa.²⁸ Canada is another country that has recently set up a DFI.²⁹

However, DFIs' ability to contribute to sustainable development and combat poverty (as opposed to merely economic growth) remains to be demonstrated. A 2012 report commissioned by the Private Infrastructure Development Group, which is itself a DFI, found that although DFIs could theoretically increase services to address poverty, there is actually no evidence so far that they are doing so.³⁰ A more recent paper by a US-based think tank would suggest that there has been little progress since then in linking DFIs to pro-poor economic growth.³¹

Prominent Brussels-based think-tank the European Network on Debt and Development (EURODAD) has outlined a range of problematic impacts that DFIs have caused in the countries that they operate in. First, the databases which track DFI operations are poor, making it unclear and unprovable that DFIs have had positive development outcomes. Secondly, the nature of DFI ownership and voting power means that their agenda is driven by developed and not developing countries. Thirdly, although the IFC has relatively robust transparency and accountability mechanisms, bilateral DFIs rarely have these. Fourthly, because of the need for bankable projects, DFIs tend to focus on countries and sectors where private capital is relatively abundant and thus do not tend to provide goods and services to poorer countries. Finally, DFIs have a tendency to be associated with industries that are, in turn, associated with natural resource extraction, profit repatriation and tax evasion, and preferential conditions for foreign companies.³²

In summary, both potential models for the AIFFP - a revamped DIFF scheme or a new DFI - have serious drawbacks, especially when it comes to their proven ability to address the needs of the majority of residents of small island developing countries.

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Part 5: Vulnerabilities

5.1 Debt vulnerabilities

Several analysts have already pointed out that the primary problem with a new infrastructure loan fund for the Pacific is that it would be debt-creating. Around the same time that the new fund was announced, Rohan Fox and Matthew Dornan noted that although China was largely not to blame, there was a serious sovereign debt problem in the Pacific. Using IMF data, they showed that of the 15 countries eligible for the AIFFP, six are already at high level of debt distress (Kiribati, Marshall Islands, Micronesia, Samoa, Tonga, and Tuvalu). Four are at a moderate debt distress (PNG, Solomon Islands, Timor Leste, and Vanuatu). Fox and Dornan also showed that the trend has in fact been getting worse over recent years: that more Pacific nations have been moving from low to moderate risk, and more from moderate to high risk.¹

While the Fox and Dornan piece was done ahead of the Pacific step up announcement and therefore did not specifically mention the new policy, a number of analysts and commentators have since weighed in. University of Wollongong's Susan Engel drew on Fox and Dornan's research and her own expertise to write that 'the last thing that Pacific nations need' is a loan fund of the type being proposed. She further noted that adding to these debts 'is not a wise or a decent thing to do'.² The former Minister for International Aid and the Pacific, Concetta Fierravanti-Welles, critiqued the new policy on similar grounds: 'I don't want to see a situation where one debtor is swapped for another.'³ Dornan himself further fleshed out the arguments about the debt headaches that a new loan facility would pose in a draft paper co-authored with Director of the ANU's Development Policy Centre Stephen Howes, which was released in February 2019.⁴

The development of the debt problem in the Pacific has not happened in a vacuum. Indeed, research by Jubilee Australia's partner organisations over the last few years has

identified that many impoverished countries are entering or at risk of a new debt crisis. Annual lending to low and lower middle-income country governments more than quadrupled from \$57 billion in 2007 to \$260 billion by 2016. As of October 2018, the IMF and the World Bank found that of 67 low income countries, 7 were already in default (including Mozambique, Congo, Chad and Gambia). Meanwhile, 12 were at high risk of debt distress, and 28 were at medium risk.⁵ The same ingredients that led to the first debt crisis in the 1980s have been driving the return of this phenomenon. On the one hand, the post-financial crisis policies of quantitative easing and low interest rates in the advanced economies has driven a glut of new lending by bilateral and multilateral donors. Also, and as was the case in the 1980s, low commodity crises have made it harder for developing countries to repay the loans: from mid-2014 to mid-2017, the commodity price index fell by 40 per cent.⁶ The other pertinent factor, of course, is that the architecture to deal with the last debt crisis was not permanent. The Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI) were one-off schemes, even though they managed to provide significant assistance (US\$127 billion) for debt relief for the 36 countries. But because calls for a more systematic and permanent debt mechanism to be created were resisted, it has been easy for the same pattern to reproduce itself.⁷

Small island states are bearing the brunt of this new debt problem. All seven of the independent members of the Organisation of Eastern Caribbean States (OECS) have debts that barely meet the indicative threshold for Caribbean debt sustainability of 55 per cent (Antigua & Barbuda, Dominica, Grenada, St Kitts & Nevis, St Lucia, and St Vincent & the Grenadines). Elsewhere in the Caribbean, Barbados is in an even worse situation. The Caribbean states' debt distress has been exacerbated by the convergence of debt, climate change and natural disasters (an issue that we discuss in more depth in the next section^{5,2}). Many small island states in the Caribbean, as

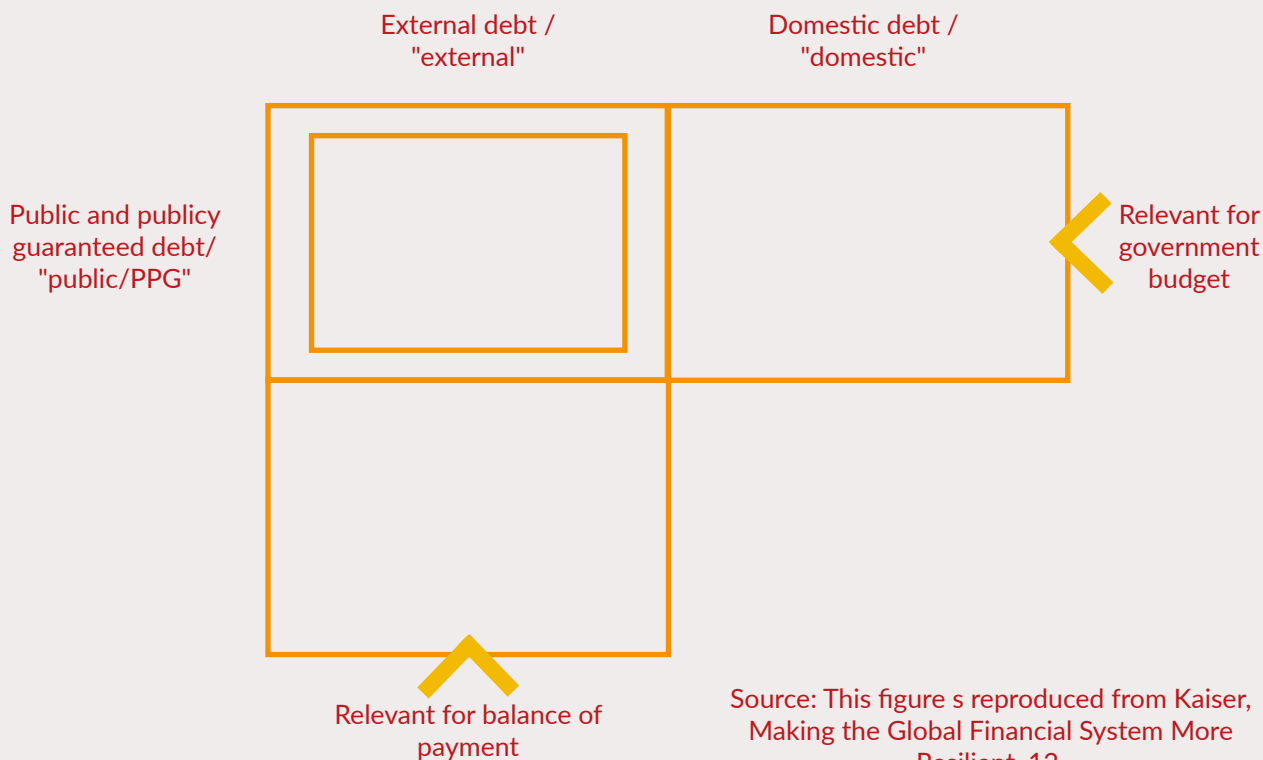
well as in other places like sub-Saharan Africa, have already fallen into a situation known as a 'debt trap' - a phenomenon where debt loads are so high relative to a country's ability to pay, such that no amount of loans are able to get the country out of it. In these cases, loans are only helping the country service its interest payments, meaning that the country is trapped in a permanent cycle. The only way out of a debt trap is debt relief or cancellation.⁸

