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POLICY BRIEF

Avoiding a Pacific lost decade: Financing the Pacific's COVID-19 recovery

ROLAND RAJAH AND ALEXANDRE DAYANT

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KEY FINDINGS

- The Pacific faces a potential 'lost decade' owing to the economic devastation caused by the COVID-19 pandemic and an inability to finance the scale of government largesse needed to limit the damage.

- A multi-year 'recovery package' of at least US$3.5 billion (A$5.0 billion) is needed for the Pacific to fully recover from the pandemic. This should be funded by the region's official development partners.

- Australia should establish a US$1.4 billion (A$2 billion) COVID-19 Pacific recovery financing facility, and advocate for other parts of the international community to follow its lead in contributing to the Pacific's economic recovery. Once Australia has stepped up its own Pacific recovery financing contribution, it will be in a much stronger position to call on other development partners to do the same.

EXECUTIVE SUMMARY

What is the problem?

The economic and social damage wrought by the COVID-19 pandemic threatens a Pacific 'lost decade'. The Pacific has been hit particularly hard by the pandemic because of its heavy reliance on a few key income sources, which have been badly affected by the crisis, especially international tourism. Even when the pandemic has eventually been brought under control and vaccines become widely available, the Pacific's economic and developmental progress is likely to have been permanently set back. More people will be left struggling or unable to meet their basic needs and the prospects for a more prosperous, stable, and secure region will be greatly reduced.

What should be done?

The Pacific requires a multi-year 'recovery package' financed by its official development partners totalling at least US$3.5 billion (A$5.0 billion) if it is to fully recover from the pandemic. This should take the form of an increase in grant assistance to the extent possible. However, with limited political appetite for this strategy, the use of appropriately structured recovery loans is also feasible as a lower cost option to reach the full scale of financing required. In line with its own interests, values, and international responsibilities, Australia should establish a A$2 billion COVID-19 Pacific recovery financing facility, and advocate for other parts of the international community to increase their own contributions to help the Pacific recover from the worst economic shock in the region's modern history.

INTRODUCTION

The Pacific is staring at a potential lost decade. The region has been among the most successful in the world in terms of limiting the domestic spread of COVID-19. Despite this public health success, the grim reality is that the economic and social devastation in the Pacific is likely to be among the world's most severe and long lasting. Barring an ambitious and urgent increase in outside assistance, the Pacific will never recover the lost ground and will be set on a permanently lower economic and developmental trajectory.

The Pacific will need a package of at least US$3.5 billion over three years in additional international assistance to get through and recover from the pandemic.

In this Policy Brief, we estimate that the Pacific will need a package of at least US$3.5 billion (A$5.0 billion) over three years in additional international assistance to get through and recover from the pandemic.[1] This is the minimum figure, with significant risks that more will be needed. This should be met with an increase in international grants to the extent possible. Yet, there is limited political appetite in donor countries to increase international financial assistance at a time when they are themselves facing domestic crises. We therefore argue that the use of appropriately structured loans is also feasible as a lower cost option for meeting the full scale of recovery financing required. Concerns about excessive public debt are less relevant given the sheer scale of the crisis, with the economic returns from investing in the recovery likely to be very large. Other concerns about the 'moral hazard' of international bailouts (i.e. that they could encourage irresponsible policymaking in future) make little sense when responding to a once-in-a-century emergency for which even advanced economies were ill-prepared.

As the principal development partner in the region, Australia should aim to provide at least US$1.4 billion (A$2 billion) of the required recovery package — in line with its own national interest and its 'fair share' contribution to the Pacific in its time of need. This can be achieved by establishing a special Pacific recovery financing facility, building on Australia's recently established COVID-19 Response Package for the Pacific. The latter provides grant funding, but is well below the size needed to match the sheer scale of the crisis. Additionally, expanded lending by the multilateral development banks (MDBs) and international debt-for-recovery swaps, particularly in relation to bilateral Chinese loans, could help meet the total scale of Pacific recovery financing required. Australia should advocate for these in relevant international forums, notably the G20. Moreover, if Australia steps up with a significant increase in its own Pacific recovery financing contribution, it will be in a much stronger position to call on other development partners to do the same.

COVID-19 THREATENS A PACIFIC LOST DECADE

The economic crisis unleashed by the COVID-19 pandemic is hitting the Pacific especially hard due to the region's reliance on a narrow set of external income sources, notably tourism. Uncertainty remains high, and existing forecasts are sobering. The latest estimates by the International Monetary Fund (IMF) suggest that the Pacific will experience an overall economic contraction of 8 per cent in 2020, with a feeble 3 per cent recovery in 2021. Those countries with the greatest reliance on international tourism are the most severely affected. Fiji's economy is expected to contract by 21 per cent in 2020, Palau's by 11 per cent, and Vanuatu's by 8 per cent. Weaker commodity demand, pressure on remittances, and disruptions to supply chains and major infrastructure projects all add to the short-term dilemma.

Those countries with the greatest reliance on international tourism are the most severely affected.

