**SUBMISSION: DFAT DEVELOPMENT FINANCE REVIEW**

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This submission addresses the three main elements of the Terms of Reference established for the Review. It recommends:

1. a legislated, stand-alone Development Finance Institution with an explicit development impact mandate, supporting regulations, additional resourcing and dedicated capability be established within three to four years; and

2. an interim, whole-of-government Office of Development Finance to advance the detailed design work, scope potential projects and modalities, and coordinate legislative and regulatory preparations be established within the next 12-18 months.

**A. Regional financing needs**

Attempts to quantify regional development financing needs are complex and vary in their estimates. According to UNESCAP, developing countries in the Asia-Pacific need an additional US$1.5 trillion in investment annually, or about 4-5% of regional GDP, to 2030 in order to meet the SDGs.

This gap is likely to grow as a result of the ongoing impacts of the COVID-19 pandemic which has adversely affected revenues across developing economies in the Asia-Pacific. In Fiji, for example, government revenues shrank by over a third in 2020. The financing gap will likely widen in the event of ongoing supply chain disruptions, sharp rises in US interest rates to avert inflation, and/or a global recession. Vulnerability to the impacts of future climate and geopolitical shocks also have the potential to widen the regional financing gap. Even where low-income countries are expected to "graduate", experience shows that development progress is unlikely to be linear and that the "middle-income trap" will remain a prominent feature of the regional development landscape. As a result, there will remain a strong demand for development capital to be accompanied by high quality technical advice and expertise on complex policy and governance reforms.

As well as high levels of uncertainty, aggregate estimates are also complicated by substantial inter- and intra-regional differences. Estimates of the financing gap vary significantly across the region, rising to 16% of GDP in LDCs and 10% in South Asia. In Southeast Asia, domestic resource mobilisation and private flows will continue to play predominant role, as will debt finance, both public and private. But within Southeast Asia, the mix of resources varies widely — for example, while FDI accounts for between a fifth and a quarter of private flows across the ten ASEAN economies, Singapore attracts half of this investment.

In the Pacific, intra-regional differences are also stark in terms of flows such as remittances – which account for 40% of Tonga's GDP, but which are virtually non-existent in Papua New Guinea. Nonetheless, international public finance — whether in the form of traditional grants, loans or "blended finance" — will play a larger role in the Pacific than in Southeast Asia.

**B. Existing mechanisms: performance and reform**

As well as traditional project-based grant financing, Australia has moved to embrace other forms of development finance in recent years.

*1. Sovereign finance: fiscal support and project lending*

During periods of economic turbulence such as the Asian Financial Crisis and the Global Financial Crisis, Australia has worked with regional governments and the International Financial Institutions to support the macroeconomic stability of its neighbours. In 2020-21, during the COVID-19 shock, Australia used sovereign non-concessional loans to provide direct fiscal support to both Indonesia and Papua New Guinea. These mechanisms are likely to continue to be required and valued by our neighbours, as will a greater focus on direct budget support through our grant programs. These programs should continue to be coupled with long-term technical assistance in public financial management capacity, accountability and oversight institutions, and civil society platforms.

In terms of project lending, in July 2019 Australia established the Australia Infrastructure Financing Facility for the Pacific (AIFFP) which focuses mainly (but not exclusively) on sovereign lending for large scale projects in areas such as energy, transport, water, and telecommunications. The non-concessional loan component of the AIFFP has recently been raised to A$3 billion and the grant component remains capped at A$500 million.

A major part of the previous government's Pacific "Step-Up", the AIFFP has been criticised for its lack of independence (its Board is chaired by DFAT and mainly comprises senior government officials), the associated role of "tactical" geopolitical considerations in driving its investment decisions, and the fact that it is competing with other sovereign lenders (including the multilateral development banks, which Australia also funds) for a scarce pool of viable projects. Its low level of concessionality – it is, overall, less concessional than the assistance Australia provided to Indonesia after the 2004 Indian Ocean tsunami – has also been criticised, as has its lack of transparency when compared to its multilateral peers. The Labor government has said it plans to use the AIFFP to deliver its promised "Pacific Climate Infrastructure Financing Partnership".

