

## 2012 Commentary and Looking Forward

2012 has certainly been a momentous year for both Papua New Guinea and the global community.

**Internationally:** Globally, it's been a period of dramatic socio-political, economic and environmental news and events. 2011's seemingly unstoppable drive towards democracy and freedom of expression, highlighted by the Arab Spring, turned widely to disappointment, and in some places seemingly intractable conflict, but there remains little turning the clock back, and, combined with the continued rollout of ICT across the globe, has affected households and their relationships with governments and business, right into some of the most remote communities, including in PNG, providing new economic, social and political opportunities, as well as some less positive consequences.

The Global Economic and Fiscal Crisis of 2008/9, sometimes termed the Great Recession, demonstrated its tenacity and capacity to spread into the hitherto less affected and more dynamic BRIC and other emerging economies, notably in Asia and South America. Rooted in longer-standing financial imprudence (or make-belief), both in commercial financial markets and by some States, and epitomised by toxic debt levels of certain governments and financial institutions, the path to economic restoration and advancement clearly requires a firm and steady hand, and a return to basic principles. However, there's limited experience of handling a crisis of this extent and complexity or of the most appropriate tools, with tough debating between those demanding immediate balanced budgets and others emphasising growth (and even inflation) as the means of climbing out of debt and safeguarding employment (and tax revenue), using various fiscal stimuli and tools such as 'quantitative easing' (i.e. printing money).

This debate, and the associated viability of whole economies, is pervasive in the drawn out negotiations over Euro-debt, to the brinkmanship over Washington's 'fiscal cliff', but also reflected to different degrees in economic policy making from Tokyo to Canberra and Port Moresby. That Argentina remains unable to resolve its long standing economic difficulties, using the alternative approach of walking away from its debt obligations, highlights that there may be few alternative parachutes available. In response to crisis, except in some countries like PNG, where the 2013 Budget has been driven in large part politically, there has been a general shift from elected governments managing the economic processes, to Central bankers, extending their roles and responsibilities from inflation and monetary management, into fields of fiscal and growth stimulation, normally the preserve of governments.

As different countries' economic, political (and military) strengths, weaknesses and dogmas wax and wane, 2012 saw a regrettable reversion to seemingly Cold War style intransigence and risky muscle flexing, over Syria to microdots in the South China Sea, and with brinkmanship sometimes prevailing over multilateral processes, from North Korea to the Middle East. On the other hand, seemingly solid progress has been achieved in re-embracing some semi-pariah States, from Burma/Myanmar to Somalia/Somaliland, whilst other countries from Congo to Mali, are dragged back into insatiable conflicts, too often fuelled by control over natural resources.

On the environmental front, forecasts for global warming have escalated, with greater and faster temperature rises predicted, combined with other hazardous impacts prevalent, such as ocean acidification. Despite continued differences over specifics, 2013 saw greater consistency amongst climate scientists and the wider scientific and business community on the realities and causes of climate change, but without governments seemingly any readier in Doha to take firm steps, beyond extending the outdated and largely ineffectual Kyoto protocol. The protocol largely sets ceilings on emission levels in developed countries, but heavy industry has largely shifted, with so-called developed countries now releasing less the ¼ of global emission. So, issues of emission equitability notwithstanding, clearly this pressing issue will not be addressed effectively without embracing the primary factors and players emitting CO2 and other greenhouse gases.

2012 was also a year of major elections, from Washington to Port Moresby, including the 10 year changing of the guard in China, with major sporting and cultural events, including the 2012 Olympics and the Pacific Festival of Arts providing international high points and relief from the gloomier economic and political scenarios.

**Papua New Guinea:** The political uncertainty and sabre-rattling, which had reached a crescendo in 2011 between PNG's volatile political factions and with the Supreme Court, were largely put to rest with the National Elections in July 2012. Although during 2011, there was much concern that the Government had lost touch with the concerns of the wider populace, over poor service provision and the high living costs, the dispute itself was confined largely to a relatively small number of individuals amongst the nation's political and public sector clique. More serious confrontation was avoided, largely owing to the reticence and perhaps maturity of the wider public and public service, including disciplined services. Social media, with increased public access to more affordable (though still costly) communications, no doubt played its part in generating wide public debate and consolidating and delivering strong messages from civil society, including church leaders and the wider community, to the protagonists, particularly against any notion of deferring the National Elections. The markets monitored the tense political fracas, but commerce and much investment continued relatively unimpeded, to the extent that, in early 2012 the kina continued appreciating, even on the day that the country's credit rating was reduced. Indeed, it was an indication of market demand and an achievement for the consortium that the massive PNG LNG project financing of US\$16 billion (initially) had been achieved, despite PNG's relative poor credit rating, potentially paving the way for future prospective major project financing, though within some realistic ceiling for country exposure..

