

## PNG's Economy – past, present and future prospects

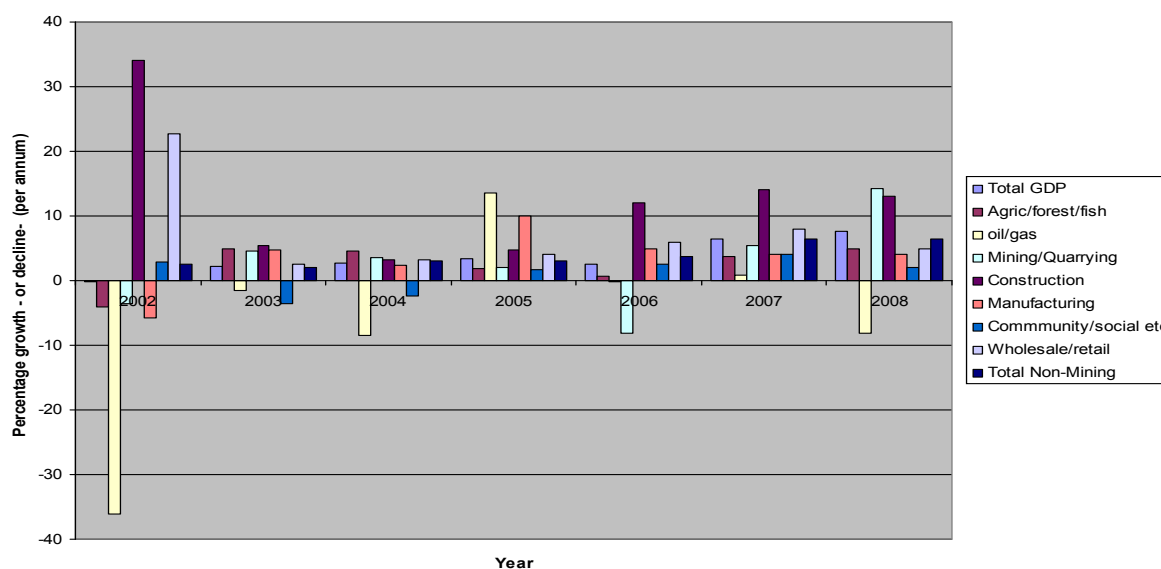
*By Paul Barker, Executive Director, Institute of National Affairs*



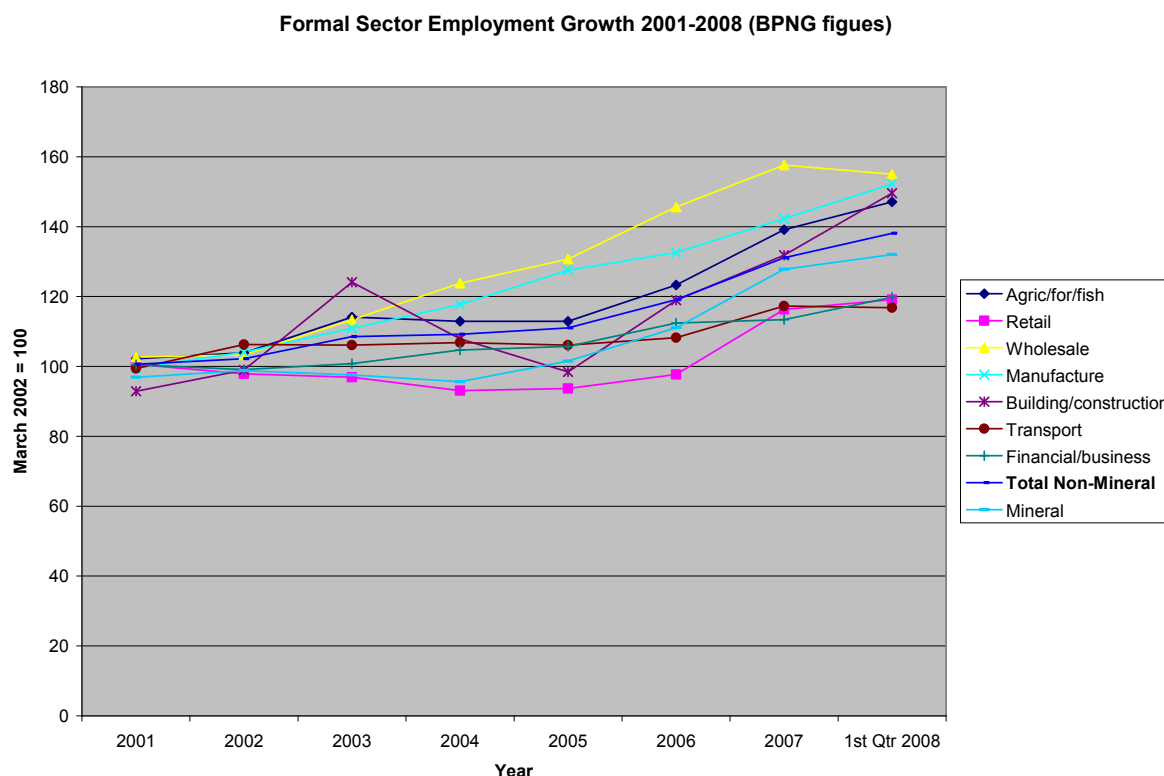
*PNG's growing economy is heavily dependent upon open and fair trade, with poor infrastructure severely handicapping economic and social opportunities, including food security, especially for rural communities.*