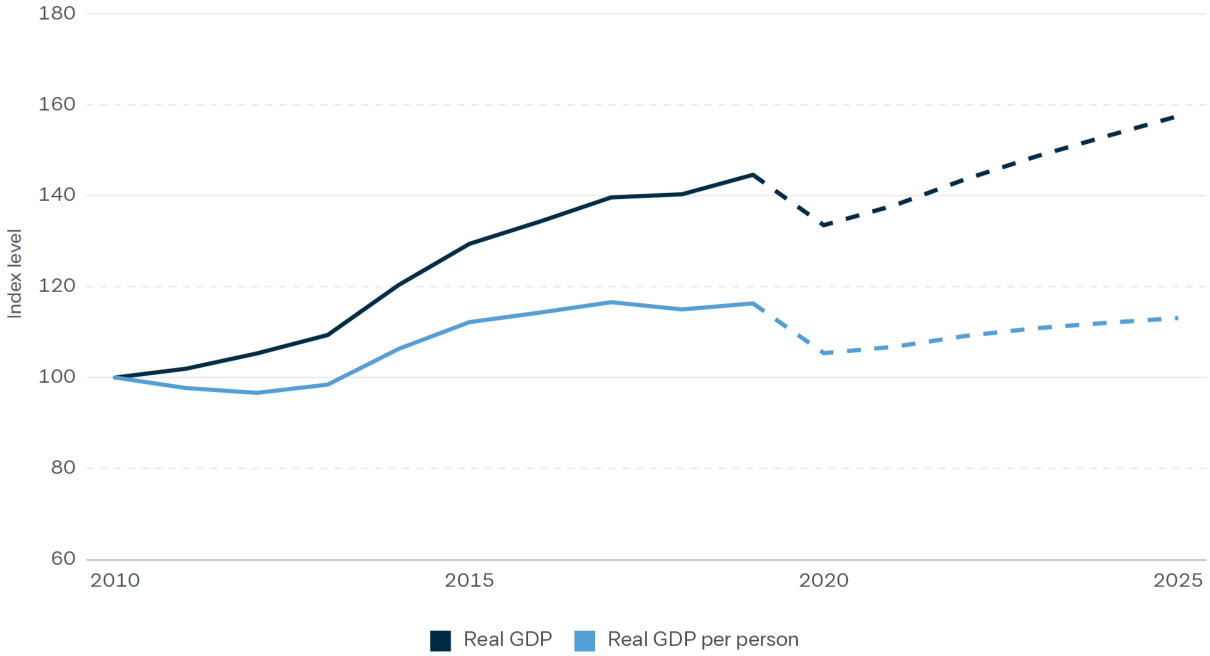
The economic damage from the pandemic is expected to be prolonged. On the IMF forecasts, real GDP per person in the Pacific will not recover to its 2019 level until sometime after 2025 (figure 1). By our estimate, it would not happen until 2028. Progress in reaching broader human and sustainable development objectives will be similarly set back as governments and individuals are forced to reduce long-term social investments to focus on near-term survival. And all this assumes that the global pandemic and economic crisis will be under control by late 2021. When and how quickly international travel and tourism might recover is a major point of uncertainty and downside risk.

The pandemic has generated a pressing need in all countries around the world for a massive increase in government spending aimed at keeping economies, and societies, afloat through the depths of the crisis, and providing enough stimulus to enable their recovery thereafter. But most Pacific governments cannot finance such economic largesse — being aid-dependent and having little-to-no access to international capital markets. Although several Pacific governments have announced seemingly large 'stimulus packages', the degree of actual fiscal expansion involved is limited (figure 2). That is especially so in the larger economies of Fiji and PNG. Even where Pacific governments have been able to ramp up spending (drawing on their own fiscal reserves or with the help of outside assistance), the degree of fiscal expansion remains far below that of advanced economies. While larger fiscal responses in advanced economies are to be expected, the more limited response in the Pacific means that the economic damage from the crisis will be much deeper, longer lasting, and more socially detrimental.

The Pacific's official development partners, for their part, have responded so far with approximately US$1.8 billion (about 5 per cent of regional GDP) in announced COVID-related support.[2] But this has only been enough to plug the immediate funding gaps caused by drops in government revenue and external income — not enough to enable the large-scale counter-cyclical budgetary expansion that is needed. Much of this outside support has not been additional funding: some of the support is reprioritised assistance, while a large share is frontloaded financing from the Asian Development Bank (ADB) and World Bank, leaving less funding available in the coming years for financing the recovery. Overall, the reality is that the scale of external support has not matched the scale of the crisis.