Given this commitment and the significant sunk costs to date, it is not clear whether government has the appetite to substantially reform the AIFFP. A potential ANAO audit in 2022-23 will be an opportunity for the government to assess the AIFFP's effectiveness against its existing objectives. For this reason, it is not considered in *Section C – Policy Options.* Previous work by the Centre has highlighted the need to increase the Facility's level of concessionality (without cutting the aid budget), link its lending to the domestic policy environment in borrowing countries, base future replenishment decisions on performance, and clarify its role in respect to EFA's infrastructure financing (see below).

*2. Non-sovereign finance: EFA*

As well providing back-office support to the AIFFP, under changes to Export Finance Australia's (EFA) authority made in 2021 the agency has the ability to seek equity stakes in (as well as lend to) overseas infrastructure projects. In 2022 the government provided a package worth US$1.33bn in "equity and debt like securities" to support Telstra's acquisition of DigiCel Pacific.

But, consistent with EFA's objectives, the primary criterion for these investments is "benefit to Australia", not development impact per se — this broad definition makes it hard to assess whether programs are successful from a development perspective. This is particularly the case where investments might lead to unintended consequences, such as entrenchment of monopolies in developing economies in our region. The latest Ministerial guidance to the EFA requires that EFA should ensure that the infrastructure project is "appropriate for the relevant nation", but, given the legislation and EFA's orientation, such guidance provides little comfort that EFA will not primarily be driven by Australia's commercial advantage.

*3. Non-sovereign: private sector and blended finance*

Australia has also been active in pursuing private sector and blended finance initiatives. The OECD defines blended finance as "the strategic use of development finance for the mobilisation of additional finance towards sustainable development."

These kinds of programs, of which DFAT already manages several, represent the most promising avenue for DFAT to scale-up because, if designed well, they can complement the Government's existing geo-political and tactical focus (through sovereign and export lending) with modalities that have as their primary objective genuine "additionality" and development impact in key areas such as formal employment generation, climate finance, and women's economic empowerment. There is now a body of impact studies on the benefits (and pitfalls) of blended finance, as well as its own internal expertise and experience, from which DFAT can draw useful lessons. Australia's domestic experience in delivering blended finance through agencies such as the Clean Energy Finance Corporation (CEFC) could also be instructive.

*4. Portfolio considerations*

While Australia has pursued a range of alternative development finance initiatives over the last several years, a key concern is the issue of strategic coherence – that is, how do these initiatives relate to one other and, when viewed as a whole, what is their broader objective and impact? Some aspects of Australia's engagement on development finance are led through Treasury, while others are led by DFAT. It is hard to assess relative performance in the absence of an overarching, whole-of-government development strategy, which is also currently being developed (but which will likely be delivered in 2023, after the Development Finance Review).

Another, related concern is the transaction costs involved in standing up multiple, fragmented initiatives across DFAT's global, multilateral and country and regional programs – DFAT's Emerging Markets Impact Investing Facility, for example, took more than two years from to approval to commencement due to the various legal and regulatory hurdles involved in setting up the direct financing arm. These "portfolio" issues of strategic objectives, improving coherence and reducing transaction costs should be considered by the Review.

**C. Policy options: from "Business-As-Usual" to "Development Finance Australia"**

In terms of future policy paths, the government has three basic options: continue with a largely "business-as-usual" approach focused on improved coordination between existing partners and programs; strengthen DFAT and whole-of-government engagement on new development finance modalities through specialised administrative structures; and establish a dedicated, standalone Development Finance Institution (e.g., "Development Finance Australia"), an entity with a legislated development impact mandate and supporting regulations and administrative infrastructure. These options are not mutually exclusive (i.e., there are aspects of each that could be combined), but they are treated as distinct here for the purpose of brevity and clarity.