In 2012 PNG again enjoyed strong growth, at an estimated 9%, driven substantially by PNG LNG construction (peaking in August), despite prices of many of PNG's mineral and agricultural commodities falling back, albeit largely to levels at or above recent historic levels; (it should be recognised that GDP merely measures total activity, and the growth figure is markedly lower when recording only that which is retained within PNG). Employment growth continued in most sectors, although tailoring off and less buoyant than before. Inflation fell back to about 4%, largely as a result of the higher kina value and discontinuation of school fees, although expected to rise again in 2013 (forecast at 8%). The stronger kina reduced the competitiveness and earnings from agricultural exports and import replacement industries, along with manufacturing

and tourism, jeopardising the economic diversification which is critical for broad-based economic development and employment generation. Interest rates remain steady and relatively low, although spreads remain wide by international standards and access to capital difficult for a wide range of businesses, although recent years have seen very positive steps towards greater financial inclusion, with an increased number of institutions and instruments geared to the smaller saver and user of a range of financial products.

The kina (and some other markets, including property/rental) have probably peaked for the time being, with tighter economic conditions in the next couple of years, at least until LNG production commences (expected late 2014), but sound and well-coordinated monetary and fiscal management will be required over the next years to avoid a return to the syndrome of boom and bust prevalent in the 1990s. There has been much hype over massive increases in GDP and revenue over forthcoming years, but in reality much of that extra GDP will flow promptly back out of the country, notably to service debt and to shareholders, whilst the extra revenue will substantially only replace mineral revenue, notably from some of the country's major current mineral projects (notably OTML, Porgera, Kutubu oil and Lihir), some of which are in late maturity, with diminishing resources and output and lower current prices. The reality is that, although longer term prospects for minerals development are solid, with extensive resources and long term market demand, the global markets are in a cyclical downturn, at the end of a strong period for global prices, which extended even beyond the GFC thanks to the strength of the BRIC and emerging economies. Unlike in 2008/9, when PNG was relatively unaffected, PNG is likely to be more affected by the prevailing global downturn for the next few years. While the extent and duration of that global downturn will be determined substantially by the firmness, spontaneity, appropriateness and cooperation with which the global authorities, notably Central banks and governments, respond, so too will PNG's economy be influenced by the suitability and coordination of monetary and fiscal responses by the PNG authorities

In the 2013 Budget the Government has raised planned expenditure to 13 billion kina from K10.5 bill in 2012. K2.5 billion of that will be borrowed, on top of the 0.5 bill deficit in 2012. That raises debt to GDP from a satisfactory level of 24-25% of GDP, to a forecast level of 32%, rising further in 2014. These levels are manageable, and look sound against various developed countries from Europe to Japan; however, unlike most of these economies, PNG's economy remains relatively narrow-based, and dependent upon a few commodities, each of which may face less buoyant years. Fairly optimistic commodity price forecasts are used in the Budget. Furthermore, PNG is already carrying substantial contingent liabilities and off-line debt, which are expected to grow substantially over the next months, with cost blow-outs on PNG LNG. Initially the increased 2013 debt was announced as domestically financed, but there are now plans for around half of that K2.5 bill. to be sourced from overseas markets.

The main thrust of the Budget is towards infrastructure, education, health, law and order and the districts, which is all sound in principle, and all are certainly priorities and in need of revitalisation, entailing extra resources, combined particularly with good management, accountability and coordination. Taking a bold step to overcome past deficiencies is sound. Increasing funding to absorb capacity released into the market with the progressive layoffs from LNG also has merit. The concern is that throwing money at the problem is not the solution. Extra funds are certainly needed at the sub-national level, and for infrastructure, health, education and

justice, particularly in some provinces, but it also requires much more emphasis on restoring/upgrading capacity and oversight at the same time. We know that the capacity at the district/LLG level, particularly, is very limited, and that the system established with District grants over recent years, notably DSIP, has generated little lasting benefit in most Districts. Borrowing heavily in 2013-15 and mortgaging the future, both in local currency, but also in foreign currency (notably Renminbi, for the EXIM loan for infrastructure, which is expected to appreciate over the next years) may not be the best investment, particularly until better systems, checks and balances and capacity are also in place. Clearly the two must go hand in hand, but omitting training and oversight mechanisms (including restoring regional training colleges), or leaving it all to development partners indicates a kneejerk rather sustainable approach.

