ADDRESS ON THE STATE OF THE PNG ECONOMY TO THE 2006 PNG MINING SEMINAR

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Minister for Mining, Hon Sam Akoitai, Executive Director of the Chamber of Mines and Petroleum, ladies and gentlemen. I'd like first to thank the organisers of this important seminar for the opportunity to address you all. I must say I am a bit in awe of such a gathering of mining expertise, and feel I should perhaps first head off with Professor Hugh Davies and a geological hammer for a little crash training!

GDP Growth:

The Papua New Guinea GDP grew for the third year running in 2005 at approximately 3 per cent, and so far this year is living up to its Budget expectation of slightly exceeding that level.

In 2005 all sectors of the economy grew, except mining and quarrying, which comprises approximately 11 per cent of GDP, which showed a decline in real terms of 4.5 per cent, owing largely to reduced gold production at Porgera following a landslide. The biggest leap occurred in the oil and gas sector, with an 11.1 per cent growth recorded, despite a temporary shut-down of the marine terminal in early 2005. This reflected slightly increased overall production, particularly from Moran and the markedly higher oil price.

The agriculture sector, including forestry and fisheries, which together comprise 38% of GDP, recorded a growth of 4.1 per cent, although with some export prices falling back, total export earnings from the sector declined. This was despite increased production across the board, and markedly increased export earnings in some major crops, notably coffee, which enjoying good prices and a positive supply response, reaching 72,000 tonnes of exports for the first time since 1999.

Manufacturing, construction, transport and communications, wholesale and retail, finance and real estate and utilities, all grew in 2005, contributing together about 31 per cent of total GDP.

The first quarter of 2006 has seen the positive trend continue, driven particularly by markedly higher prices particularly for PNG's mineral export commodities, and continued buoyant, if slightly lower prices for most agricultural export products. Whilst mineral exports were slightly down from the last quarter of 2005, at 2.1 billion kina they were almost a third up from the corresponding quarter of 2005, despite some production problems in major mining projects, but reflecting the higher output from Kutubu and the newer oil fields.

Formal Employment Growth:

The Bank of PNG's index of formal sector employment showed an increase of 3.4 per cent over 2005, largely again driven by the mining and retail sectors, but more disappointing in other sectors. Whilst the formal sector admittedly provides a direct income for only a small portion of PNG's population, it has a markedly larger impact, supporting a significantly largely portion, including providing a market for produce from the informal sector.

The first quarter of 2006 also recorded an 8 per cent leap in the Bank's employment index, positively affecting all sectors (except transport), including mining and also agriculture.

Balance of Payments and Trade:

2005 saw a slight decline in the Balance of Payments over the previous two years, from 329 million in 2004 to 255 million kina in 2005. This entailed a major leap in the current account surplus from 393 million kina in 2004 to almost 2 billion in 2005, largely as a result of increased export earnings and stable imports, whilst the capital and financial accounts saw a deficit of 1.69 billion kina in 2005, against only 80 million kina in 2005, as a result largely of mineral companies holding increasing funds in foreign currency accounts.

After two quarters of positive balance, the balance of payments for the first quarter of 2006 slipped into deficit by 17 million kina. This was, nevertheless markedly less than for the first quarter of 2005, with a deficit of 255 million kina, or other first quarters in recent years. It partly reflects lower capital expenditure and imports by the mining sector, although offset by increased exploration spending by the oil industry. Export prices recorded for copper for March 2006 were 58% above those at the start of 2005, 27% higher for gold, 58% higher for rubber and slightly up for oil palm and coffee, but down for the other agricultural crops, especially copra. Export prices for crude oil were 53% higher in the first quarter of 2006, as against the same period in 2005. Exports, at 10.1 billion kina in 2005 were 23.6 per cent above those for 2004, whilst imports, at 4.7 billion kina were only 0.6 per cent higher in 2005 than 2004.

45 per cent of imports were from Australia in 2005, with the US trailing far behind at 13.8 per cent as the second major source, followed by Singapore particularly with crude oil supplies, latterly for the Napa Napa refinery. Australia remains also by far PNG's principal export destination with 43 per cent of exports in 2005, followed by Japan at 11 per cent and South Korea and Germany at 7 per cent apiece. Total imports for 2005 were recorded at 4.7 billion kina, only marginally above the level for 2004, as against total exports, including re-exports, of over twice as much at about 10.1 billion kina.

