PACIFIC ISLANDS FORUM SECRETARIAT

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FORUM ECONOMIC MINISTERS MEETING
AND
FORUM ECONOMIC OFFICIALS MEETING

Suva, Fiji
3-6 April 2017

DEVELOPING A REGIONAL FINANCE FACILITY FOR THE PACIFIC

Purpose

To provide a feasibility analysis and propose possible policy options for the development of a Pacific regional finance facility.

Background

2. At the 2015 Forum Economic Ministers Meeting (FEMM), the Ministers approved the concept of a Regional Finance Facility (RFF) noting the mounting challenges in financing development both nationally and regionally, to achieve the Sustainable Development Goals (SDGs). The concept of the RFF presented at the meeting (see Figure 1 of Annex 1) suggests the mobilisation of around 10-20 percent of the regional long-term savings for long-term investment in the region. A preliminary survey of the Provident/Superannuation Funds (PSF), Trust Funds (TF), and Sovereign Wealth Funds (SWFs) in the region, highlighted that Forum Island Countries (FICs) in total own around US$7 billion. The need for the FICs to look into a regional model for development financing, largely to overcome the non-existent or underdeveloped national financial markets and diseconomies of scale, to stimulate and sustain economic growth and development in the region, has become critical.

Issues

3. The quest for sustained positive economic growth in FICs requires sustained flows of development finance. The demographic and economic transition of Pacific economies has put additional demands on financing for new and/or upgrading social and economic infrastructure as enablers of conducive economic conditions. These social and economic financing needs are exacerbated by the vulnerable and fragile environmental conditions and negative economic impacts from frequent occurrence of natural disasters in FICs. Based on these qualitative estimates, it is imperative that the required development finance in FICs is significantly more than a proportional increase in economic activity, to maintain a sustained economic growth path over time. Unfortunately, domestic capital markets in FICs are underdeveloped and rarely serve as a major source of development and investment financing. Correspondingly, most FICs' domestic credit market currently do not (and in future will not) have the capacity to finance these development needs on their own.

4. For FICs, especially for Smaller Island States (SIS), barriers to robust, deep, and economically functional financial market development can be insurmountable without a regional solution. This is evident even in the case of larger emerging and developing economies with relatively larger and complex domestic financial markets, which have supported regional solutions in pursuit of their national goals. The Asian Bond Market Initiative, Africa50 Infrastructure Fund, and Regional Governments Securities Market (RGSM) in the East Caribbean countries are admirable examples of how regional solutions can overcome national financing gaps and challenges. Regional collaboration, solidarity, political will and commitment can transform common challenges into shared prosperity.

5. A regional solution will enable FICs to mobilise funds regionally and will be an essential strategy in mobilising excess liquidity (experienced in some FICs) and/or investable funds (such as excess windfall revenues, savings) to those FICs that need it. This approach will ensure a diversification of systematic and unsystematic risks (that is, geographical, country, market, credit, interest rate and political risks), and elevate the Pacific regions' credibility in managing its financial resources.

6. A regional financial arrangement is the best alternative for an insurmountable national option. It is the optimal policy option for improving development financing for regional and national public goods and services with spill-over regional benefits. The proposed Regional Finance Facility will amplify economic and political gains by transforming national markets into a combined regional market for financial assets. As such, countries will be able to fully benefit from the *"Integration Dividend"* by overcoming diseconomies of small national market size, limited financial market participants and investable/loanable funds, high domestic transactions costs, varying degrees of country risks, and limited competition for public and private financing needs. This will benefit, in particular, the SIS countries which have very limited options and probabilities to develop a national capital market for public and private investors. The Regional Finance Facility can be a catalyst for the region to take control of their development agenda and financing, for regional public goods and services, development of economic sectors, etc.

Conceptual Design of the Proposed Regional Finance Facility

7. The conceptual design of the Regional Finance Facility is presented in Figure 2 of Annex 1 and key propositions of this Facility are to develop:

(a) ***Government Finance*** focused on developing a regional bond market for participating FICs. It is anticipated that a regional bond market can provide:

(i) an additional source of short-term and/or long-term financing and can be tailored to consider different currency options (i.e. using a combination of currency options - domestic currency, foreign currencies, indexed to a weighted basket of regional and/or foreign currencies) coupled with the option to look at single and multi-country bonds to avoid currency and maturity mismatch;

(ii) wider application for Pacific countries with debt overhang (or high debt distress) and those seeking options for restructuring expensive debt through the regional bond market with various instruments like debt-for-nature swaps; and