Figure 1: COVID-19 threatens a Pacific 'lost decade'

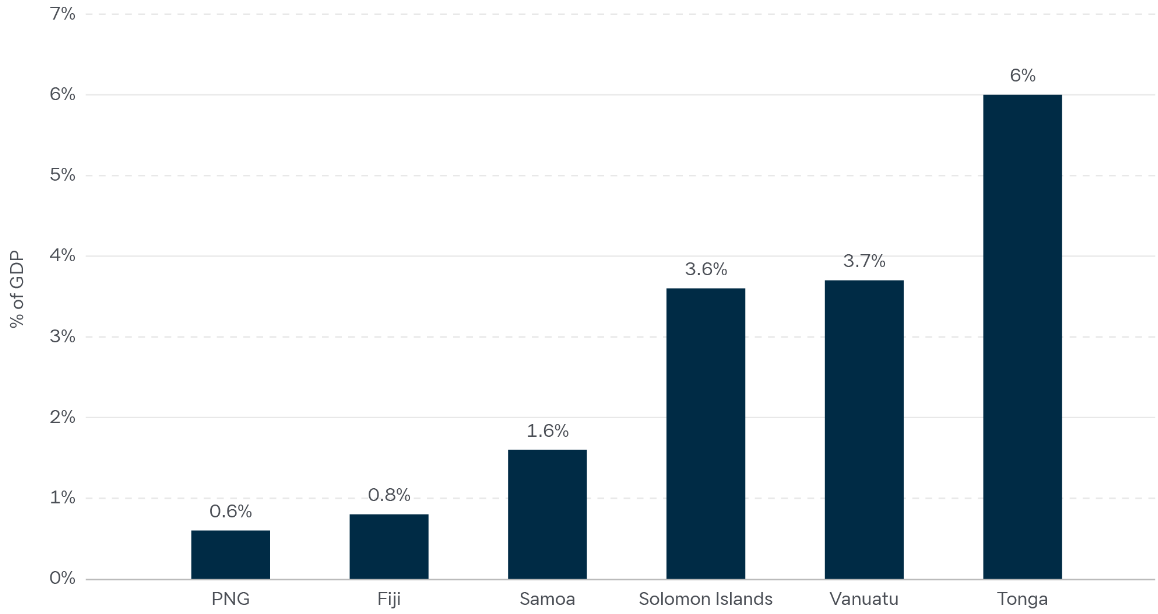
OVERALL AND PER CAPITA REAL GDP, INDEXED (2010 = 100)



Source: Authors' calculations based on IMF October 2020 World Economic Outlook database

Figure 2: A limited fiscal response to COVID-19 in the Pacific

ADDITIONAL GOVERNMENT SPENDING COMPARED TO PRE-CRISIS BUDGET, % OF GDP



Source: Howes and Surandiran (2020), ANU Pacific Covid Economic Database

HOW CAN THE PACIFIC RECOVER FROM COVID-19?

The Pacific's economic recovery will hinge firstly on a resolution of the global health crisis via the discovery and widespread availability of effective vaccines and treatments. It will also depend on the breadth and strength of the global economic recovery, particularly in key regional economies such as Australia, China, New Zealand, and the United States, which are critical sources of external income via trade, tourism, and remittances. The question of how fast international tourism recovers is a major source of uncertainty. But even as the pandemic recedes and global recovery eventually takes hold, the damage caused is likely to leave the Pacific on a permanently lower development path — on current estimates remaining around 9 per cent below its pre-virus economic trajectory.

A large-scale, multi-year recovery package focused on productive public investment and financed and supported by the Pacific's development partners would enable a much stronger economic rebound (figures 3 and 4). We estimate that the Pacific needs at least US$2.3–3.5 billion (A$3.4–5.0 billion) over three years in additional external assistance to recover from the pandemic (figure 3). This figure has been calculated by using estimated multiplier effects to determine the scale of stimulus required to return the Pacific as a region to its pre-COVID economic trajectory. A recovery package on this scale would return real income per capita in the Pacific to its 2019 level by 2024, with the region catching up to its pre-COVID economic trajectory by 2028 (figure 4). Most of the funds should be directed to PNG and Fiji, since they are by far the largest economies in the Pacific.