Foreign exchange reserves reached 2.3 billion kina at the end of 2005, a record level of 6 months of total and 8.2 months of non-mineral import cover, falling back to 5 ½ months of total cover and 7 ½ months of non-mineral cover by the end of the first quarter of

2006, particularly following net repayments of debt by government and major companies, and funds being shifted to foreign denomination accounts.

Monetary and Prices:

Inflation rose during 2005, whilst interest rates continued to decline. After a period of eased monetary policy in 2004, the Consumer Price Index (CPI) rose to 4.6 per cent for 2005, as against 2.4 per cent for 2004 partly as a result of higher fuel prices, but with falls in a wide range of largely seasonal products at the beginning of the year it has been calculated to have fallen to 0.8% for the first quarter of 2006.

Continuing its policy of monetary easing and interest rate reductions, the Bank of PNG kept its Kina Facility Rate, which had been at 14% in early 2004, at 7% during 2005, until reducing it to 6% in September 2005, where it remained through the first quarter of 2006. Treasury Bill rates have also fallen from 16% at the start of 2004, to less than 3% for shorter periods in early 2006, although with their current liquidity the authorities have reduced availability of TBills, encouraging investment in more productive activities.

Commercial bank lending rates have fallen more gradually, with overdraft rates at 8% at the start of 2005 and 7.2% at the end of the first quarter of this year, some rates slightly appreciating. Deposit rates have, however, fallen during this period from a range of 0.65% to 4.85% in early 2005 for shorter periods, down to 0.25% to 1.35% at the moment. The growth of well supported networks of micro-finance facilities during 2005 has extend access to needed savings and credit facilities through the community.

The total money supply (M3) rose by 30.7% in 2005, compared to 15.7% in 2004. The growth in 2005 was the result of an increase in net foreign assets (33.5%) and lending to the private sector (25%), whilst there was a 24% reduction in net credit to Government. At the end of 2005 the Government transferred about 560 million kina with the Central Bank into a special deposit, largely to fund 400 million kina of equity investment in the gas project. In the first quarter of 2006 the money supply grew by 3.4%, with significant increased lending to the private sector and a 28% increase in net credit to Government, whilst net foreign assets declined.

According to the Bank of PNG credit to the private sector, official entities and non-monetary financial institutions rose by 26 per cent to 1,827 million kina by the end of 2005, and a further 6 per cent to 1,940 million by the end of the first quarter of this year. I’ll take their word for the numbers, as from their tables I come up with a somewhat higher figure, but perhaps they have incorporated estimates for bad debt or other factors.

The kina appreciated against all major currencies during 2005, 7.2 per cent against the Australian dollar, 0.9 per cent against the US dollar and against the trade-weighted index. Although the currency has been floated, it is understood that the Central Bank may have taken measures during the year to minimise exchange rate fluctuations and undertake “inflation targeting”, perhaps also restraining upward pressure on the kina. Such a rise in the kina would jeopardise the competitiveness of PNG’s critical agriculture sector, and it was long a concern that the hard kina policy of the late 1970s and the 1980s, whilst providing valuable stability and encouraged by solid balance of payment figures, undermined the prospects of agricultural exports (largely denominated in US Dollars) and import substitution.

Fiscal Management

Following a budget surplus of 202 million kina for 2004, or 1.5 per cent of GDP, 2005 recorded a surplus of 47 million kina, against a Budget estimate of a 138 million kina deficit. This occurred after revenue and grants exceeded forecasts by about 9 per cent, notably owing to tax income being an estimated 17 per cent higher than budget. This resulted from the high tax and revenue receipts from mining and oil, with unexpectedly high commodity prices and permitted an 8 per cent additional expenditure and net lending above budget, including the 400 million kina equity contribution to the gas project.

The 2006 Budget forecasts a deficit of 90 million kina, or 0.6 per cent of GDP. Figures for the first quarter of 2006 show a deficit of 30.6 million kina, or 0.2 per cent of GDP. This may be partly explained by front end loading of warrants to provinces and other justifiable causes, but gives cause for concern.

