Time to Calm Markets and Investors and Government to Focus on Core Functions

The Treasurer is about to present the 2014 Budget to Parliament. 2013 has proven a challenging year for Papua New Guinea and its government. What will next year bring?

The Government presented an ambitious and expansionary Budget for 2013, aimed at helping sustain economic growth in the face of the winding down of the construction phase of the major PNGLNG project, whilst setting the basis for longer term economic and social development, through overdue investment in the country's core transport infrastructure, human resources (notably education and health), districts, and ostensibly reinforcing law and justice capacity and taking a stand against corruption, which has for so long undermined public sector output and also handicapped private sector investment and business activity. Much of this was welcome, in principle, as it focussed on the needs of the wider community, and also the private sector, which generates most of the economic activities including jobs and income-earning opportunities in the formal and informal economies.

2012 was a good year economically, despite the political disruption, thanks substantially to ongoing strong global commodity prices, peak activity in the PNGLNG construction and a continued urban construction boom, fuelled in part by strong liquidity in PNG's financial sector. The kina in turn strengthened, reducing previously high inflation rates, but not unduly affecting incentives to agricultural whilst crop prices remained high.

2013 has seen mineral and agricultural commodity prices slide down, the winding down of LNG construction activities, and a markedly expanded and deficit-financed Budget, partly intended to sustain employment levels following PNGLNG construction and economic activity in the interim, until LNG production commences in the second half of 2014. As predictable, Budget implementation was delayed by lack of capacity, particularly in the Districts, after years of running down of public sector institutions, although expenditure invariably proceeded full tilt often in some of the lower priority activities, which require less preparation, not least politicised expenditure and overseas travel. Fortuitously LNG construction dragged on at a level longer than intended, making up in part for the delay in Budget implementation, and helping maintain jobs for a while and foreign investment influxes.

The lower commodity prices have pushed down earnings and profitably, and hence tax revenue, from the resource sector. They also resulted in various proposed resource projects being put on hold, and a major downturn in mineral exploration, although less so for gas. However, the recent development of accessible shale gas in north America and elsewhere has changed global energy markets dramatically, reducing gas prices and enthusiasm for costly new LNG projects, with consolidation the main focus.

The growth rate for 2013 remains strong, perhaps at 5%, albeit driven partly by domestically-funded projects, by both private sector and increasingly this year, government. Invariably, with export earnings from minerals and agriculture well down, reduced overseas investment from PNGLNG and other resource projects, but an increased level of imported goods and services funded by government (apart from overseas property acquisitions by PNG enterprises, funds and individuals), the value of the kina has slid quiet substantially from mid-2013. It's like a sink, if the inflow exceeds the outflow down the plug then, with a floating exchange rate, the kina value rises, but conversely if the outflow is dominant, then the value declines. The Central Bank can step into the market, and use its reserves to help stabilise the currency, within limits.

Until 1994 PNG's currency (in the days of the so-called "Hard Kina" policy) was pegged against a basket of the currencies of it's main trading partners, but in 1994, when foreign reserves were virtually exhausted, there was no choice but to allow the kina to 'float' and find its own level. There are considerable advantages to a currency remaining steady, including to provide relative predictability for investors, traders, governments and households. A strong currency has some advantages, notably when servicing overseas debts, importing overseas-supplied inputs and other goods and services (including overseas educational fees) and generally keeping inflationary pressures down; those on fixed and especially lower incomes including in the informal economy largely benefit from a stronger kina (especially with the absurdly high cost of living experienced in PNG's main towns, even for better of PNG households); however, it should not be assumed that a strong currency is universally beneficial. For a business or trading economy to be competitive, or viable, its products must be in demand and affordable to overseas buyers, or it prices itself out of the market, and where the kina is too strong, it's cheaper to buy imported products, and by-pass local supplies, for example of fresh produce, or to travel relatively cheaply overseas. Where commodities are priced in US dollars, as most are, a strong kina reduces the income to local producers, after conversion, whilst local tourists operators selling their services in US dollars also earn less, with costs in kina. Europe's current economic crisis is partly over having a standard exchange rate across Eurozone countries, traded at a rate which is fine for stronger economies, but makes Greece and some other countries uncompetitive and unable to adjust their currency (down) to meet their needs.

So, what is best for some in the economy may not be best for others. PNG has long had a dual, or two-speed economy, with a relatively dominant minerals sector tending to drive the currency up, and with the urban sector generally favouring a stronger currency, whilst the majority dependent upon rural industries benefitting from a lower kina. As stated, the kina's recent fall has given modest relief to PNG agricultural producers, already suffering from low US dollar prices for their copra, oil palm, coffee, copra, rubber, etc. The planned Sovereign Wealth Fund is designed partly to stabilise the kina, and prevent its undue appreciation, notably when LNG earnings commence, thereby safeguarding the prospects for broader-based economic development.

So the current lower kina is nothing to panic about, per se. It certainly has added unwelcome inflationary pressure back in, but the kina remains at the level it was two years ago, before its strong recent appreciation, but well above its rock-bottom days of the late 1990s-early 2000s. The Bank of PNG has intervened, buying kina to help restore confidence, but over the next months, until LNG production commences in later 2014, or commodity prices start picking up, with more positive global economicprospects, or another major externally-funded project commences, then there is unlikely to see much upward stimulus for the kina.

To help the Central Bank maintain desired stability it is therefore important that the Government coordinates its fiscal policy well, and avoids sending shocks to markets and investors. Of late international and many local investors in PNG have become perplexed and anxious, with potential investors and contractors increasingly cautious. PNG's risk ratings have improved in recent years, particularly following the successful financing and development of PNGLNG, but there is now a level of nervousness which the Government must address, which has the potential to drive away, not only needed new investment and job creation, but also encourage capital flight from PNG, which incidentally would also put further down pressure on the kina.

With low commodity prices and revenue, and an already sober investment sentiment, it's not the time for the Commerce Minister to be scaring new or existing investors away with tough and counter-productive foreign ownership restrictions (except on micro-enterprises) or blanket domestic-processing requirements (when employment generation and value-adding should be the objective) or offering gas/petroleum licenses to new investors (when these licences are already held); domestic SME's are best assisted by addressing the real impediments to business and investment, which are largely sharing with larger investors (overseas and domestic); likewise, uncertainty over mineral rules and nationalising a major mining project and associated development company, already both PNG-owned, are sending stark messages out, both internationally and to domestic markets.

Now it's time for Government to reassure markets, and dialogue better with the business sector and wider community in planning well-considered, rather than knee-jerk, policies and plans, with a focus upon addressing the real impediments and committing public funds to genuine public needs and priorities, and strengthening implementation, oversight and anti-corruption capacity, and slashing opportunities for abuse and waste, and limiting the burgeoning Budget deficit, including over-priced contracts and white-elephant projects, which will become a burden into the future. There is no reason for the State even to buy into major resource projects, when it has major outstanding n obligations for public expenditure to meet ordinary household's needs (with totally inadequate funding for community health workers and child welfare staff, for example); with extractive industries, government must focus on meeting its (social, labour and environmental) regulatory and community responsibilities more effectively.

PNG's prospects should be sound into 2014 and beyond, and the envy of many developing countries. However, it currently looks far from certain, and Government must avoid repeating the mistakes made in the previous resource boom-era of the 1990s, which turned to bust, including sliding currency, only finally reversed with a period of reform and relative austerity (including greater independence for the Central Bank on monetary policy and for the superannuation funds from tampering). The Government needs to get its house in better order promptly, and avoid contradictory policy signals, and generating damaging market anxiety.