Inquiry into Australia activating greater trade and investment with Pacific island countries

Contents

1 Introduction

As an institutional fund manager with direct experience in PNG, there are two main initiatives that are required to assist the private sector, specifically, the institutional superannuation community, to increase investment in the Pacific region. Such initiatives are consistent with terms of reference, as listed in the Appendices.

In general, these initiatives are designed to alleviate some problems that are apparent in terms of investment in the Pacific, which are as follows:

- **Lack of institutional investor knowledge of the Pacific:** Even though Australia is physically adjacent to Pacific region, hereafter 'the region', most institutional investors are focussed on developed world, and emerging market investments, which are far from the region. While the region has vast potential and while it also has a strong strategic alignment with Australia, the level of knowledge remains low. This issue is discussed in the section entitled "Institutional Investor initiative:, and

- **Market failures in the Pacific:** Australian institutional investors face three main risks, or market failures, which require government intervention to address, and these are discussed in the section entitled "Risk Mitigation Strategy for Institutional Investors".

In order to assist the Australian government, in terms of developing the Pacific region, institutional investors first need to acquire knowledge of the Pacific, especially of PNG. While large potential rewards await investors, the strategic risks for investors are large, and the strategic risk for Australia remains elevated. In order to unlock the potential rewards, and to moderate risk, a long-term, strategic, approach is needed to be initiated by the Commonwealth government. Even if this approach was adopted the requisite knowledge of the Pacific needs to be acquired, and then several market failures need to be addressed. Accordingly, the Commonwealth government will need to take steps to work cooperatively with institutional investors, so as to gradually alleviate knowledge deficiencies and to address these failures.

2 Institutional Investor Initiative

Institutional investors in Australia remain generally unaware of the investment opportunities in PNG.

This lack of knowledge, among other things, then allows other sovereign entities to operate in ways that might not be consistent with the objectives of the Australian government. Pertinently, when resident in Port Moresby, the High Commissioner was made aware of this important issue, and he did recognize that this was an issue that needed to be addressed; at some point. While Australia does encourage small firms to invest in PNG, through various agencies, the encouragement does generally not extend to institutional investors.

Accordingly, it can be argued that this encouragement, specifically to institutional investors, is now needed. However, this encouragement needs to be executed in a careful manner, with a view to medium term outcomes.

In order to alleviate this situation, a regular investor update, and institutional investor tour, should be initiated. Such an initiative is consistent with what the semi-government authorities, such as Queensland Treasury Corporation (QTC), who used to do with institutional debt investors, so as to promote investor familiarity and confidence. More specifically, the tour would provide insights into the many opportunities, and the challenges, which are involved with PNG/Pacific region investment.

As you may also know, while there are a number of new projects coming up for funding in PNG, there is no regular contact with institutional investors, except for individual companies, such as Oil Search. By broadening the familiarity of institutional investors with PNG, it may be possible to build investment knowledge, and appetite for investment, over the medium term.

While nothing can reasonably be expected to occur in the short term, it can be expected that medium term developments may eventuate form this important initiative.

Funding of the investor tour may be jointly borne by DFAT, and possibly some of the larger superannuation funds.

Please note that I do not have authority to commit funds, however I can lobby for such funding if needed, as I am working in the sector at this time.

Just as a starting point, the tour would focus, among other things, on the following:

- meeting of super funds with Kumul consolidated holdings, NasFund, and NSL,
- Meeting with the major banks in PNG, such as BSP, and Kina,
- meeting of super funds with Total, Exxon, and Oil Search,
- meeting of super funds with members of the PNG government,
- meeting of super funds with high commissioner,
- renewable energy development in PNG, Markham Valley in Morobe Province,
- resource development sites in PNG, such as the new PNG LNG project, and
- tourism development sites in PNG, such as Kavieng.

3 Risk Mitigation Strategy for Institutional Investors

Toward a new, and better, way of creating Pacific infrastructure investment [1]

With much fanfare, Prime Minister Scott Morrison announced on 8 November the establishment of a new facility to help fund infrastructure in the Pacific, yet there is a much more effective solution that is possible, as sketched herein.

While the initiative is sensible in intention, it essentially does what all Australian governments have done with the Pacific: it treats the region as if the private sector can't, or won't, assist. It's as if the public sector is the only solution to infrastructure issues in the Pacific.