We might further interrogate the debt risks posed for relatively underdeveloped economies, beyond those already raised in the papers cited above. When it comes to debt indicators, there are three types of debt to consider: (1) external public debt, (2) domestic public debt, and (3) external private debt. External public debt is government debt owed to international creditors and which might include bilateral and multilateral aid donors, commercial creditors such as bank, and foreign holders of a country's sovereign bonds. Domestic public debt is government debt owed to domestic lenders, such as local banks, and local holders of government-issued bonds and securities.

Finally, there is external private debt which is owed to foreign creditors by the private sector. Public or sovereign debt is the sum of (1) and (2), and external debt is the sum of (2) and (3). This is represented graphically by the figure below.

The reason for considering public debt and external debt separately lies with the fact that repaying each of them poses somewhat different challenges. In some countries, public debt has a large domestic component (e.g. PNG and Fiji), due to there being a large enough economy that allows the government to borrow from local banks and/or have its bonds and securities purchased by domestically-based individuals and corporations. In such a scenario, the capacity of a government to repay this debt is more of a function of its GDP than anything else, given that GDP is a measure of the overall size of the economy from which the government collects revenues to repay its borrowings. In general, a public debt to GDP ratio of over 50 per cent should be a cause for concern. Looking at figure 5.2, therefore, Fiji, Samoa, Tonga and Vanuatu are approaching danger levels, and Nauru is already in serious trouble. These figures

FIGURE 5.1: THE RELATIONSHIP BETWEEN EXTERNAL DEBT AND PUBLIC DEBT



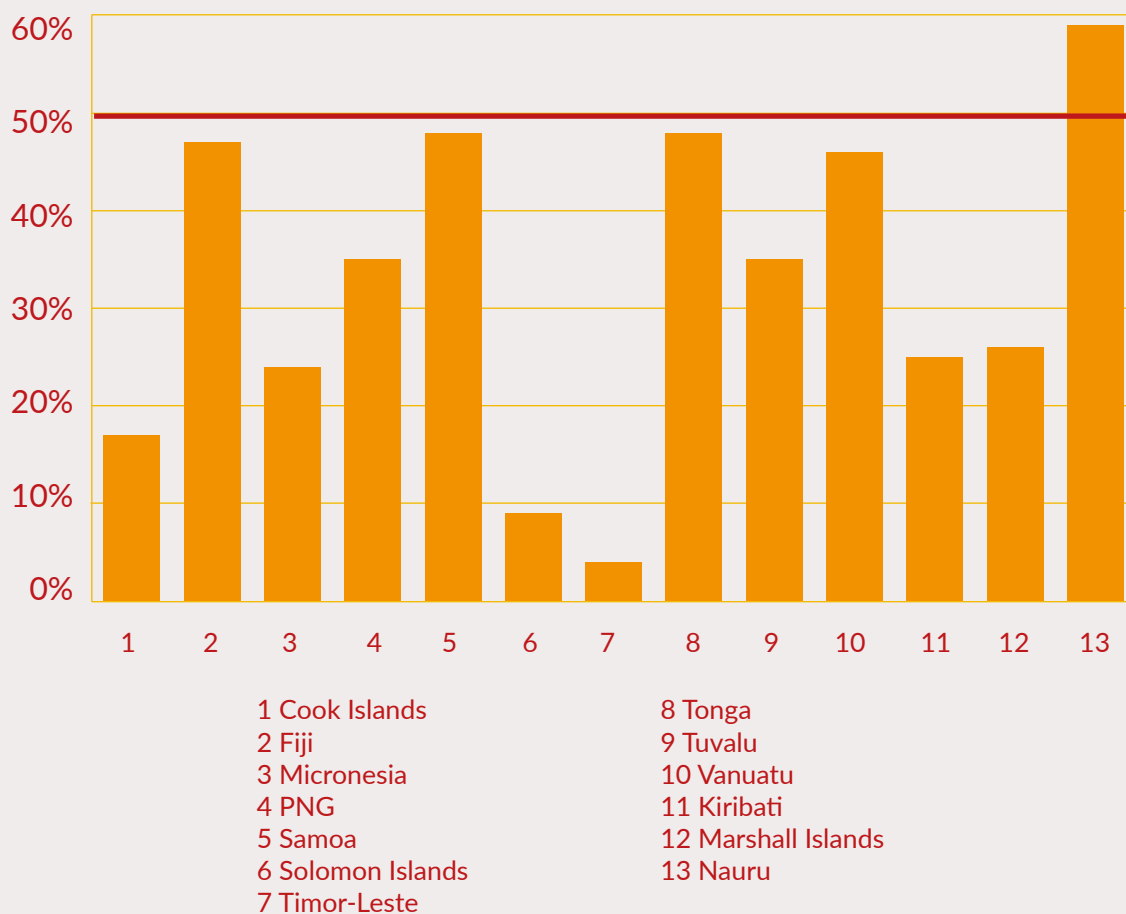
are interesting in light of the main creditors identified by Fox and Dornan. As mentioned, PNG and Fiji owe mainly to domestic creditors, whereas the Cook Islands, the Solomon Islands, Micronesia, Samoa and Tuvalu all owe significant amounts to multilateral creditors. Only Tonga, Samoa and Vanuatu owe significant amounts to China—and of these, Tonga’s proportion, close to 60 per cent, is the most extreme.⁹