Papua New Guinea is currently enjoying a period of unparalleled growth, thanks largely to the strong prices of its export commodities, but partly also to reforms (largely) made early this decade, combined with generally prudent fiscal and monetary management subsequently, which have in turn contributed to conducive and relatively stable macro-economic conditions. (Real) GDP growth has been at, or exceeded, the population growth rate (estimated at 2.7%) since 2004. Growth has risen to 6.5% in 2007 and forecast by the Bank of PNG at 7.6% for 2008.

**Growth Rates (GDP) by Sector (Treasury estimates and forecast 2003-2008)**

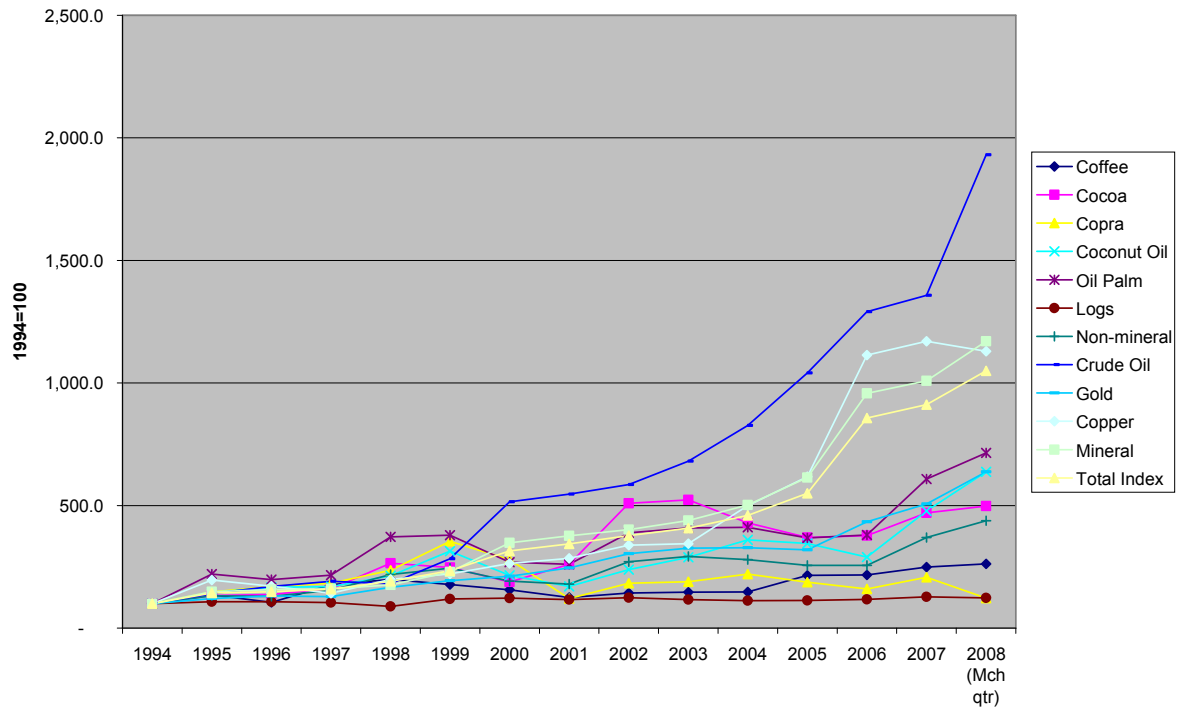


This growth, albeit driven largely by external factors, has been remarkable both for its duration and its rate. It has also spread to all sectors, though still largely concentrated in major towns, enclave projects and a few rural industries. Formal sector employment has been growing since 2002, and more firmly since 2005, recently extending to all sectors and all regions, if somewhat unevenly.