Figure 3: Additional recovery financing needed

3-YEAR TOTAL, US$ BILLIONS

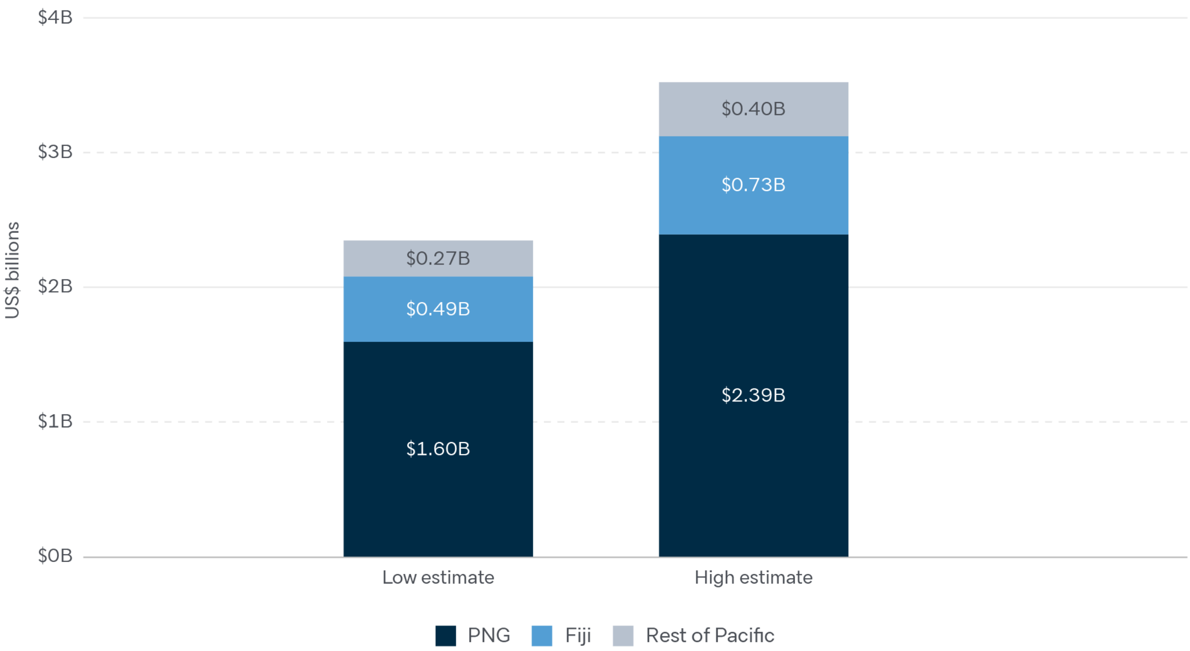
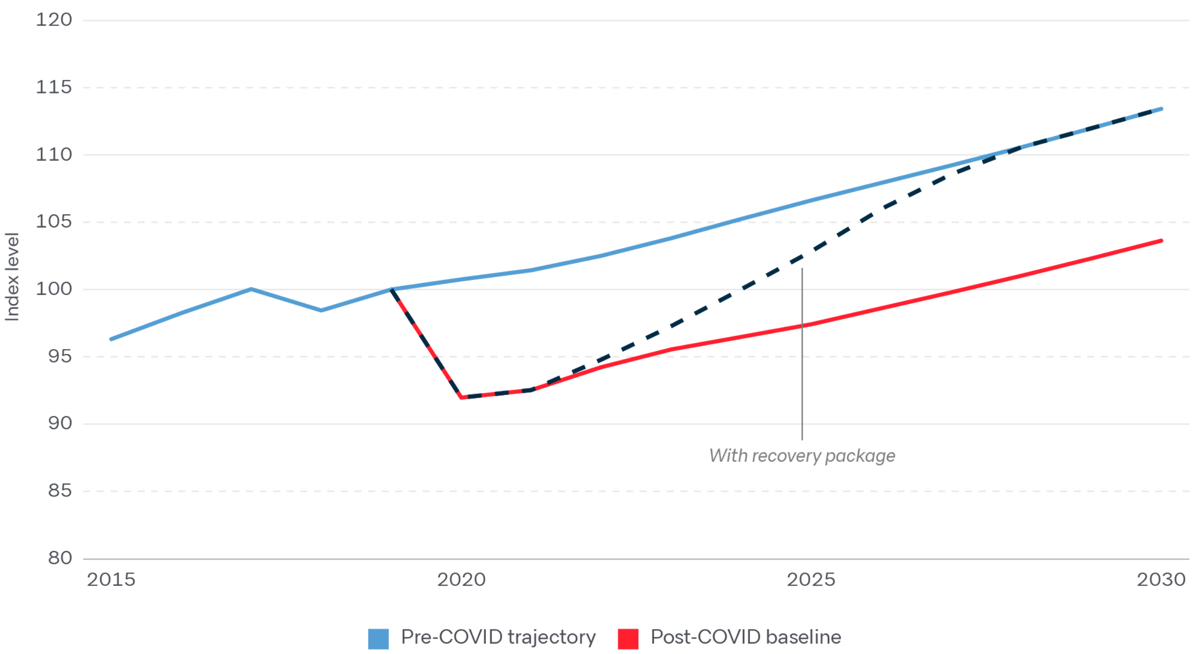


Figure 4: Pacific recovery – baseline vs stimulus

REAL GDP PER CAPITA, INDEXED (2019 = 100)



Source: Authors' estimates and IMF projections (various)

The returns from investing in the Pacific's recovery are likely to be significant.