External debt, on the other hand, poses a different problem. First, the problem is not just one of how much the government owes to foreign creditors, but also one of how much banks and corporations owe. This is because, if commercial operators and banks are not able to meet their obligations to their external creditors, the government may have to step in, out of fear that collapse of a bank or an industry sector on account of a loan default could have profound impacts on the economy as a whole. This was seen in the case of the recent

Eurozone crisis, where Ireland’s, Spain’s and Portugal’s foreign debt problems were mainly due to the loans taken on by private borrowers (i.e. banks and companies). In the case of Ireland, for instance, the government decided to step in and bail out corporations who had overborrowed and ended up fuelling a construction bubble, which in turn resulted in fiscal problems and a devastating economic downturn.¹¹

Second, the best way to assess a country’s health with respect to external debt is not GDP but export earnings, as external debt is generally denominated in foreign currency (e.g. Australian or US dollars, Euro, Japanese Yen). The key means through which countries, especially small countries that do not have overseas investments or a large shipping sector, can earn the foreign exchange to repay these debts is with its exports. Therefore, the relevant indicator here is external debt as a proportion of export earnings (which

FIGURE 5.2: PUBLIC DEBT AS PERCENTAGE OF GDP¹⁰



The broader point here relates to the question about the wisdom of using a concessional loan facility for the AIFFP.

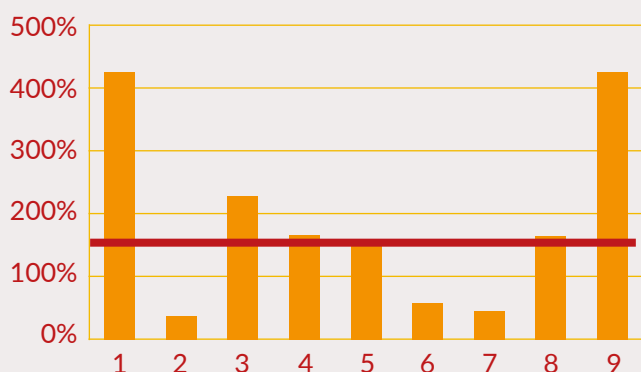
should be less than 150 per cent) or annual external debt service as a proportion of export earnings (which should be less than 15 per cent). We were only able to acquire data for nine of the countries in question, but of these nine, only Fiji, the Solomon Islands and Timor-Leste were not above the threshold for one or another of these ratios.

The broader point here relates to questions surrounding the wisdom of using a concessional loan facility for the AIFFP. The response has been that there are two ways that the AIFFP could get around this dilemma: one is to lend to the private sector (rather than either lending to governments or requiring governments to guarantee the loans); and the other is to lend in local currencies. With respect to the first solution, lending to the private sector would still raise serious questions about foreign exchange earnings for all those countries

whose external debt, as a function of exports, is already high (i.e. Cook Islands, Tuvalu, PNG, Micronesia, and potentially Samoa and Tonga).

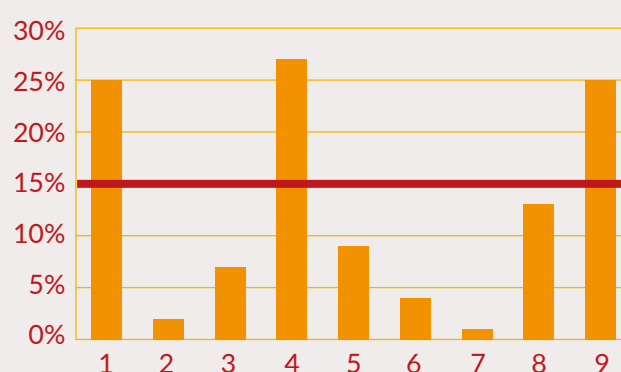
The second solution (i.e. lending in the local currency), would reduce exchange rate risks, but would still create a balance of payments risk because the payments still leave the country. Moreover, even loans denominated in foreign currencies need to be repaid out of a country's resources, and this could cause problems for Fiji, PNG, Tonga, and Vanuatu, whose public debt to GDP ratios are already high. This is not to mention Nauru, whose public debt to GDP ratio is already well above the safe threshold. In any case, with respect to fairness, denominating loans in Australian dollars for some nations, and in local currencies for others, is likely to cause unwanted headaches and complications, therefore making this solution ultimately untenable.

FIGURE 5.3: TOTAL EXTERNAL DEBT AS PERCENTAGE OF EXPORT EARNINGS¹²



1 Cook Islands
2 Fiji
3 Micronesia
4 PNG
5 Samoa

FIGURE 5.4: EXTERNAL DEBT SERVICE AS A PERCENTAGE OF EXPORT EARNINGS¹²



6 Solomon Islands
7 Timor-Leste
8 Tonga
9 Tuvalu

5.2 Ecological vulnerabilities and climate change

In the Caribbean, the frequency and severity of climate-related disasters such as tropical storms, hurricanes/cyclones, and floods have been increasing in recent years. In the Eastern Caribbean, a tropical storm or hurricane can strike most nations at a rate of one every ten years—in some cases, such as St Lucia and Dominica, even more frequently. These disasters have a tremendous impact on the affected nation's GDP, due to lost economic output and the clean-up bill that usually follows (see table 5.1 below).

The frequency of such disasters also means that nations cannot financially recover from the last one before the next one strikes.¹³

However, such storms and hurricanes can have a dramatic effect on sovereign debt as well. Research by the UK's Jubilee Debt Campaign has shown that, in almost every case, a tropical storm or flood has resulted in a substantial increase in government debt two years later in Caribbean and Pacific nations (see table 5.1 below). Vanuatu's storm disaster, for example, not only saw economic damage that cost 60 per cent of the nation's GDP, but the two years following witnessed government

TABLE 5.1: CLIMATE-RELATED EVENTS AND PUBLIC DEBT

Country	Year	Disaster	Economic damage as percentage of GDP	Total damage (USD)	Government debt year before the disaster	Government debt two years after
Dominica	2017	Storm	330%	\$2,000,000,000	73%	N/A
Grenada	2004	Storm	150%	\$889,000,000	80%	93%
Dominica	2015	Storm	90%	\$482,810,000	81%	69%
Vanuatu	2015	Storm	60%	\$449,400,000	21%	39%
Guyana	2005	Flood	35%	\$465,100,000	119%	60% Got HIPC and MDRI debt relief
Belize	2000	Storm	35%	\$277,460,000	47%	83%
Tonga	2001	Storm	30%	\$51,300,000	32%	41%
Belize	2001	Storm	30%	\$250,000,000	67%	96%
Haiti	2016	Storm	25%	\$2,000,000,000	30%	N/A
Bahamas	2004	Storm	20%	\$1,550,000,000	27%	30%
Samoa	2012	Storm	15%	\$133,000,000	42%	54%
Tajikistan	2008	Extreme temperature	15%	\$840,000,000	34%	37%
St Vincent and the Grenadines	2013	Flood	15%	\$108,000,000	72%	79%
Fiji	2016	Storm	15%	\$600,000,000	48%	N/A

Source: Jubilee Debt Campaign¹⁴

These disasters have a tremendous impact on the affected nation's GDP, due to lost economic output and also the clean-up bill that often follows (see table below). But the frequency means that nations cannot financially recover from the last one before the next one strikes.

debt rise from 21 to 39 per cent of the country's GDP.