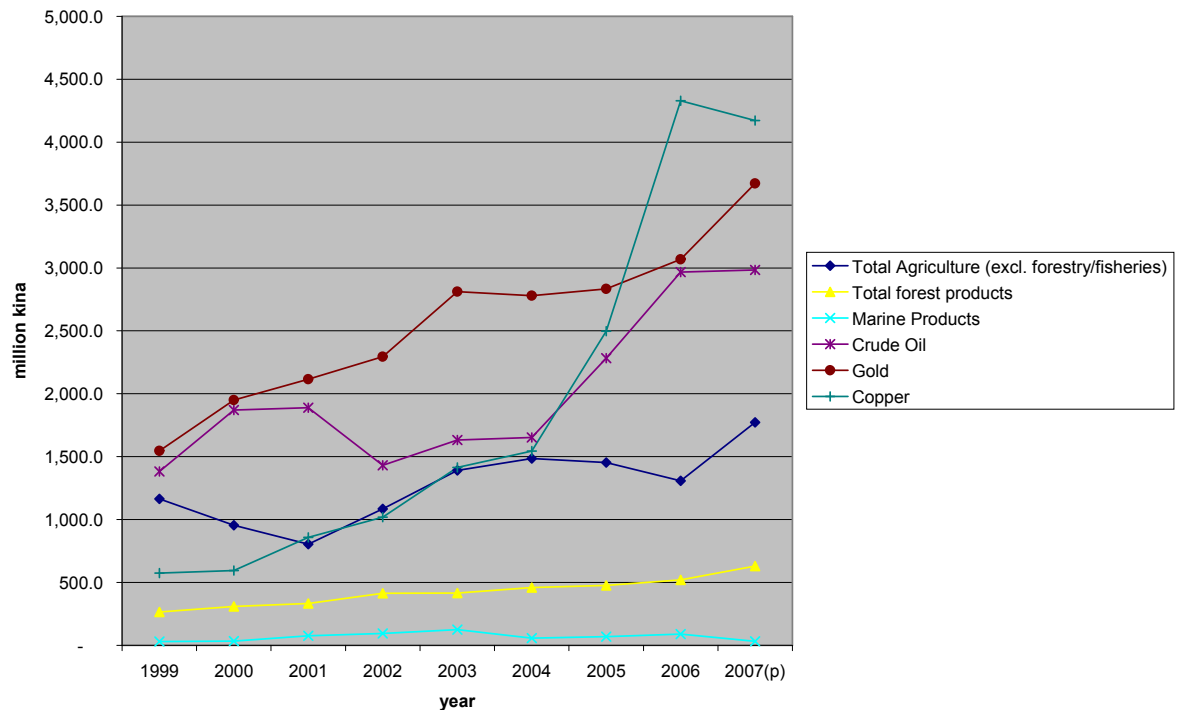


The strong commodity prices driving the current improved growth are benefiting particularly the mining and hydrocarbon sector, but also, to a lesser extent, the agriculture sector, including both tree crops and this year particularly also food crops. Papua New Guinea is almost unique in the East Asia and Pacific region as an overall beneficiary of the high commodity prices, being less affected by higher oil prices still being a net exporter and with the majority of the population still engaged in agricultural production. Nevertheless, there are clearly winners within the community and losers, notably those for whom energy and/or food purchases form a major portion of net expenditure and who have little protection from these market forces.