The returns from investing in the Pacific's recovery are likely to be significant. Numerous studies show that the multiplier effect of increased public spending tends to be greater when the economy is operating far below normal, when there is a high amount of uncertainty, when households and businesses are cash constrained, and when increased spending is directed towards productive public investment.[3] The sheer scale of the pandemic shock means that stimulus spending should produce a very large multiplier effect. In advanced and emerging economies, for instance, the IMF has estimated that a dollar invested in additional public investment could deliver 2.7 dollars in additional economic activity over the medium term.[4] Multiplier effects in the Pacific are likely to be much lower, given these are very small and import-dependent economies facing a range of other growth constraints. However, the multiplier benefits will still be considerable. For instance, an IMF study focused on small states concludes that the multiplier effect of public investment stimulus is 0.6–1.1 over the medium term during normal economic conditions, but as high as 1.5 during recessions.[5]

A well-designed recovery package — financed and technically supported by development partners — would have a multiplier effect towards the top of this range. Many Pacific governments already have infrastructure investment pipeline plans that can be used to quickly identify potential projects.[6] Economic returns from increased investment in infrastructure maintenance and climate adaptation measures could be particularly strong, given the Pacific's high needs in these areas.[7] Labour-intensive small-scale public works would also be a good target for recovery spending. Coupling development partner financing with substantial technical assistance will help alleviate the problem of limited institutional capacity, which can otherwise limit the multiplier benefits. Finally, the likelihood of a drawn-out recovery means that a multi-year approach can be used to target high quality projects (not only those that are immediately 'shovel ready'), while still being a timely recovery stimulus.[8] In any case, since pandemic travel restrictions and supply chain disruptions will hamper effective implementation in the near term, the multi-year approach is necessary.

Based on a multiplier of 1.0–1.5, the Pacific will require US$2.3–3.5 billion in additional external assistance over three years to return to its pre-COVID economic trajectory. This is a minimum estimate. First, it only captures the narrow requirements for enabling a full *economic* recovery. It does not take into account what would be justified from a humanitarian or social development perspective or in terms of reducing the risks of political instability that increase during periods of intense economic hardship. Second, there are considerable downside risks to the economic outlook in terms of the precise fiscal and growth projections for specific countries. This may necessitate even more near-term financial assistance than already committed, for example to meet immediate budget financing gaps. Or if Pacific economies contract by more than expected, an even greater stimulus will be required in order to make a full recovery.

Due to these factors, the target for the recovery package should be at the upper end of our estimated range — US$3.5 billion. This will allow part of the increased recovery spending to be directed at addressing broader social and humanitarian priorities, while leaving some buffer to allow for the highly uncertain economic outlook. Of course, more may be needed. But the focus for now should be on mobilising this substantial amount, while acknowledging that it may need to be increased depending on how the economic crisis and subsequent recovery phase unfold.

HOW COULD A PACIFIC RECOVERY PACKAGE BE FINANCED?

The best solution would be to finance the recovery package with increased grants from development partners.

The best solution would be to finance the recovery package with increased grants from development partners. From the Pacific's perspective, this is the most generous form of assistance and would be the most beneficial. For donors, the reasons for increasing overseas assistance are the same as those invoked for injecting large amounts of domestic government spending in response to the COVID-19 crisis. These reasons include the extremely low long-term borrowing costs for governments in most advanced economies (which are negative in real terms), and the high returns that can be achieved by spending money now rather than later to limit the long-term economic, developmental, and social damage that the pandemic would otherwise inflict.

However, there is limited political appetite in donor countries for significantly increasing international assistance at a time of simultaneous domestic crisis. Other options must therefore be considered. Increased grants come at a direct cost to donor budgets. Neither could the MDBs simply scale up their own grant financing without themselves receiving greater financial support from donor governments.

While additional grants should be used as much as possible, appropriately structured recovery loans can also be employed as a second-best option to reach the scale of recovery financing required. The advantage of using loans is that there is little-to-no economic cost to the donor, depending on the specific loan terms used and how generous these are.[9] Another advantage of using loans is that they help avoid cannibalising funding to other longer term development priorities that require grant funding (e.g. community development or strengthening governance) but would suffer should resources be shifted towards the more immediate priorities of fighting the crisis and financing the recovery.

Some might be wary of using loans to finance the recovery given concerns about debt sustainability in the Pacific even before the pandemic. But such concerns are misplaced. While financing the post-pandemic recovery through additional grants is the preferable solution, appropriately structured loans are a feasible second-best option. The usual worries about excessive debt are less relevant in the pandemic context as long as increased spending stimulates the economy by enough to justify the additional debt servicing costs. Because of the potential for a large multiplier effect, this condition should be met provided the loans are made on a 'semi-concessional' basis or better — that is, at an interest rate of 2 per cent along with a 5 year grace period and 20 year total maturity.[10]

WHERE COULD THE RECOVERY FINANCING COME FROM?

The bulk of the Pacific recovery package will thus still need to come from new financing.

The first priority for donors is to increase the amount of assistance they provide through grants. Once their capacity for that has been reached, they should supplement that grant funding with a program of lending. There are three key possible sources of loans for an effective recovery package. First, the MDBs could expand their lending programs. Second, other existing creditors (such as China) could provide debt relief in the form of debt-for-recovery swaps. Third, bilateral donors could expand their own lending programs. In this section, we focus on the first two options; in the next section we consider the third option in terms of what Australia should do as the region's leading development partner.