Another factor when considering the appropriateness of a debt-creating mechanism denominated in foreign currencies, is that nations may be tempted to engage in practices harmful to the ecological balance both on land and in Pacific waters. Unsustainable forestry, mining, and fisheries practices may increase, putting a further strain on this delicate ecosystem.

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Part 6: Alternatives

6.1 Is growth really the answer?

Effective aid programs in the Pacific have long been seen as elusive. Helen Hughes and John Connell have alluded to the ‘Pacific Paradox’—the phenomenon of high aid volumes to the region, contrasted with poor progress on poverty reduction and prospects for self-reliance.¹ This issue has been attributed to the false premise that developing financialised, export-based and market-based economies on these islands will serve as an impetus for bettering the overall quality of life for people. The ongoing scarcity of a strong, educated population base and strategic natural resources continues to threaten the prospect of specialisation for each Pacific Island economy, which is further exacerbated by the challenge and costs of transporting goods to overseas markets. This does not mean that Pacific economies should be cut off from the world. It does, however, mean that there are inherent limits to the scale and speed by which Pacific nations can develop along traditional capitalist lines and, in so doing, integrate into the global economy.

Though we recognise the importance of developing strong economic institutions within the region, the goal of ‘economic growth’ tends to focus on macroeconomic indicators and economic integration with Western economies, rather than a direct commitment to poverty alleviation through self-sufficiency. This notion has been expressed by programs such as the PACER and Aid for Trade agreements, Pacific Private Sectors Development Initiative (PDSI), and through the numerous Memorandums of Understandings (MOU) that have been signed with corporations such as ANZ, Carnival Australia and Westpac. These all aim towards boosting financialization

and greater capital flows in the Pacific. The AIFFP seems to be based on the same presumption: that a single-minded focus on economic growth and integration of these fragile island economies into highly competitive Western markets are the way to go.

The dangers of an overly-aggressive pursuit of economic growth are never clearer than in the cautionary tale of the region’s largest economy, Papua New Guinea. Lured by the promise of a resources-backed development path, since independence, PNG has attempted to work its way up the ladder by the extraction of mineral resources, then through a full-scale exploitation of its accessible forests, and finally and more recently, by tapping the nation’s rich reserves of natural gas and oil. But as work by Paul Flanagan and Jubilee Australia has demonstrated, real per capita GDP has declined just as the resource sector’s contribution to GDP has increased. PNG has the highest rate of any population of the Asia-Pacific living below the poverty line - 39.3 per cent. Other health and social indicators, such as infant mortality, maternal mortality, child malnutrition, and incidence of malaria, are all alarmingly high. Moreover, the LNG boom in recent years, which was backed by Australia’s Efic—the very institution which has been slated to administer the AIFFP—has seen the country decline (relative to where it would have been without the gas boom) on virtually all non-GDP economic indicators even since 2009.² Most Pacific nations differ from PNG in terms of size—they are much smaller—and the extent of their natural resources, but this makes them no less vulnerable when it comes to the dangers of trying to fast-track economic growth at all costs.

Recent analysis by Abhijit Bannerjee and Esther

The dangers of an overly-aggressive pursuit of economic growth are never more clear than in the cautionary tale of the region’s largest economy, Papua New Guinea.

As Wesley Morgan has argued, not only is supporting PNG's agriculture important for maintaining the current health of Pacific communities, certain cash crops are the most promising way for many Pacific nations to sustainably increase their exports. Cash crops will provide employment and money for a wider slice of the population than the tourism industry.

Dufflo in their book *Poor Economics* has unveiled the sobering reality behind the claim that Western countries (and Western economics) has figured out the magic formula to stimulate economic growth in developing countries. They demonstrate in their book how economists (and other experts) actually have very little useful to say about why some countries grow and others do not. There is a lot there is known, however, about how to combat poverty:

Even if all of this is not correct—if social policy has nothing to do with growth—the case for doing everything possible in order to improve the lives of the poor now, and not waiting for the growth spark, remains overwhelming. ... To the extent that we know how to remedy poverty, there is no reason to tolerate the waste of lives and talent that poverty brings with it. As this book has shown, although we have no magic bullets to eradicate poverty, no one-shot cure-all, we do know a number of things about how to improve the lives of the poor.³

Similar arguments are made by E.F. Schumacher's in *Small is Beautiful*, a seminal text that captures the core of the social principle of subsidiarity and a human-centric approach to public economics.⁴ For these reasons, the Australian government and its Pacific partners might reconsider their 'macro'-scale approach, in favour of a proportionate, 'micro' scale approach.

6.2 Resilience, ecology, livelihoods

Given the vulnerabilities that an unbridled commitment to a debt-fuelled infrastructure boom in the Pacific might engender, we should

consider the questions of whether there are any alternatives, and what principles should they be based around? For instance, a focus on protecting household-scale economies and the Pacific's environmental resources, strengthening resilience and implementing policies to further benefit trade opportunities for small scale producers would seem much more pragmatic strategies.

First, one of the obvious alternative pathways is to follow the requests of the Pacific nations themselves for resilience, especially given the challenges arising from our changing climate. Given the increased propensity for storms and cyclones in the Pacific, rising sea levels that lead to the salination of water supplies, and the loss of prime land for food cultivation, and the increasing problem of climate refugees, the need for building more resilient communities has never been more dire. Certainly, as we saw in section 3.2, this seems to be the preferred strategy of the Pacific Islands Forum Secretariat. This strategy has also received strong support from the former Aid and Pacific Minister Concetta Fierravanti-Welles, who said that instead of big infrastructure projects, focussing on climate-proofing existing infrastructure and disaster preparedness were more important regional priorities.⁵

Second, most Pacific peoples still live in rural areas and are reliant on local systems of food production. Agriculture is still the main source of livelihoods, cash-employment and food security for them. Gardens and other locally-produced products, supplemented by fishing for coastal communities, are the main source of calories and also are used to trade for other necessities

in local markets. Agriculture for cash crops is also important in some areas—for example, around half of PNG’s population is dependent to some extent or other on coffee produced for export, - and copra (a coconut product) -is also an important revenue generator for many other island communities.⁶

As Wesley Morgan has argued, not only is supporting PNG’s agriculture important for maintaining the current health of Pacific communities, but certain cash crops constitute the most promising way for many Pacific nations to sustainably increase their exports. Cash crops will provide employment and money for a bigger slice of the population than the tourism industry. And despite falls in commodity prices for common Pacific exports like copra and sugar, a focus on high-value, low-volume exports like specialised plantation timbers, and other specialty products like fruits, vegetables, cut flowers and nuts (some of which only grow in Pacific locations), represent a great opportunity for further expansion.⁷

Certainly, improving market access by better road and port facilities would be an important part of enhancing this sector. But as Morgan points out, simply building the new infrastructure alone, without it being part of an overall strategy, will not be successful. This includes steps that local governments and even aid donors could help facilitate, such as developing a marketing strategy for selected commodities and a focus on maintaining the quality of supply through training and outreach support. As important, importing countries like Australia could facilitate these sectors by reducing overly restrictive quarantine rules.⁸

Finally, placing ecological concerns at the centre of Pacific policy would be another good start. The most precious resource that the Pacific has is its unparalleled natural resources, which includes coral atolls, beaches, mountains, and forests. Although further development of the tourism sector is likely to be less effective than focussing on agriculture, there are opportunities there. This will not be possible, however, if the places that tourists come to see—pristine beaches, mountains and coral atolls—are ruined by unsustainable mining or logging of native forests.