However, as I've argued before, we need to remember, among other things, that the size of the pool of private-sector capital that's ready, willing, and able, to invest in regional infrastructure. Specifically, the Australian institutional superannuation market is very large, at around $2.5 trillion. [2]

As investors begin to appreciate the benefits of infrastructure investment, the search for 'good' infrastructure projects is, among other things, pushing new transaction yields lower and lower around the world.

Yet, despite the demand for infrastructure projects by the large Australian superannuation sector, virtually no institutional investor is looking to the Pacific for infrastructure investment opportunities. In many ways, the Pacific constitutes an investment vacuum, which the institutional investor must traverse, so as seek infrastructure opportunities elsewhere. The primary reason for their lack of interest remains market failures, of various forms.

These market failures can be indicated by considering the following three main risks for investing in a foreign infrastructure project:

- **Risk one**:·*Currency risk*—A lender, in this case the private sector, needs to obtain regular payments in the currency that funded the investment—that is, Australian dollars. In many cases, selling Pacific currencies and buying Australian dollars is impossible in the short term, although medium-term US dollar flows allow some sporadic hedging. This is an example of a market failure, which might be addressed by the public sector,
- **Risk two**:·S*overeign default risk*—Many infrastructure projects in Pacific nations link back to the state. Reference to a recent US dollar issue by one Pacific country might, in some cases, establish how much it would cost to hedge this risk through the credit default swap market. Even though hedging may emerge, the market depth is still woefully inadequate. This is another market failure that needs to be addressed, which might be addressed by the public sector, and
- **Risk three**: *Project risk*—These are the risks associated with the operational aspects of a project, which wouldn't be borne by the Australian government, but by the institution that funded the project.

Levelling the infrastructure investment playing field, by introducing risk-sharing arrangements that address areas of market failure, as noted in risk one and two above, should significantly increase the private sector's interest, and involvement, in the Pacific.

By insuring itself against currency and sovereign default risk, and charging subsidized premiums to institutional investors, the Australian government could possibly provide a new, and much improved, solution to the problem of funding Pacific infrastructure; a solution that involves the public and private sectors.

Here, instead of lending money, the Commonwealth would subsidize insurance for hedging against the main risks of investing in the Pacific, where evidence of market failure exists. Accordingly, the insurance provided by the Commonwealth could form the for large private sector involvement in Pacific infrastructure.

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[1] Published version of this note has been provided in the appendices.
[2] Australian Strategic Policy Institute (ASPI) strategist article, 'Towards a new and better way of accelerating Pacific infrastructure investment', by Dr. Stephen J. Nash, 26 November 2018, https://www.aspistrategist.org.au/towards-a-new-and-better-way-of-accelerating-pacific-infrastructure-investment/

Instead of putting $2 billion of public sector money directly to work, as recently proposed by the prime minister, it would be better to use the suggested insurance technique, so as to vastly expand the amount available to fund Pacific infrastructure; possibly allowing up to ten times more investment.

Importantly, such an approach may begin to build bridges between the infrastructure needs in the Pacific, on the one hand, and the large institutional Australian superannuation sector, on the other.

While most large Australian institutional investors don't know much about the Pacific infrastructure sector, the suggested approach may begin to build that, all-important, regional investment knowledge base.

The scale of Pacific infrastructure development required is large. However, the suggested structure may provide something that is closer to an adequate amount of funding over the medium term. By contrast, the government's proposed approach probably won't be adequate to address the medium-term infrastructure funding needs in the Pacific.

Alan McCormack's recent *Strategist* contribution highlighted an approach used by other countries for engaging with the private sector under an outward foreign direct investment model. There are many things that can, and should, be learned from these models.

However, the specific risks I've noted with reference to market failures, specifically, insuring against sovereign default risk and currency risk, need addressing before institutional investors can begin the task of adequately considering infrastructure investment in the Pacific.

Addressing these risks will help provide institutional investors with an adequate initial investment experience in the Pacific. That initial experience should then help ensure that, over the medium term, they'll continue to provide infrastructure capital to the Pacific.

Editors' note: Many of the issues raised in this post will be examined in greater detail in an ASPI report by Anthony Bergin and Rebecca Moore on Australian business and the Pacific to be released on 28 November.

4 Conclusion

Australia has a large strategic risk in the pacific, yet the region could provide Australian investors a rich reward, one that assists both Australia and the pacific, if adequate government guidance and assistance to the private sector is provided in the medium term.