The objectives in the Medium Term Development Strategy, Medium Term Fiscal and Debt Strategies and the 2006 Budget are towards: - improving conditions for economic growth, notably through private sector investment, including the informal sector, refocusing expenditure towards priorities, including infrastructure and basic services and reducing the level of debt and government overheads. Budget revenue for 2005 was 5.31 billion kina and expenditure was 5.27 billion kina, 27 per cent above the 2004 figure, and incorporating some shift to priority activities in accordance with the MTDS, including some infrastructure restoration.

The 2006 Budget set revenue and expenditure at lower levels than for 2005, namely 4.7 and 4.8 billion kina respectively. This was to reflect the reforms, including to the tax system to encourage private sector-led development, and better targeted expenditure. Total revenue, of 713 million kina in the first quarter, is 4.3 per cent above that for the same quarter in 2005, and expenditure, of 744 million kina, is 33.8 per cent above the equivalent period. Whilst the latter may only amount to about 15 per cent of year's spending, it has had to be financed from extra borrowing, and the first quarter always provides markedly lower receipts and expenditure than the other quarters. If extrapolated through the year and if further loosening of expenditure control occurs the considerable gains achieved from the past four years of fiscal and monetary prudence would be lost rapidly.

Direction:

Past experience, notably in 2002 and hitherto, has shown us only too visibly the pressure to loosen expenditure control and the serious implications on the wider economy. Despite its deficiencies, in terms of weak commitment to firm reform and sound governance of the renewable resources sector for example, this Government has achieved a great deal through providing political and economic stability, and firmly resisting the temptation to loose expenditure and borrowing. It has also achieved a modest level of refocusing expenditure towards priority activities, although much more is required in that regard to provide the basis for sustainable economic growth and to achieve tangible progress towards the Millennium Development Goals and related improvements in social conditions.

Whilst a 0.6 per cent budget deficit, as forecast in the 2006 Budget, is responsible and clearly below levels of the past, and levels prevailing in many developed as well as many developing nations, allowing it to rise significantly above this level would be very serious, although some targeted increased expenditure for MTDS priorities, such as competitively contracted infrastructure, backed by extra revenue could be justified, and remain within ceiling. On the basis of the first quarter's figures, however, more serious slippage could easily occur over the next months if the Government allows firm control to weaken. The positive budget situation of the recent years is the result of prudence and good economic management, based partly upon solid reforms, introduced substantially by the previous government, but especially also the result of good fortune, in terms of record and sustained good prices of many of the country's commodities. Whilst forecasts are for continued good prices, at least during 2006, it would be foolhardy to bank on this unduly, hence windfalls should be handled cautiously and partly used to improve fundamentals, such as reducing the public debt burden, which, although more manageable, could still prove a major burden if market and other conditions deteriorated.

Any changes to the 2006 Budget, notably through a mini-budget, need first to regularise the situation allowed to prevail in the first six months, and should remain consistent with the objective of funding for MTDS priorities and debt reduction. It should be recognised that our current high levels of revenue are still partly fortuitous, not be unduly banked upon, and focus should be given to growing and diversifying our economy and making it, and our revenue, more resilient to international market fluctuations. The steady 3 per cent growth rate over the past three and a half years has been an enormous gain upon the widely fluctuating, but normally much lower growth rates of previous years, yet it is barely above our population growth rate. It delivers only a miniscule par capita growth, and, with our growing economic discrepancies between provinces and districts and within the community, it means that much of the population is still going backwards, whilst only a relatively few, particularly in NCD and working in enclave projects, are advancing. We need to shift the growth rate to nearer a steady 6 per cent if we are to see real progress and employment and income earning prospects spread throughout the community, as highlighted in a number of recent studies, (for example by Ebrima Faal from the IMF, Satish Chand from ANU and John Millet, formerly with the INA).

Recent studies by the National Economic and Fiscal Commission have highlighted how far short expenditure is in terms of basic service delivery needed in the provinces, with some provinces, such as Sandaun, Simbu and Central receiving only a fraction (nearer 20 percent) of what is required for such health, education, infrastructure and other services, although a few provinces are actually securing more than adequate funding for this purpose. Sadly, some of the provinces which are relatively well funded, as we all know, lack accountability and badly squander their resources, and provide shamefully poor infrastructure and basic services. NCDC, one of the better resourced areas, seems by contrast, to have become markedly more transparent and responsible in its operations over recent months, and the recent regional development forums found a few provinces in each region, such as the Eastern Highlands, achieving commendable progress in starting to plan and manage their funds in a more accountable manner, and shifting expenditure towards priorities. But it will be a long process.