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Conclusion

In summary, we conclude that AIFFP is a solution to a crisis that is largely exaggerated (i.e. the challenge posed by China to Australia in the region), and to a problem that is yet to be carefully and sufficiently demonstrated (i.e. the benefit that infrastructure development will have on the Pacific). It pushes a model of development that is likely to primarily benefit Australian and other Western companies and contractors, as well as the small middle-classes in some of the larger Pacific nations like PNG and Fiji. The development model that it is based on is, in effect, not suited to the financial and ecological realities facing Pacific countries today.

The Pacific step up program is perceptibly predicated on the the strategic motive of countering growing Chinese influence in the Pacific, and there is good reason to believe that this is a major factor. But in doing so, the Australian government would be similarly guilty of politicising aid- Canberra would also run the risk of further exacerbating the governance woes of its Pacific neighbours by inadequately prioritising local needs and perspectives, and pushing disgruntled Pacific countries even closer to China. Part of the reason for why Chinese aid and investment have been able to gain traction in the Pacific stems from perceptions of Australian ‘neo-colonialism’ and ‘interference’ in the domestic affairs of these Pacific Island nations on the one hand, and of strategic neglect on the other.¹

Indeed, neither of the two models that the AIFFP might follow have a history of delivering broad-based development to the widest possible number. The AIFFP smacks of an election policy that has been designed on the basis of faulty strategic and economic planning. As such, it is unlikely to meet the objectives it sets for itself: that is, to improve the lives of the greatest number of our Pacific neighbours and which will improve Australia’s reputation in the region.

No one is questioning that the Pacific needs development, or even that the Pacific nations

would benefit from the delivery of relevant infrastructure. The pertinent questions are: what type of development does the Pacific most need, what types of programs, including infrastructure programs will most serve this need, and what are the right vehicle for Australia to develop these programs. The AIFFP, as currently constituted, is not an answer to any of these questions.

As the region’s key donors compete in an ‘influence game’, this is already resulting in instances where aid money has been channeled into less-than-exigent priorities. Here, inadequately-regulated Australian infrastructure schemes have the potential to result in the same bad outcomes as the Chinese ‘low quality’ projects that give rise to long-term financial and reputational costs. Should Australia seek to occupy both the strategic and moral high ground in the region, then Canberra’s foremost priority in the Pacific should be building trust and enhancing its reputation as a constructive partner in the PICs’ sustainable development. Money might be able to buy influence, but influence without legitimacy and a degree of trust will invariably be short-lived.

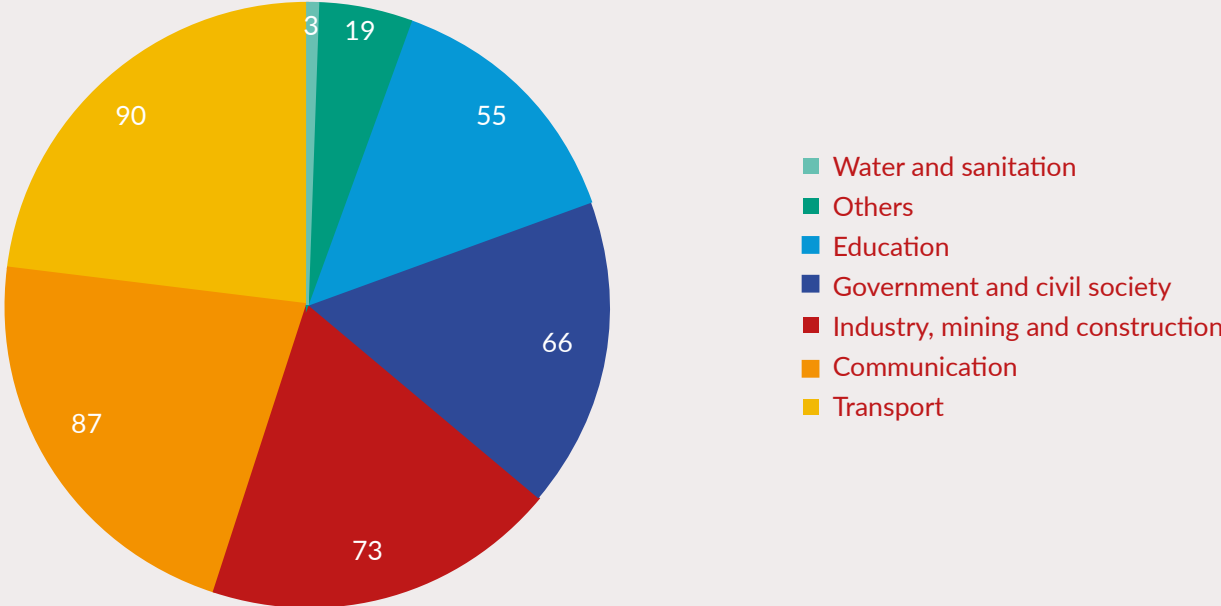
We therefore recommend that no further steps be taken to progress the AIFFP until after the upcoming Federal election, until a more complete and public assessment of the infrastructure needs of the Pacific nations is done, and until a more thorough investigation of the appropriate mechanisms for such a program can be explored. This assessment should include in-depth engagement and consultations with Pacific nations, the Pacific Island Forum Secretariat, as well as with civil society groups both in Australia and the Pacific.