1. *Option 1: "Business-as-usual"*

A business-as-usual option would involve DFAT doing nothing more than tweaking its existing investments (e.g., by building in more evaluations and impact studies, better coordinating with and seeking reform of the IFIs) and opportunistically looking for new blended finance investments. Better coordination between Treasury and DFAT to leverage our relationships with the MDBs to inform our own approaches would also be relatively cost-free. But tactical sovereign lending (through the $3.5 billion AIFFP) and export finance (through EFA) would continue to do the bulk of the heavy lifting when it comes to bilateral non-grant finance.

The advantage of this approach is that it would save DFAT the upfront costs of investing in new arrangements or structures and would involve little in the way of additional risk. This would save both scarce departmental resources, allow DFAT to maintain its current level of flexibility and minimise disruption in a department that continues to be stretched across multiple, contending demands, and that remains under-resourced.

The risk of this approach is that it would limit Australia's ability to engage with a changing development finance landscape and, outside of the regular grant program and would make us heavily reliant on our tactical investments in sovereign lending and export finance when it comes to development impact, something they were not specifically designed to do and that are largely retrospective considerations. It could also limit our ability to work in creative ways in the region with partners such the US and the UK, both which have recently scaled-up existing or, in the case of the US, established new DFIs. Nor would it solve already immense pressure on a declining overall aid budget as, in the absence of additional funding, new grant funded initiatives would displace other programs.

2. *Option 2: A DFAT "Office of Development Finance"*

DFAT could establish a dedicated whole-of-government office within the Department specifically focused on driving new investments in innovative forms of finance. The Office could be headed by a senior DFAT official (say at the Deputy Secretary level) and would bring together a "critical mass" of expertise from across the Department, whole-of-government and the private sector to support different parts of government to assess and engage with non-sovereign and blended finance opportunities. This would be funded by departmental supplementation and, where strong projects are identified, additional administered funds and instruments. A first task of the Office could be scoping the regional market for viable blended finance investments in priority sectors. It could also establish streamlined whole-of-government procedures for assessing and standing up new mechanisms.

The advantage of this approach is that it would support a strengthened "portfolio" approach to Australia's engagement with innovative development finance, supported by a dedicated capability. It would also support greater whole-of-government coordination and buy-in through secondments, allowing DFAT to leverage the expertise and networks of central agencies such as Finance and Treasury (including the latter's links with the MDBs), as well as specialised domestic agencies such as CEFC in the area of climate finance.

A primary risk associated with this approach as a viable long-term option is that as a function within DFAT, the Office could be subject to high levels of "churn", fail to attract specialised staff, and become subject to the vagaries of changes in personnel and priorities. The experience of the now abolished DFAT *InnovationXchange* is instructive in this regard. Even relatively "institutionalised" (and externally praised) specialist areas within DFAT, such as the Office of Development Effectiveness, have been subject to short-term resource pressures, undermining long-term impact, learning and skills. In this sense, a hybrid arrangement that is not properly designed and resourced could be the worst of both worlds – it could both raise expectations, and then fail to deliver.

3. *Option 3: "Development Finance Australia"*

A dedicated DFI would be the most ambitious of all three options and would involve the establishment of a legislated entity with dedicated governance, capital-raising powers and staffing capabilities charged with the objective of using blended and other forms of finance to maximise development impact. National interest considerations would be limited to geographic focus, with some priority sectors (climate, gender) also identified at the outset. Choices around projects would balance of investment return and development impact, with government contributions (e.g., grants, equity) used strategically to shift marginal risk calculations, "crowd-in" investment, and pursue additionality.

The advantage of this option is that there would be a much clearer line of sight between objectives, finance and capabilities, allowing for more vigorous pursuit of development impact. Accountabilities would be stipulated via legislation, which would also specify how government contributions such as equity, guarantees and grants could (and could not) be used. Special accounts could be established to ensure the returns on investment are used to replenish capital fund. And Ministerial oversight could be supplemented by parliament's aid sub-committee, as well as through regular reporting to Cabinet via DFAT, Treasury, PM&C and Finance. As well as investment and finance expertise, a specialised monitoring, evaluation and learning function would focus on the issue of "additionality". Australia would become part of a broader DFI community whose emphasis on transparent, effective markets could provide a common point of competitive differentiation (as opposed to imitation) from statist models of development being promoted by China. Indeed, there could even be scope to bring in other donors if like-minded countries wanted to contribute capital and benefit from risk sharing arrangements.