PNG is like an engine only using some of its cylinders, or perhaps a team of horses where some of the animals are pulling in opposite directions. There needs to be markedly increased coordination of the limited resources available for priority infrastructure investment and services, but a core focus must be to free up and reinforce the skills and energy and other resources within the wider community to drive a more sustainable, wide-based, private sector-led growth.

This requires that various major reforms, which were put on hold, recommence, including the privatisation and more competition amongst some of our key public enterprises, with the priority on expanded, reliable and affordable services. This is required also because, despite legislation, government generally continues, with notably exceptions, to demonstrate an inability to appoint managers and boards of statutory bodies and SOEs on merit.

It also requires the overdue reforms to the public service, recognising the need for a steadily increasing number of schools and teachers, firmly cutting out wastage, duplication and low priority activities, particularly those which undermine, rather than encourage, sustainable economic development. For those functions, however, which the State must perform, such as policing, to address the chronic law and order problems which continue to pervade some of our major towns and cities, merit-based appointment and, where needed, outside management inputs are required and adequate funding to make these services operational. With some other services, such as agriculture, outsourcing to community-based service providers may be a more cost-effective approach, with headquarters costs and staffing kept to minimum, but entailing highly skilled professionals focusing, as the Minister for Agriculture stated last week, largely upon facilitating, rather than trying to control their sectors.

As stated, the current economic upturn and improved confidence can be attributed to far reaching economic, governance and political reforms, launched largely during the period of the previous government but sustained by the current Government, combined with firm application of fiscal and monetary strategies, including firm expenditure control and debt management during the term of this government, plus fortuitous commodity prices. After some revisions to investment incentives for the mineral sector at the beginning of the decade, the improved tax conditions and related measures for the sector in 2003 and 2004 provided it a major stimulus, combined with the tireless efforts of the Petroleum Minister and his team, with the respective companies, to conclude the necessary sales to justify the investment in the gas project. The latter project has received some critical reactions, but it has played a crucial role in boosting longer term economic confidence in the prospects of the PNG economy, particularly in the light of declining known oil reserves. Let me say that, whilst prospective benefits from LPG and associate industries, and possible future LNG sales to Asia (once resources have been clarified), provide a basis for greater value added and prospective returns, the credibility of the industry and the capacity to achieve tangible milestones in the foreseeable future is dependent first upon the pipeline to Australia. That provides the foundation upon which the industry will develop, rather than imposing constraint to other developments, as perhaps suggested in some quarters.

Whilst specific incentives in mining and elsewhere have provided a valuable stimulus, it is sound policy to ensure universally applied investment conditions, adequately attractive, transparent and stable. Providing tailored agreements for individual investors inconsistent with the norm, is disruptive, triggers tit for tat behaviour and is ultimately bad for the industry and the country. Incentives in general are not favoured by economists, and invariably come at some cost to other parts of the economy. They're currently being sought by the agriculture, tourism and other sectors, and whilst valuable in stimulating activity in the shorter term, they do not provide the longer term platform for broad-based development, which comes from ensuring a level playing field and sound stable investment conditions, including infrastructure, law and order conditions, minimal corruption and red tape.

The private sector in PNG ranges from the world's largest corporations, such as Exxon, to literally hundreds of thousands of small entrepreneurs fending for themselves with their own resources, many on the fringe of the cash economy. Agricultural related activities, largely by smallholders, comprise nearly 40% of GDP, and smallholders provide the bulk of most cash crop exports (except oil palm, tea, and rubber). Investment conditions need to be able to meet the needs of the range of potential investors, not just the larger players. Many requirements are shared, but some, for example related to tax conditions, only really affect the formal sector. It is important to be aware of potential policy impact and seek appropriate balance. With major industries, such as mining, that also clearly means minimising the social and environmental impact of projects, and avoiding causing damaging effects on the livelihood and local habitat, which can last well beyond the project's life.