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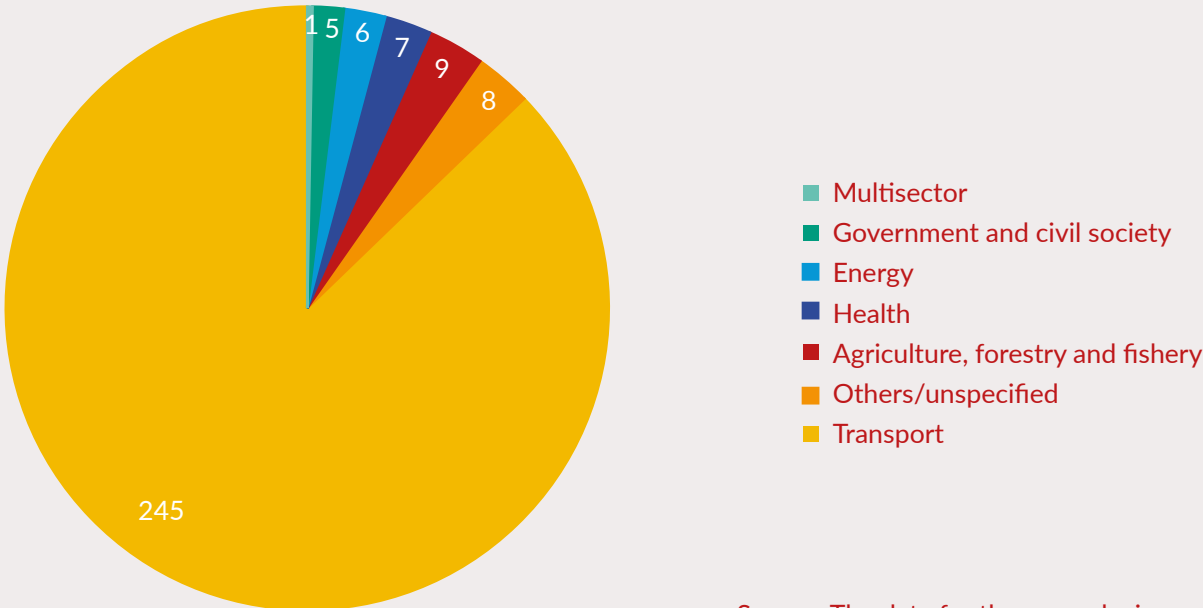
1. See AFP, ‘Fiji should align itself with ‘visionary’ China instead of Australia and NZ, says Bainimarama’, *The Australian*, 11 August 2010, <https://www.theaustralian.com.au/news/world/fiji-should-align-itself-with-visionary-china-instead-of-australia-and-nz-says-bainimarama/news-story/5801487d6ee6ea45592fbfoa7138a6b7?sv=2e99577fa4aa44f543c81bfa74a6ca6d>; and Thom Woodroffe, ‘Australia has neglected its relationship with the Pacific – but that can change’, *The Guardian*, 25 April 2018, <https://bit.ly/2HPHSYf>

Appendix 1: Chinese aid programs in the Pacific

A: PAPUA NEW GUINEA (MILLION USD)

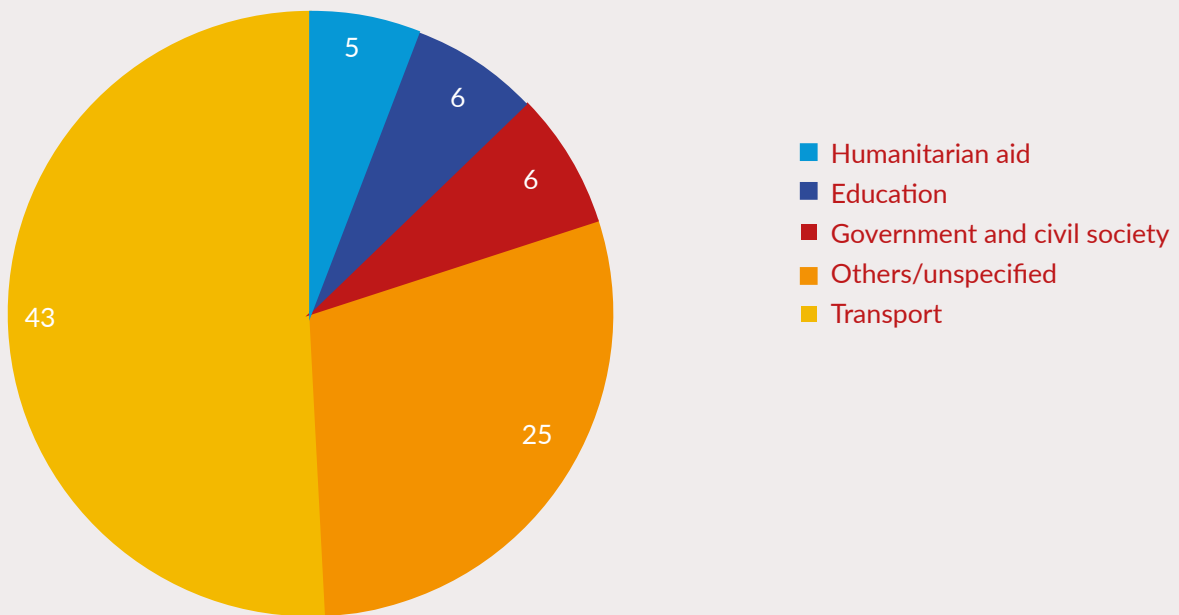


B: FIJI (MILLION USD)

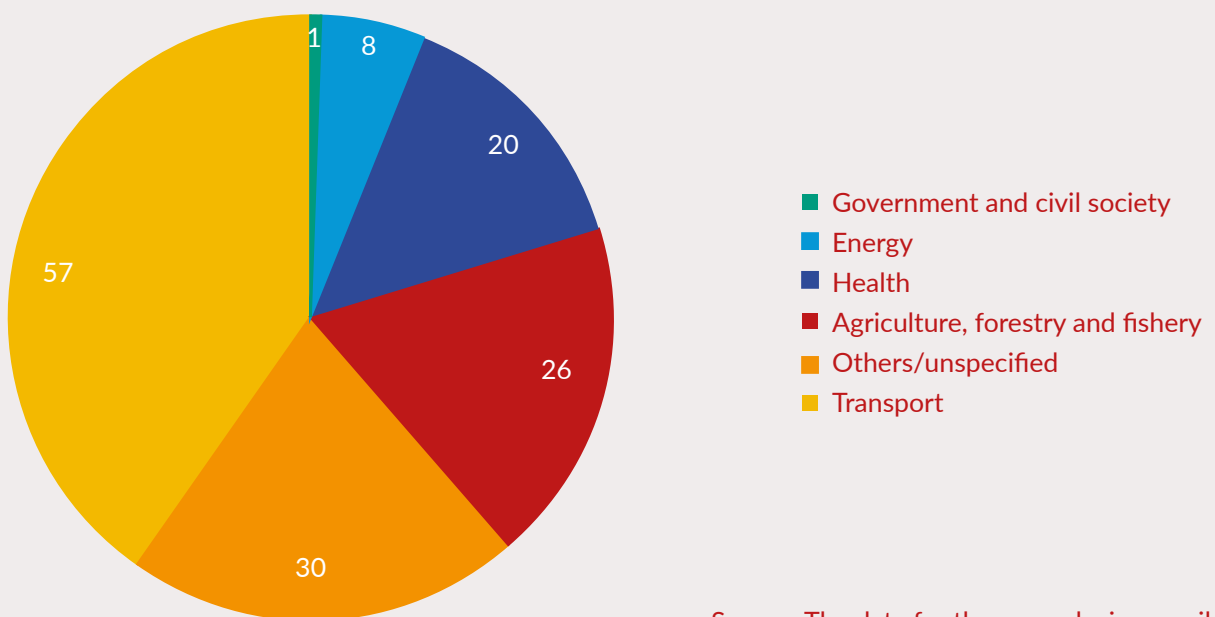


Source: The data for these graphs is compiled from the Lowy Institute's Pacific Aid Map.