A prior question for the DFI is whether the Australian government wants to invest in something that will be of benefit to Asia, but of little benefit to the Pacific, as the latter region has few opportunities for DFI investments and is already adequately serviced by the private sector arms of the World Bank Group and the ADB.

The risks of creating a DFI are that would require significant upfront investment, including detailed preparatory work across government, as well as new legislation specifying the objectives, capital raising powers and regulatory arrangement. Without clear upfront political buy-in across government, at Cabinet level, this work would falter. Moreover, the experience of other donors such as Canada suggests that standing up a new entity could take several years. A standalone institution with its own separate mandate and board would also make the task of coordination more difficult. Finding appropriately qualified staff and expertise may be challenge and would require a different model of recruitment than that pursued within the APS. Given the timeframes and scoping and preparatory work involved, Option 2 (with clear Ministerial mandate, whole-of-government and expert staff and dedicated resourcing) would be a sensible interim step.

An Australian DFI would be a significant change. But the proposal has been debated for almost a decade, the risks are manageable and there is now sufficient international experience and evidence to inform the design work. In the defence realm, Australia has shown an ability to think big and "outside the box" when it comes to addressing our changing strategic circumstances – e.g., nuclear submarines and AUKUS. Doing the same (in a considered, staged way) in the development sphere would be consistent with the government's "3D" approach to foreign policy (development, diplomacy and defence) and its assertion that Australia must look beyond military capability to all elements of national power – "strategic, diplomatic, social, economic" – as it seeks to compete for greater regional influence.

A short overview of some (but not all) of the more detailed considerations involved in establishing an Australian DFI is provided at Annex A.

**ANNEX A: Potential considerations for an Australian DFI**

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| *Objectives* | - Stipulated through founding legislation<br>- Focused on balancing investment returns <u>and</u> development impact with national considerations only defining geographic focus (e.g., Pacific/Southeast Asia)<br>- Some key sectors identified (e.g., climate, gender) |
| *Principles* | - Fraud and anti-corruption standards<br>- Sanctions compliance<br>- AML-CTF requirements<br>- Due diligence and risk management policies<br>- Social and environmental safeguards<br>- Paris Agreement compliant on energy investments<br>- Transparency standards |
| *Governance* | - Independent board with role/composition determined through legislation<br>- Government presence on Board, supported by a dedicated whole-of-government unit within DFAT, to engage on strategic use of government contributions to achieve investment and development additionality, |
| *Role of government contributions/ finance* | - Set out in legislation<br>- Multiple forms – equity, grant capital, insurances<br>- Shift marginal risk/return calculations and generate "additionality" in terms of investment returns and development impact<br>- Dedicated technical assistance to support project preparation, due diligence and monitoring |
| *Capitalisation* | - To be set out in legislation, including treatment through Special Accounts<br>- Explore potential use of Australia's remaining 2021 SDR allocation (approx. AUD7 billion) as a form of guarantee for initial seed capital |
| *Accountability and oversight* | - Oversight by Minister for Foreign Affairs and aid sub-committee under JSCFADT<br>- Reporting to Cabinet through PM&C, DFAT, Finance and Treasury |
| *Capabilities* | - Specialised investment and ESG expertise, including climate finance<br>- Audit, risk and due diligence expertise<br>- An Evaluation and Impact Unit to report directly to Board<br>- Links to Australia's overseas post network to support assessment, due diligence & engagement with partners |
| *Partnerships* | - Explore joint projects in the region with British International Investment, US Development Finance Corporation and other bilateral and multilateral partners<br>- Engage through on knowledge, learning and best practice through OECD network on DFIs and with MDBs |