Expanding MDB lending

Expanding MDB lending is the most obvious solution, but would require MDB shareholders to back important changes to their operating models at the global level, not solely in the Pacific. As noted above, expanding MDB grant financing would be difficult without an increase in donor contributions. However, expanding MDB lending would be readily achievable with some adjustments. First, the MDBs could take a less conservative approach to capital adequacy requirements, increasing the total scale of their lending.[11] Second, MDBs could broaden access to both concessional and ordinary loans to countries that are otherwise only eligible for grant financing, but for which recovery loans would be feasible without compromising the sustainability of their public finances.[12]

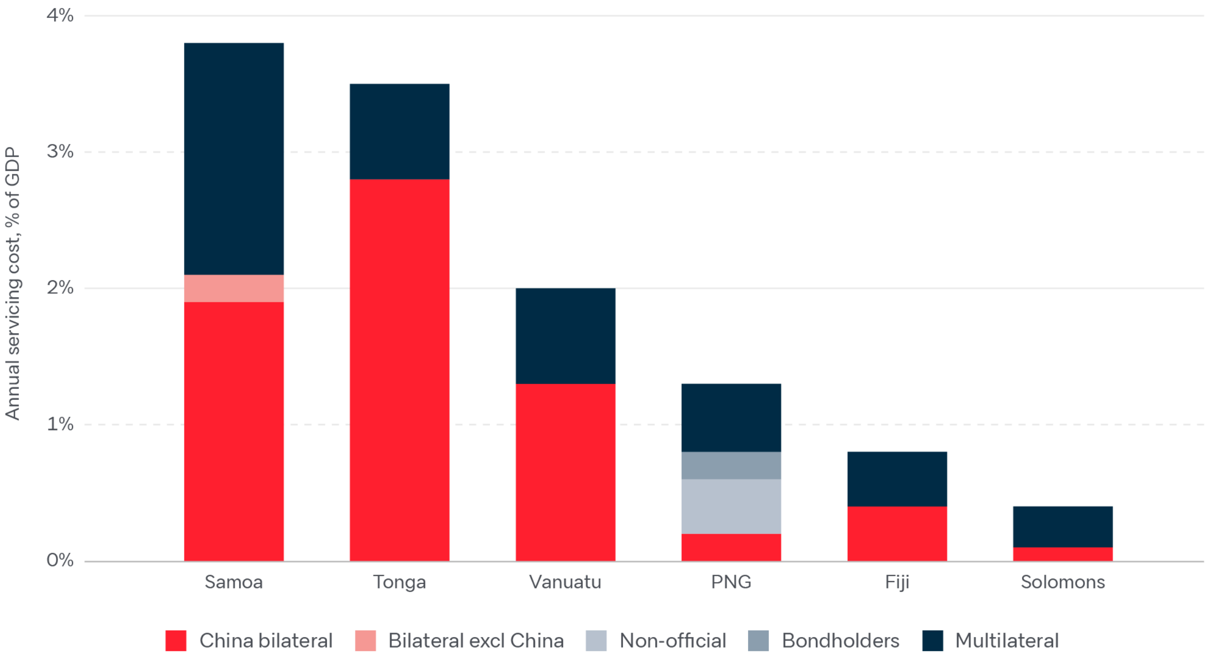
Debt-for-recovery swaps

Debt relief in the form of debt-for-recovery swaps could finance at least part of the Pacific recovery package. This would involve converting debt service payments falling due over the next few years into new loans (or better yet, grants) that can then be used to finance increased recovery spending. In the Pacific, the vast majority of external public debt is owed to official development partners, rather than private creditors.[13] If the MDBs were to provide debt relief it would complicate their ability to expand their lending in response to the pandemic.[14]

Bilateral debt relief however would be useful. Several Pacific economies owe China very sizeable debt service payments and these are set to increase substantially over the coming years as more China EXIM bank loans enter their repayment periods, notably in Tonga. The G20 debt service suspension initiative has provided temporary relief. However, this very limited support expires by mid-2021.[15] A multi-year debt-for-recovery swap initiative would be of much greater assistance, particularly for Samoa, Tonga, and Vanuatu. For most others it would only provide modest help. The bulk of the Pacific recovery package will thus still need to come from new financing.

Figure 5: Multi-year debt relief could unlock sizeable recovery financing for some Pacific countries

ANNUAL COST OF SERVICING EXTERNAL PUBLIC DEBT (2021, % OF GDP)



Source: World Bank International Debt Statistics database

WHAT AUSTRALIA SHOULD DO

It is in line with Australia's values, interests, and international responsibilities to act decisively to support the Pacific's economic recovery.

Australia has a special interest in helping the Pacific. It is the region's leading development partner and has a voice in key international forums, including as a donor shareholder at the MDBs and as a member of the G20. Australia's role therefore is vital in both directly contributing to the recovery package needed and in advocating for contributions from the international community. But regardless of what other countries do, it is in line with Australia's values, interests, and international responsibilities to act decisively to support the Pacific's economic recovery. Concerns about the potential 'moral hazard' of international bailouts are largely irrelevant in the context of a once-in-a-century exogenous shock such as COVID-19.