(iii) countries with policy space and specific self-insurance mechanisms in bonds, that is, seeking financing loans with minimal or no conditions and policy constraints. In addition, specific self-insurance can be endogenised in the bond by embedding:

- *vulnerability criteria* to account for the inherent economic and geographical disadvantages of the region, similar to the vulnerability criteria based loan options provided by the Caribbean Development Bank to its members;
- *counter-cyclical options* to adequately account for, and adjust to unexpected economic and/or climatic shocks and to ensure countries are provided sufficient time to adjust to the unexpected adverse shocks, which significantly lowers their short-to-medium term economic capacity; and
- *GDP indexation* to stabilise government spending and limit pro-cyclicality of fiscal pressures during episodes of lower-than-envisaged economic growth, hence, hedging against the constraints to fiscal space, mitigating fiscal retrenchment and reducing the likelihood of default.

(b) ***Private Sector Finance*** directed towards development of the private sector (especially corporate) bond market to support short- and long-term financing for cashflows, capital investments, financing mergers and acquisitions. This mechanism can:

(i) cater for the State-Owned Enterprises requiring of continuous infrastructure upgrades and re-investment for maintaining, and enhancing their efficiency, and improving the return-on-equity for shareholders;

(ii) act as a regional platform for developing regional financing options for Small & Medium Enterprises (SMEs) and Start-up entities to blend debt market instruments with innovative sources of financing through venture capital, crowd funding (or angel financing), impact (social) investment, and public finance (including donor funds) as Public-Private Partnership (PPP); and

(iii) enhance cashflows and integrate mitigation (such as exploring regional risk-sharing mechanisms) and with the private sector financing mechanisms to drive their participation in national and regional PPPs, inter-and intra-regional trade (including establishing multi-country supply chains and/or production sharing), promote innovative solutions for reducing business costs (using emerging fintech solutions, captive insurance for resilience, etc.) and enhance business intelligence (e.g. harnessing the power of available and future market data).

(c) ***A Regional Bank Account*** which proposes the establishment of a regional mechanism for regional allocation of earmarked international development funds for the region. Similar to the established Global funds, the proposal is to develop a combination of options, such as regional trust/vertical fund e.g. the Climate Insurance Fund, that can be utilised by development partners to support and finance regional development such as technical assistance for capacity building, blending for specific projects and PPPs, and public goods and services (such as regional shipping, aviation, connectivity etc.). This can be flexible by design to accommodate regional and/or multi-country funds (for SIS) and short-to-long-term funds. However, this proposed mechanism is not meant to replace FICs' bilateral arrangements with development partners but is to complement national resources and improve FICs' collective bargaining power. The establishment of this proposed regional fund will also support the region to overcome challenges in navigating global development finance, specifically:

(i) limited access to much needed international public and private finance;

(ii) imbalance in accessing these finance (as FICs with limited financial and human resources have to compete with other larger developing countries and other SIDS);

(iii) overly burdensome criteria to access funds by small FICs' administrations; and

(iv) imposition of onerous co-financing and/or blending rules set by donors, Multi-lateral Development Banks and Private International Banks.

(d) ***Financing Instruments & Options***, that is, the development of appropriate financial tools to support regional government and private sector finance and the regional bank account. The successful development of a regional bond market for both the public and private sector depends largely on financial innovation and FICs' ability to use such instruments for financial enhancement and risk mitigation. Some of these instruments that can be developed through the Regional Finance Facility to support the regional financial integration agenda are:

(i) Green and Blue bonds market and integrating this option for public and private sector financing for FICs. Both of these initiatives hold immense potential for FICs in generating new development finance;

(ii) Securitisation options (whereby the Regional Finance Facility acts as the Special Purpose Vehicle) for remittances and export earnings; and

(iii) Derivatives option which can enhance hedging and risk shift options through:

- captive insurance market for weather-based community resilience;
- weather indexed derivatives for key exports (like coffee, cocoa, sugar, etc.) for hedging against adverse climatic events; and
- regional and/or national supply chain derivatives to cushion supply-side shocks and intra-regional trade by covering a wide range of unanticipated economic and climatic shocks at different stages of the supply chain.

8. **Annex 1** provides further details on the development and operationalisation of this proposed Facility with potential benefits and analyses of perceived risk.

Resource Impact

9. The proposed development of the roadmaps for this Facility will require financial and technical support from the Forum Secretariat and relevant development partners.

Pacific Islands Forum Secretariat
Suva
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