Commitment, which is not interrupted by successive governments, is needed.

Specifically, along with the public sector, the private sector in general, and the institutional investment community in particular, can play an important role.

Accordingly, this paper has outlined some of the barriers to knowledge and the market failures that prevent the private sector participating in Pacific regional development. If the Commonwealth now needs to include the private sector, as the task of investing is far too large for the Commonwealth government, alone, to bear, then two areas need to be addressed, as follows:

- first, barriers to knowledge need to be broken down, and
- second, market failures need to be adequately addressed.

Appendix 1: Lowy Institute article, published version

Reference:

"Australian Aid Can Secure Private Sector Investment in Frontier Markets", Lowy institute, *The Interpreter*, 25 January 2018,

https://www.lowyinstitute.org/the-interpreter/australian-aid-can-secure-private-investment-frontier-markets

Content:

Last month in *The Interpreter*, Clay O'Brien proposed the creation of a Development Finance Institution (DFI) for Australia's aid program. This shift in thinking about the way the government could engage in development is most welcome, particularly in Papua New Guinea. More can be done.

PNG urgently needs funding for a series of important infrastructure projects, including ports, roads, and power plants. Despite a significant amount of aid from countries such as Australia and institutions such the Asian Development Bank, the demand in PNG is so large that many projects may end up being funded by other actors, most notably China.

Australia has superannuation institutions estimated to hold approximately $2.5 trillion – a large private sector source of capital. There are clearly barriers for this capital to be invested in riskier markets, such as PNG. But an underappreciated reason for this failure to invest is a lack of emerging market expertise relative to other jurisdictions, such as the United Kingdom. This is where a change of emphasis in Australia's aid program could play a valuable role.

PNG remains excluded from most, if not all, emerging market bond and equity indices. This is unusual in the context of Asia, although Pacific nations do struggle for inclusion in such indices. PNG is ranked as a "frontier market", a tier below emerging markets. The failure to attract private investments is therefore a partly to do with a lack of Australian skills, and party to do with the nature of the PNG market.

Expertise in emerging markets may well develop in Australia over time, but the needs of PNG are pressing. The longer it takes to connect private capital to public infrastructure in PNG, the greater a vacuum there will be for actors, such as China, to instead provide the capital, further compromising Australia's strategic interests in its closest neighbour.

Australia gives more than $550 million in foreign aid to PNG each year. This funding is spread across numerous sectors, and is significant, but will not meet the immense need for direct infrastructure investment in PNG. Private capital investment must be encouraged in two main ways.

First, Australian institutional investors need to be adequately, and systematically, informed about potential infrastructure projects in PNG. The Australian public service can do more to help with the flow of this vital information.

Second, to overcome a lack of skills in Australia in emerging markets, some form of financial guarantee is required for institutional Australian investors or appointed managers. While in the usual course of business these guarantees might not be provided by the export credit agency EFIC, it might be possible to expand the agency's scope to incorporate such investments. However, it would probably be more effective to establish a specialist organization – or at least a specialist arm of EFIC – to provide guarantees of this nature.

These kinds of guarantees have been used widely elsewhere. For instance, the US Development Credit Authority (DCA) uses risk-sharing agreements to mobilize local private capital. Australia has also announced a $40 million Emerging Markets Impact Investment Fund (EMIIF) designed to support small-to-medium size enterprises (SMEs) that generate positive outcomes.

However, partial financial guarantees for private investment in infrastructure would need to be different to what is offered currently under arrangements such as DCA, or EMIIF:

- The guarantees would not look to support small and medium enterprise, and would instead be targeted at much larger institutional investors and large infrastructure projects in PNG,
- Banks would not play a role in these guarantees, except possibly as facilitators, and
- The primary parties would be the Australian public sector – possibly under a new agency and subsidised by the aid program – and Australian institutional investors.

Such an arrangement, using the two suggested forms of assistance, would lead to a significant shift in the way Australia invests its aid in PNG. Instead of the aid program acting as a direct investor in PNG infrastructure, the program would become a facilitator of Australian private sector investment. By combining partial guarantees with an enhanced quantity, and quality, of communication, it can be expected that the knowledge within Australian institutions regarding frontier markets, such as PNG, will grow and develop over time.

Establishing intellectual capital may reduce the need for the partial guarantees in the medium to long term, as investors become more confident in these markets. Over time, these skills could then be profitably applied anywhere in the world, providing an even greater benefit to Australian investors.