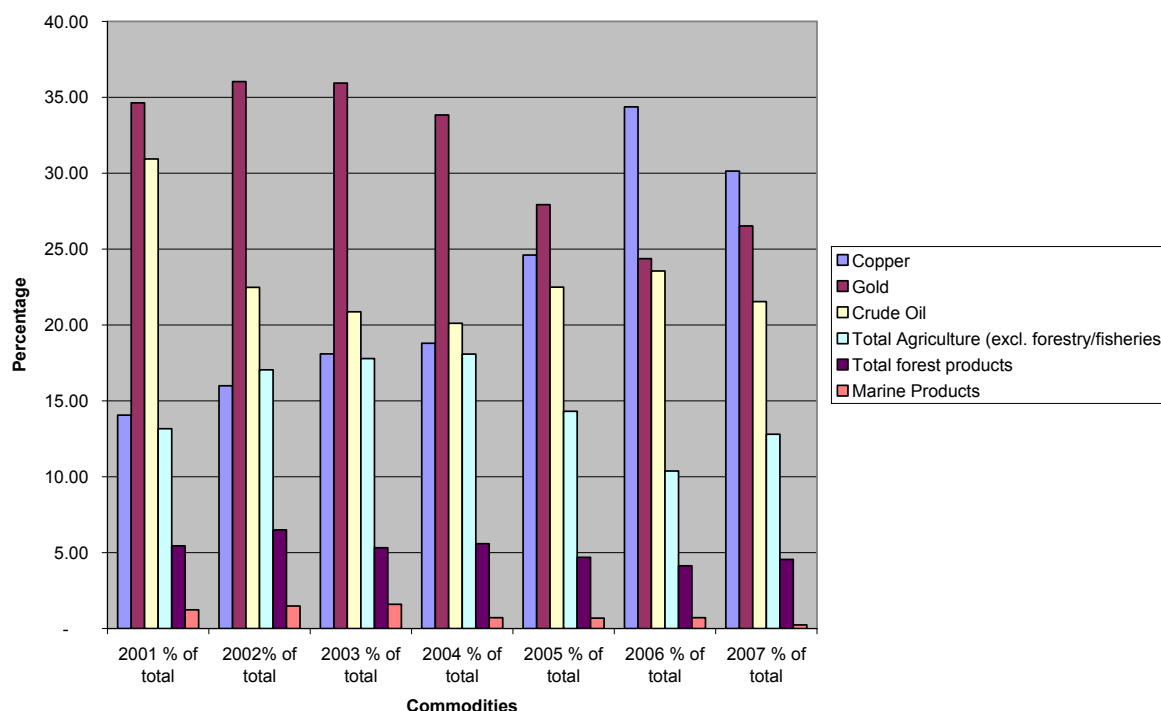
Export Price Indices 1994-2008 (Mch Qtr) 1994=100 (source: BPNG)



Exports -Value FOB (million kina) 1999-2007 (BPNG)



Percentage of Total Exports - by Value 2001-2007 (BPNG, 2007 Prelim)



Unfortunately, so far the increased income gained from the production and export (or import replacement) of these locally-produced goods is attributable largely to the improved prices, with limited, if any, supply response apparent yet. Of the export products, only palm oil<sup>1</sup>, logs<sup>2</sup> and, less consistently, copper (which in 2007 accounted for 35% of export earnings), have seen significant production growth over the past decade, although improved conditions for the mineral sector, including under its more competitive post 2003 taxation regime, have spawned a revival of exploration activity and revived development plans (from LNG to major mines like Frieda River). Tourism numbers have grown in recent years (particularly linked to tracking and other adventure travel), although remaining low in relation to Pacific neighbours, such as Fiji , Vanuatu and Samoa, which have more readily embraced market reforms, including competition, such as in air and telecommunication services. The contribution of fisheries to the economy has grown steadily<sup>3</sup>, including greater domestic processing and on-shore based operations, but the local industry faces ongoing handicaps related to high fuel and freight costs, resource management and licensing arrangements.