The last survey undertaken by the INA of private sector perspectives on the business and investment environment back in 2002 found that law and order problems posed the biggest hindrance to business and investment in PNG, followed, in order of severity, by political uncertainty, variable exchange rate, corruption, inflation, interest rates, regulation stability, availability of skilled labour, communications, transport and electricity infrastructure, input costs, skilled labour costs, standard of financial services, land compensation claims, access to land, company tax rate, unskilled labour cost, lack of subsidy or tariff support, VAT and lastly international terrorism.

In terms of business's top priority to encourage business and investment, tackling law and order came out well ahead, then addressing corruption, followed well behind by political uncertainty, variable exchange rate infrastructure and interest rates. The earlier 1999 survey made a comparison with the situation 10 years earlier and found a marked decline in perceived standards of government service and infrastructure, and markedly increased governance and corruption factors acting as constraints to business activity. Of course, some businesses, particularly those with short time horizons actually thrive on back door dealings, but these are not the enterprises with longer term commitments needed to build the PNG economy.

The INA intends to update this survey in the near future. Whilst perhaps premature to forecast the outcome, it is likely that at the moment the results would suggest: -

- Law and order remains the worst constraint, imposing a major added direct and indirect cost, (with the police considered to be too often part of the problem, rather than part of the solution, despite recognised strong commitment of many of its officers). It should be noted, however, that several other countries have law and order problems as bad or worse than PNG, yet have vibrant economies, and even tourism industries, as in South Africa and Kenya; The resolution entails both better enforcement, but especially greater employment generation;

- Political Stability, will be seen to have improved with a government expected to last the full five year term, thanks in great part to the reforms of 2000 and 2001. However, there is heightened concern over recent instability in government and it is critical to raise investor confidence that there's less risk of arbitrary shifting of goal posts and adequate security of title or business ownership etc;

- Economic conditions, such as exchange rate, inflation and interest rates, etc, will all be viewed more favourably thanks to the reforms of the start of the decade and sound management by the Treasury and Bank of PNG, whilst noting exchange rate conditions may not favour some rural sector viability. There will be alarm if recent Ministerial changes lead to looser fiscal control, particularly in the lead up to the election, and an apparent reinforced proneness to appointing wantoks to critical senior positions in government;

- Corruption. This will be considered to have become an increasingly serious impediment to reputable investment, with apparent inadequate attention by the Government to addressing the problem, and the only institution making steady headway, the Ombudsman Commission, under potential threat, and forestry non-compliance and pressure for excessive fisheries licenses issued and past reforms dumped. Recent progress by the auditor general, Parliamentary Public Accounts Committee and the fraud squad, with reducing the backlog of outstanding audits and taking government bodies to task, including potentially some provincial governments, is positive and well overdue;

- Administrative matters and services, such as work permits etc may be considered somewhat improved thanks to the ongoing efforts of bodies such as the Impediments Committee and CIMC, but there is a long way to go to raise performance of services and public goods, cut the multiple and often arbitrarily imposed changes of rules by government agencies whilst the utilities and other SOEs remain generally poor or un-competitively expensive, severely pushing up the cost of business, and, for example, pushing tourists to other more affordable destinations. Resolving issues of skills shortages, including by allowing oversees engineers, where necessary, to be brought in promptly, will we critical to smooth operations; and
- HIV/AIDS and related health problems is increasingly seen as a social, economic but also commercial cost, as staff, often highly trained, in towns and major projects fall ill. Addressing this is necessarily a society-wide responsibility.

In other words, some solid improvements and increased investor confidence have been gained in recent years, particularly in the larger urban businesses and the mineral sector, but the gains remain tenuous, particularly if fiscal control is allowed to weaken and nepotism and abuse of government organisations, such as boards, allowed to prevail in the build up to the 2007 National Election. A much firmer commitment to reform, slashing waste and corruption and responding to the needs of the whole (investor) community, down to the small rural and urban producers is required, to institutionalise steadier and more sustainable growth and tackling poverty in years to come. Much of this entails less control by the State, and where control is required, that it is practised in a transparent manner. This will only be achieved if the public, including the responsible business sector, clearly demands it. It will fail if the public remains factionalised, and continues widely to see politicians, government and major projects as the providers of largesse, resource rental, compensation, or jobs and other perks, rather than development partners, responsible for provision of priority goods and services needed by the wider public and business to unleash the country’s economic potential and social development.

Let me wish you all a productive two days of Seminar.

Thank you very much.