C: VANUATU (MILLION USD)

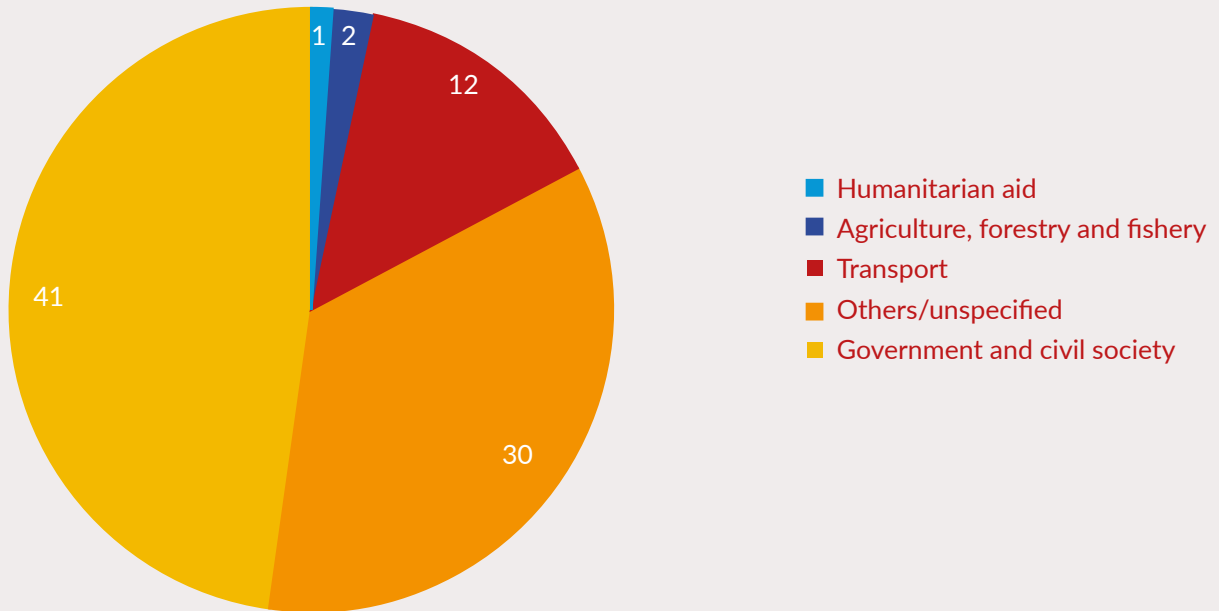


D: SAMOA (MILLION USD)

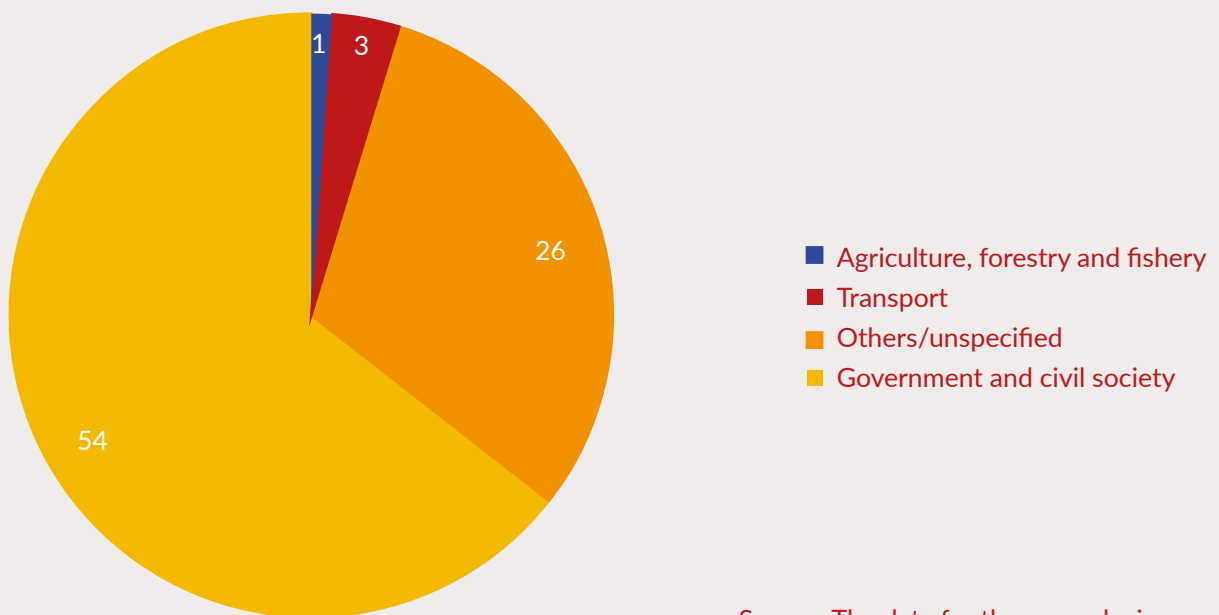


Source: The data for these graphs is compiled from the Lowy Institute's Pacific Aid Map.

E: MICRONESIA (MILLION USD)



F: TONGA (MILLION USD)



Source: The data for these graphs is compiled from the Lowy Institute's Pacific Aid Map.

Appendix 2: The ADB infrastructure needs methodology¹

Methodology

Steps involved in projecting future infrastructure needs:

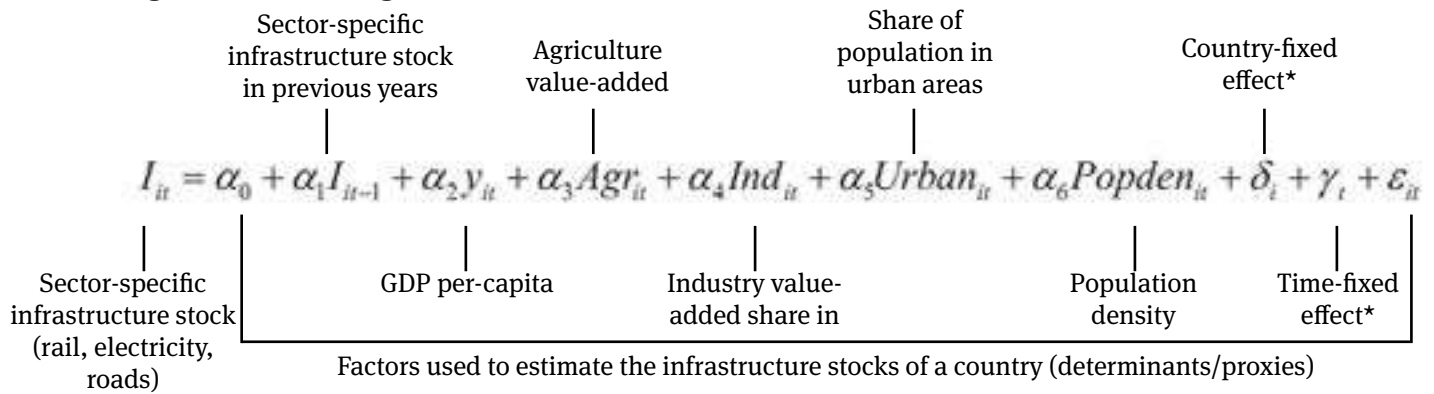
Step 1: Using country-level data of 45 of the ADB's Developing Member Countries (DMCs) develop a cross-country model of the statistical relationship between a country's investment stock (by type) and its hypothesized determinants (or proxies)² (see Figure 1). Investment stocks were modelled separately by type and included:

- a. Airports (number of passengers per 100 people);
- b. Broadband (number of subscriptions per 100 people);
- c. Electricity (kilowatts of electricity generation capacity per person);
- d. Mobile (number of mobile subscriptions per 100 people);
- e. Ports (number of twenty-foot equivalent units of cargo per 100 people);
- f. Railways (kilometres of railroad per 1,000 km² of land area);
- g. Road (Kilometres of road per 1,000 km² of land area);
- h. Sanitation (percent of population with access);
- i. Telephones (number of telephone subscriptions per 100 people); and
- j. Water (percent of population with access).

Step 2: Using future projections of these determinants the model is then used to forecast future infrastructure stocks by type for each country. Factors assumed to determine (or proxy) infrastructure stocks included:

- a. GDP per capita;
- b. Shares of agriculture and industrial-added value in GDP;
- c. Level of urbanization (share of population in urban areas);
- d. population density; and
- e. The previous year's infrastructure demand/supply.

Figure 1: Estimating infrastructure needs³



Step 3: To calculate the total cost of achieving these infrastructure stocks, after accounting for asset depreciation, infrastructure volumes are multiplied by an assumed ‘unit cost’.⁴ This gives an implied total value of a country’s infrastructure stock by country in a given year. Individual unit costs (in 2010 USD) included:⁵

- a. Roads – 600,000 USD per kilometre;⁶
- b. Rail – 3,855,000 USD per kilometre;
- c. Electricity – 2,513 USD per kilowatt;
- d. Water supply -161 per person;
- e. Sanitation – 168 USD per person;
- f. Telephone (landline) - 261 USD per line;
- g. Mobile – 127 USD per line;
- h. Broadband – 3.4 USD per person;
- i. Ports – 400 USD per twenty-foot equivalent unit; and
- j. Airports – 6.5 USD per passenger.

Step 4: Recognizing the future cost associated with mitigating and climate proofing to climate change, the ADB then adjusted their ‘baseline’ estimates by an estimate of the cost of mitigating and climate proofing infrastructure:

- a. The ADB expects mitigation to cost an additional 26 percent in the energy sector compared with baseline cost projections.⁷
- b. The cost of climate proofing is then based of experiences from ADB projects in the water, sanitation, energy and transport sectors. On this basis, it is estimated that climate-proofing would cost an additional:
 - § 1.9 per cent for water and sanitation sectors;
 - § 7.8 per cent for roads;
 - § 0.6 per cent for rail, ports and airports; and
 - § 0.4 per cent for the energy sector.

Underlying assumptions

- a. The report using a number of terms for their infrastructure estimates such as ‘supply’, ‘demand’ and ‘needs’. However, it’s important to note the difference between infrastructure needs, demand, and gaps:
 - Infrastructure demand is the term used to describe the current infrastructure supply/demand balance based off actual and forecasted determinants (such as GDP, urbanization etc). Because the ADB’s approach does not attempt to differentiate between supply or demand factors, estimates can’t strictly be called ‘demand’ or ‘supply’ estimates and are therefore often referred to as both.
 - Infrastructure ‘needs’ usually refers to normative judgements on the level of investment required to achieve a particular outcome. In the ADB’s model, the estimates do not represent a ‘best case’ level of infrastructure investment, but an average case based on data from the 45 included DMCs.
 - The infrastructure gap, in the context of the ADB’s report, represents the difference between desired investment and actual investment. But it does not indicate the actual investment vs. some ‘ideal’ level of investment.⁸
- b. Being a fixed-effect panel regression, the model assumes any unexplained cross-country differences can be accounted for by some fixed level of adjustment. In other words, while the approach tries to account for cross-country differences, it still assumes the same underlying relationships between investment and the selected explanatory variables across countries.⁹
- c. Top-down approaches to estimating infrastructure need are generally considered as preferable due to the better availability of data. However, as a result of this the ADB’s model assumes relationships between infrastructure and its assumed determinants (or proxies) are ‘generalizable’ across countries and sectors.
- d. Being based off past data also means projections do not provide information on ‘best-case’ infrastructure investments scenarios or needs. Rather, projections are more indicative of ‘average’ or ‘business as usual’ infrastructure stocks based on the included DMCs. This may be particularly important if the modality of infrastructure investment matters for converting financial resources into outcomes. For instance, if foreign aid is less effective than domestically-funded projects, more funding may be required to achieve the projected investment stocks (or vice-versa).

REFERENCES

1. Although best efforts have been made to interpret the ADB’s description of its methodology, the exclusion of the data and statistical outputs makes it difficult to assess the accuracy of estimates and their applicability to PICs.
2. As the ADB’s aim was to forecast future infrastructure stocks, in a practical sense, the factors included in the model do not have to strictly be ‘determinants’ of a country’s stock of infrastructure if they adequately proxy them (both now and in the future).
3. Based off Appendix 4.1, p. 95. Note that as some variables are not explicitly specified in the methodology, they have been implied based on the common principles used in panel regression.
*Country and time ‘fixed-effects’ are understood to have been included in an attempt to capture differences across countries and over time, that are not explained by other explanatory variables.
4. Generally, the unit costs used by the ADB appear to be based off the median realized costs of past ADB projects. These costs were stated to be highly variable and can at times include the costs of capacity building and consulting activities.
5. Based off Table A4.3, p.100.
6. This was noted as being a weighted-average price based on the assumption of 1 per cent of roads being expressways, 73 per cent highways and 26 per cent rural roads. Reflecting discussions with sector experts, the costs of roads in the Pacific were also increased by 1/3 to 800,000 USD per kilometre (see footnote 88, p. 99).
7. This appears to be predominantly based off past research outlined in ‘Asian Development Outlook 2016 Update: Meeting the Low-Carbon Growth Challenge’ (See ‘Unlocking the low-carbon transition, p.76 to 90).