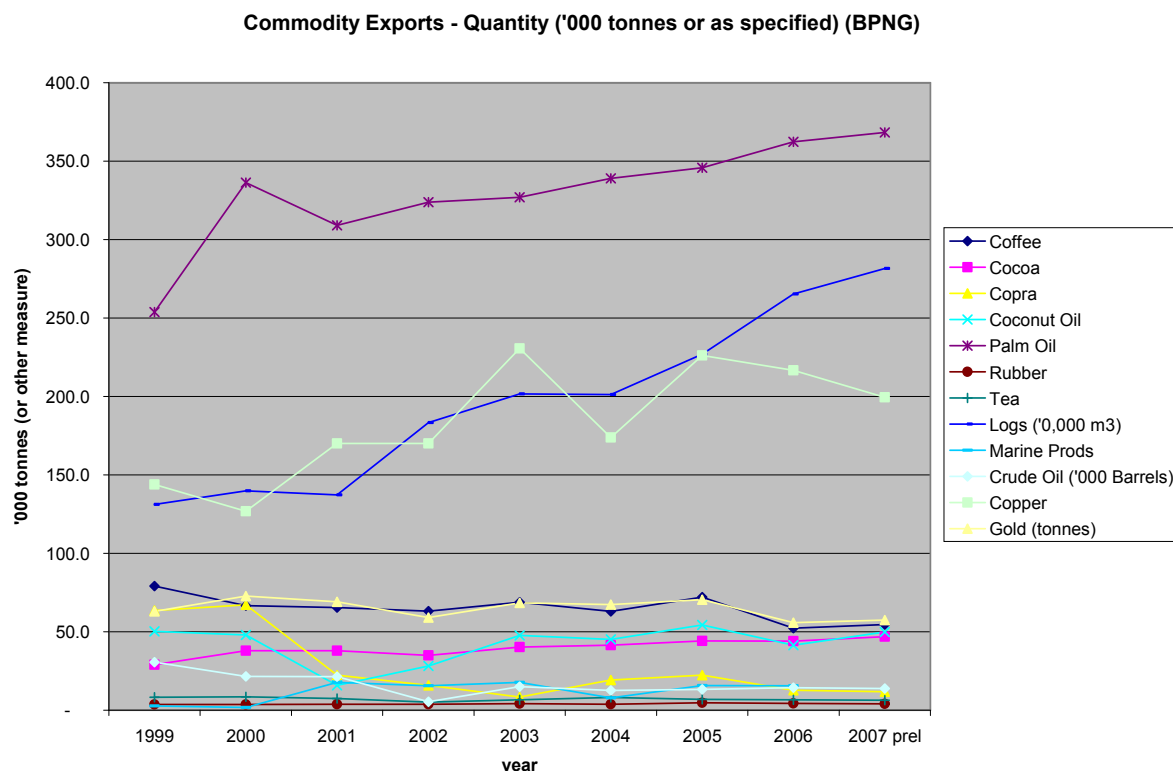
PNG's post Independence economic performance has been disappointing, with generally sluggish growth rates, interrupted by some short-lived bursts, too often followed by bust, associated with

<sup>1</sup> Worth approx K800 million FOB for 2007 including refined palm oil (K672 million from crude palm oil), and rising substantially in 2008, pressured by buoyant oil prices (now considered a fuel substitute)

<sup>2</sup> With higher market prices and reduced log export tax rates in the 2007 Budget

<sup>3</sup> Inadequately reflected in the official export figures, by the manner of recording

major events or projects commencing or closing. For example in 1992 and 1993 PNG was noted as having the highest real growth rate worldwide at 12% and above, but this related to major new mineral/oil production (notably Kutubu), combined with recovery from a low base level (with the impact of the Bougainville crisis causing economic contraction in 1990/91).



That recovery was also very short-lived, with a return to bust from 1995 onwards. By the end of the 1990s PNG suffered from many structural problems, which were undermining the capacity of the private sector to perform, as well as the capacity of the public sector to deliver basic infrastructure and services.

For economic growth to be more sustainable and broad-based, clearly requires not just good commodity prices, which invariably remain volatile, but must be broad-based, embracing the wider community in the benefits of growth, thereby avoiding damaging social disharmony. Slightly over one third of GDP in PNG comes from the agriculture sector (including forestry and fisheries) and, despite major relatively enclave industries, sustainable growth and wider economic participation depends very much upon the vitality of the renewable and largely rural-based industries.

In the early years of this decade significant institutional reforms were launched, and some implemented before a change of government occurred. These reforms included independence for the Central Bank on monetary policy, superannuation fund reform, establishing regulatory frameworks for competition and improved SOE management and launching a long heralded privatisation process, notably of the country's largest commercial bank, as well as political reforms enabling greater political stability, notably permitting the winning coalition subsequently to secure a full, uninterrupted five year term. Privatisation of telecommunications and other sectors was effectively halted with the change of government in 2002.

Although less reform focused, the new Government from 2002 progressed some valuable initiatives, many already in train, notably the introduction of the Medium Term Development Strategy 2005-2010 (with the Government currently preparing a long term plan, 2010-2040) and several sector plans (including for agriculture and tourism), improved public sector appointment procedures and, hesitantly, modest public sector reform, reduced tariff rates and revised taxation arrangements for mineral exploration and development, and, in 2005 approving overdue competition in ICT (initially, to date, only for mobile phones – which commenced in July 2007).

Solid progress has also been made to improve fiscal management and accountability (including the *Fiscal Responsibility Act*, requiring fiscal restraint, public reporting and restrictions upon public sector borrowing) encouraging improved business and investment conditions in a competitive market. Prudent fiscal management since 2002, particularly in line with the Medium Term Fiscal and Debt Management Strategies, have contributed to the economic stability needed for the current economic revival, whilst the commencement of competition in mobile phones has both directly and indirectly contributed to economic growth, both from the major investment by the operators (notably the new entrant Digicel) and associated increased business activity, by micro, small and medium enterprises, including agricultural producers in accessible rural areas.