Debt to GDP is forecast to rise from about 24 to an estimated 32% in 2013, and maybe 34% in 2014, which are within tolerable levels, although on the risky side considering there are strong downsides, but, when including contingent liabilities, - e.g. for superannuation, LNG equity and cost-blow outs etc, it raises the debt to more like 65% of GDP, which is an inadvisable condition for a developing country, particularly, especially where some of these components will be hard to discontinue, leaving debt accumulating. PNG needs to remember the lessons from this country in the 1990s, of over-expenditure and poor control and output, leading to boom and busts, and multiple structural adjustment programs, in a time of expected plenty, as well as lessons from the debt crisis overseas, from Japan to Greece. Heavy public borrowing also potentially squeezes out private borrowing, which would be especially problematic where business use of funds is more productive for the overall economy.

The great government achievement of the past decade was the greater fiscal prudence (with Medium Term Fiscal and Debt Strategies and Fiscal Responsibility Act), and more independent monetary management, which enabled economic fundamentals and market confidence to be restored, coinciding with stronger market conditions. It is critical that this achievement is not squandered, with a reversion to looser 1990-style practices, at a time when storm clouds are prevailing in the global economy. Some institutions, such as the Sovereign Wealth Fund, are being established to facilitate greater economic stability and reliable funding for priority expenditure, but with current forecast and borrowing, the likelihood of net revenue accumulation into that fund is looking remote. Perhaps the Government should rethink the current model of taking up its full equity entitlement in every mineral resource project. These major commercial investments are competing for public funds, which could be utilised for the State's core and immediate responsibilities and expenditure; they also potentially undermine the State's function as the Regulator, and, put simply, unlike private investors, the State is able to secure revenue at lower risk through fiscal means.

Business (and public services) require reliable transport access, by road air and/or sea, whether a large corporation or smallholder agricultural producer. Businesses (and churches) widely maintain and sometimes build local transport and other infrastructure themselves, occasionally accessing the tax credit scheme, but more often of their own volition. Likewise, delivering quality health and education and other services depends upon the roads and other infrastructure, including these days ICT where possible. Utilising existing public funds more effectively, including more effective coordination between the service providers, would make a big impact on improving service delivery, even before extra funds are applied, and this in part requires more

effective application and oversight of funds, and earlier (and prompt) release of funds, as release at the end of the quarter or in the last quarter also encourages misuse, as well as an absence of services.

An emphasis on routine maintenance and upgrades, rather than new infrastructure, should be applied, except where absolutely justified by current usage, or related grounds, and then, where appropriate, potential use of carefully selected Public Private Partnerships (more demanding than BOOT mechanisms), and contracts which include subsequent medium term maintenance. Simply borrowing heavily and tying expenditure to EXIM bank loans, has not proven cost-effective before (e.g. with Defence/police housing, NCD water supply, Yumi-Yet bridges, etc), and should be avoided where government/grant or concessional loan finance is available and proper tendering applied, as required by law. Ensuring the provision of public utilities, ICT and other core services (including competitive access to urban land) are open to competitive investment and provision, where practical, would also help lower costs to other businesses (including SMEs) and households.

The current backlash, by some Ministers, or tendency to revert to protective mechanisms should be avoided. Certainly PNG's micro-entrepreneurs, in agriculture or other sectors, need more effective support to be able to compete, including reliable infrastructure, law and order, affordable utilities, education and training (including in business skills), affordable inputs (not subject to high tariffs or lengthy delays in Customs) credit arrangements, etc; applying blanket protection and maintaining a range of inefficient monopolies, however will merely raise costs and undermine other local businesses. All businesses would naturally enjoy a monopoly/monopsony for their own products, but one business's monopoly is another's costs, and, as with multiple national and provincial sales taxes, adds to the costs of doing business and CPI in PNG, and could also result in punitive trade backlashes if imposed arbitrarily.

Over recent years PNG has experienced many of the characteristics of Dutch disease, with rising currency undermining non-boom industries, shortages in supply of various goods and services leading to high prices and difficulties likewise for the less competitive. These disadvantaged industries are, by and large, the core industries which provide the bulk of the country's employment and prospects for broad-based economic development and opportunities. LNG itself provides few jobs, and its benefits lie largely with how the tax, dividends and royalties are used by the State, provinces and landowners. If poorly utilised the opportunities provided will be limited and potentially even undermine other sectors. One of the more successful developing countries with resource wealth has been Botswana. It ensured that strong governance and transparency mechanisms were in place to start with, even prior to its minerals boom. Leaving the installation of those mechanisms until after minerals production and revenue flow commence invariably results in benefits never materialising, and PNG's paradox of poor social indicators and services continuing, despite the apparent resource wealth; or in a more extreme version, as occurred in much of resource rich West Africa, from Equatorial Guinea to Nigeria and beyond, where extractive industries more or less squeezed out other industries, and often drove the greatest income disparities. So, emphasis should be given to support and safeguarding other industries, including providing some targeted transport and input subsidies, but without imposing further extensive economic distortions and barriers, which are both hard to dismantle and often counter-productive.