Australia typically contributes around 40 per cent of all financial assistance flows to the Pacific.[16] Australia should therefore be prepared to shoulder at least an equivalent share of the recovery package, equating to about US$1.4 billion (A$2 billion) over three years. Australia recently established a COVID-19 Response Package that will provide about A$300 million in additional grants to the Pacific over two years. This is a good start, but needs to be greatly expanded to reach the scale of recovery financing required. Australia can certainly afford to temporarily expand the scale of its grant assistance and it should do this to the extent possible. However, providing appropriately structured recovery loans offers a reasonable lower cost option that would still be enormously beneficial in reaching the scale of recovery financing the Pacific needs.

How could this be done? One option is to reprioritise the recently established Australian Infrastructure Financing Facility for the Pacific (AIFFP). This would mean frontloading its A$2 billion facility to focus on the coming three years. But unless the AIFFP were eventually replenished, this would not represent additional financing. It would therefore compromise the AIFFP's original policy objectives, which are to address the region's longer-term infrastructure financing gaps and provide Australia with a standing capability to fund strategic projects. In addition, although both the AIFFP and our suggested recovery package are focused on public investment, their objectives are not completely aligned. Economic recovery efforts should concentrate on projects that can be implemented quickly, rather than the long-term large-scale infrastructure projects targeted under the AIFFP, which involve more time-consuming due diligence and longer implementation periods.

A better option is to establish a new A$2 billion COVID-19 recovery financing facility for the Pacific. This should include the use of grants as much as possible, while deploying appropriately structured loans to reach the full scale of necessary support. Australia has already begun to be more ambitious in using bilateral loans to assist other countries in the region. This includes the AIFFP, but also loans recently provided to PNG (A$140 million) and Indonesia (A$1.5 billion) to assist them with the financing difficulties associated with COVID-19.[17] The loan to Indonesia is especially notable given its size. It demonstrates an increased political appetite and ambition in Australia for using the government's AAA credit rating to help neighbouring countries access sufficient financing during a global crisis. Importantly, the terms used by both the AIFFP and recent bilateral loans are generous enough to limit the risk of causing future debt sustainability problems in the region.[18] Providing Australian recovery loans on similar terms to these other recent loans is therefore a logical and straightforward option and would come at little-to-no cost to the Australian government budget.[19]

Australia has already begun to be more ambitious in using bilateral loans to assist other countries in the region.

The most effective way for Australia to help the Pacific survive the pandemic and recover from the economic damage is to provide more international grant funding. But at a time of competing fiscal pressures, other options must be considered. Grants should be employed wherever possible, however appropriately structured recovery loans can be used to supplement those contributions and help reach the full level of recovery financing required. Having made its own fair share contribution, Australia would then be in a strong position to encourage other members of the international community to step up their recovery financing to help the Pacific avoid a potential lost decade.

NOTES

1 An exchange rate of US$0.7 per A$1 is used throughout this Policy Brief.

2 As at 17 November 2020, the largest components include the G20 debt service standstill, redirected and frontloaded financing from the multilateral development banks (MDBs), expanded IMF rapid financing windows, and reprioritised and increased development assistance from Australia. This estimate is an update to our previous estimates from mid-2020: See Alexandre Dayant and Roland Rajah, "Aiding the Pacific during COVID — A Stock-Take and Further Steps", *The Interpreter*, 4 June 2020, https://www.lowyinstitute.org/the-interpreter/aiding-pacific-during-covid-stock-take-and-further-steps.

3 The literature has been recently summarised by the IMF. See "Public Investment for the Recovery", *IMF Fiscal Monitor: Policies for the Recovery*, International Monetary Fund, October 2020, 33, https://www.imf.org/~/media/Files/Publications/fiscal-monitor/2020/October/English/ch2.ashx?la=en.

4 Ibid.

5 Ali Alichi, Ippei Shibata, and Kadir Tanyeri, "Fiscal Policy Multipliers in Small States", International Monetary Fund, IMF Working Papers, 26 March 2019, https://www.imf.org/en/Publications/WP/Issues/2019/03/26/Fiscal-Policy-Multipliers-in-Small-States-46679.

6 *National Infrastructure Investment Plans (NIIPs)*, Pacific Region Infrastructure Facility (PRIF), https://www.theprif.org/national-infrastructure-investment-plans-niips.

7 See Maria Corazon Alejandrino-Yap, Matthew Dornan, and Kerry McGovern, *Infrastructure Maintenance in the Pacific: Challenging the Build-Neglect-Rebuild Paradigm*, Pacific Region Infrastructure Facility (PRIF), 2013, https://www.theprif.org/sites/default/files/documents/Final%20Maintenance%20Summary%20Paper.pdf; and *Adapt Now: A Global Call for Leadership on Climate Resilience*, Global Commission on Adaptation, 2019, https://cdn.gca.org/assets/2019-09/GlobalCommission_Report_FINAL.pdf.

8 The timeliness of stimulus — that it is genuinely provided in a counter-cyclical rather than neutral or pro-cyclical manner — is critical to generating strong multiplier effects.