It remains an open question whether Australia has failed to take advantage of emerging market opportunities in places such as PNG because of a relative lack of skill, or simply because it elected not to. However, it remains clear that Australia is a nation surrounded by emerging market opportunities, as well as regional security concerns.

By supporting private sector investment into emerging markets, especially within the neighbourhood, Australia can more effectively leverage its finite aid resources; it can take advantage of regional opportunities while moderating regional threats. Regional partners will also see greater benefit than they do presently. Importantly, improving emerging market investment skills in the private sector may not be the only option for enhancing the geographic security of Australia. Such an improvement may well prove to be crucial.

Appendix 2: Terms of reference

Inquiry into trade and investment with Pacific island countries

The Committee shall examine the conditions necessary to activate greater trade and investment with countries of the Pacific region to the benefit of Australia and our Pacific neighbours. The Committee shall have particular regard to:

- the nature of Australia's existing trade and investment relationships with Pacific island countries and the potential that is presented by the Pacific Agreement on Closer Economic Relations Plus (PACER Plus) for enhancing those relationships;
- the opportunities to strengthen trade, investment, aid for trade and employment links between Australia and Pacific island countries and how they can be captured;
- the barriers and impediments to trade and investment between Australia and Pacific island countries and how they can be mitigated;
- the role and effectiveness of support structures and networks, including government, business, sport, Pacific diaspora communities in Australia, and areas of civil society, and how they can assist with identifying and capturing trade and investment opportunities for Australia and Pacific island countries; and
- the views, norms and cultural practices relating to trade and investment in Australia and Pacific island countries and how differences can be accommodated.

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Appendix 3 Note on the Author

Short

Dr. Stephen Nash has extensive experience, regarding investing in the Pacific, from his time as chief investment officer of the largest superannuation fund in the Pacific. As a Cambridge Commonwealth Trust scholar, Dr. Nash has published many opinion pieces, and peer-reviewed journal articles, drawing on his investment experience in a variety of jurisdictions, as well as his academic interests in economic theory, and the political philosophy of Locke, Aristotle, and others.

Medium

Dr. Stephen J. Nash

Ph.D. (Cantab.), M.Ec. (Hns.) (Syd.), B.A., B.Econ. (Hns.), B.Comm. (Qld.), Post. Grad. Dip. FINSIA, Senior Fellow FINSIA. Cambridge Commonwealth Trust Scholar.

Dr. Nash currently is employed by Vision Super, in Melbourne, with assets of around AUD 10bn., where he advises on issues relating to asset allocation, currency management, manager selection, and other issues that relate to the ongoing investment strategy of the fund. After four years in PNG, Dr. Nash recently relocated back to Australia, from Port Moresby, where he was the Chief Investment Officer (CIO) for Nambawan Super Limited (NSL). Dr. Nash joined NSL in March 2015 Nambawan Super as CIO, and NSL is the largest super fund in PNG, specializing in public sector superannuation, with funded assets around PGK 6bn, and total assets of around PGK 8bn. Responsibilities included, among other things, advising NSL on portfolio construction, global asset allocation, foreign exchange, and assessment of individual investment proposals.

Dr. Nash is a member of the FTSE Asia Pacific Fixed Income Index Advisory panel.

Prior to the current appointment, Dr. Nash held the following positions: (i) Chief Investment Officer, Nambawan Super Limited, (ii) Chief Investment Officer, Pacwealth Capital, (iii) Director, Strategy and Market Development, FIIG Securities, (iv) Head of Fixed Income and Cash for State Street Global Advisors, Australia, Limited (SSgA), (v) Chief – Provident Fund Secretariat – United Nations (UNRWA) in Amman Jordan, among others.

Dr. Nash is a Cambridge Commonwealth Trust Scholarship recipient, and has a diverse publication record, including several prestigious journals, such as *Perspectives in Political Science*, *The Journal of Economic Methodology*, and *The Review of Social Economy*, as well as contributing chapters to books on economic theory and philosophy, as well as a book entitled *Cost Uncertainty and Welfare: Frank Knight's Theory of Imperfect Competition* (Ashgate).

References

1 Nash S.J. (2018, Contribution to a Strategic Insight Paper, 'Partner, Australia's private sector engagement in the Pacific', by Anthony Bergin and Rebecca Moore, release date 11.59 pm 27 November 2018, Acknowledgement on page 23 of the report.

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