9 The key factor in determining the economic cost is whether the loan terms (particularly the interest rate) are considered concessional once the risks associated with the loan are accounted for. The most important risk is that of default. For most bilateral and multilateral loans, this risk is generally very low.

10 This important point is based on a more detailed soon to be published study by the authors, *Small and Isolated: Financing the Post-Virus Recovery in the Pacific,* in Asian Development Bank, *Debt Sustainability in Asia: Problems, Practices, and Policies* (forthcoming).

11 A number of analysts have called for the MDBs to adjust their approach in response to the pandemic. See, for instance, Chris Humphrey, "All Hands on Deck: How to Scale up Multilateral Financing to Face the COVID-19 Crisis", ODI Briefing Paper, April 2020, https://www.odi.org/publications/16832-all-hands-deck-how-scale-multilateral-financing-face-coronavirus-crisis); Homi Kharas and Meagan Dooley, "Sustainable Development Finance Proposals for the Global COVID-19 Response", Brookings Institution, 14 August 2020, https://www.brookings.edu/research/sustainable-development-finance-proposals-for-the-global-covid-19-response/; and *Sovereign Debt and Financing for Recovery after the COVID-19 Shock: Preliminary Report and Recommendations*, Group of 30, October 2020, https://group30.org/publications/detail/4799).

12 Ordinary MDB loans are broadly comparable to the 'semi-concessional' loans we suggest here.

13 Official creditors include the MDBs as well as bilateral lenders, the largest of which are China, Japan, Taiwan, and Australia. Fiji and PNG are the only countries that have borrowed from international private creditors and much of this is already in the process of being refinanced with development partner loans.

14 World Bank, *Protecting the Poorest Countries: Role of the Multilateral Development Banks in Times of Crisis*, Explanatory Note, 7 July 2020, http://pubdocs.worldbank.org/en/976541595021399817/DSSI-Explanatory-Note.pdf.

15 The initiative only applies to official bilateral debt and only lasts until mid-2021, with the possibility of a six-month extension to be further considered. The debt service suspension initiative (DSSI) also only effectively refinances impending debt service payments for another six years, including a one-year grace period. Clearly, this is not enough. A piecemeal approach is also not conducive to planning effective recovery activities.

16 *Lowy Institute Pacific Aid Map*, (Sydney: Lowy Institute for International Policy, 2020), https://pacificaidmap.lowyinstitute.org/.

17 "Australia and PNG Sign $140 Million Loan Deal amid Political Turmoil", *Papua New Guinea Today*, 22 November 2020, https://news.pngfacts.com/2020/11/australia-and-png-sign-140-million-loan.html; and Roland Rajah, "Putting Real Australian Money on the Table to Help Indonesia, *The Interpreter*, 16 November 2020, https://www.lowyinstitute.org/the-interpreter/putting-real-australian-money-table-help-indonesia.

18 These loans are effectively anchored against Australia's own long-term borrowing costs, and the interest rate on 10-year Australian government bonds is currently less than 1 per cent. They are therefore more favourable than the semi-concessional loans that we estimate would be the minimal degree of loan concessionality required to avoid creating future debt sustainability problems (see footnote 10).

19 Depending on the technical detail, there would be either no or minimal impact on the government's underlying cash balance (the key measure used in Australia for judging the overall position of the budget) since the interest payments incurred by Australia in raising the funds for the loans would be offset by incoming interest payments from borrowing Pacific governments.

ABOUT THE AUTHORS

Roland Rajah

Roland Rajah is the Lead Economist and Director of the International Economics Program at the Lowy Institute. Before joining the Lowy Institute Roland was a Senior Economist and Country Manager at the Asian Development Bank, where he worked on macro-fiscal policy, economic growth, and development issues in the Pacific region. Prior to this Roland was based in Indonesia with the Australian Department of Foreign Affairs and Trade, managing a wide-ranging economic reform advisory program covering macroeconomics, public finance, trade and investment policy, and the financial sector. Roland has also worked in the Economics Advisory Group of the Australian Agency for International Development and the International Department of the Reserve Bank of Australia, with a focus on emerging and developing economies. Roland has a Masters in International and Development Economics from the Australian National University, where he was awarded the Helen Hughes Prize for International and Development Economics.

Alexandre Dayant

Alexandre Dayant is a Research Fellow at the Lowy Institute, where he works on a new project mapping and analysing foreign assistance in the Pacific. Prior to joining the Institute in 2017, Alexandre was a management consultant for PwC, where he worked on strategy development and implementation projects in the infrastructure, health, telecommunications and banking sectors. Before PwC, Alexandre completed master's degrees in International & Development Economics (Australian National University) and Econometrics (La Sorbonne) and undertook internships in marketing, international business, and finance. While in Australia in 2012, Alexandre worked for the Federal Minister for Small Business Brendon O'Connor on a comparative study of OECD assistance to small business for the Australian Government. He also completed a summer course in International Law and International Relations at Harvard University. Alexandre speaks fluent French, English, and Spanish.

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