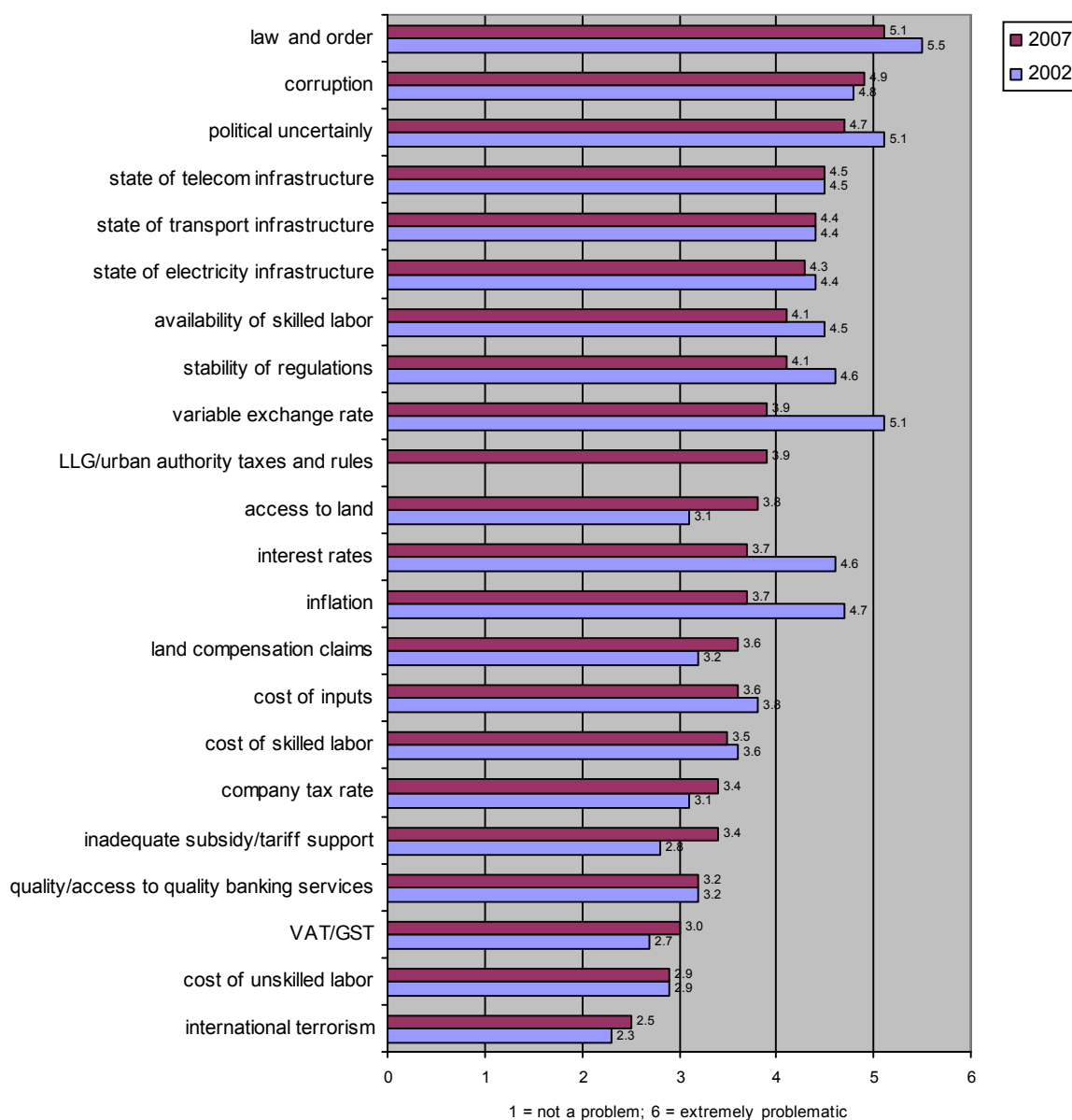
**Investment Conditions and Mechanisms for Addressing Sector Issues:** The key impediments to business and investment in PNG have been highlighted in the INA's 2007 Private Sector Assessment (with a sample of 250 businesses)<sup>i</sup>, with international comparisons on ease of business transactions shown in the World Bank's annual "Doing Business" survey. The CIMC<sup>4</sup> National (and Regional) Development Forum and Sector Committees provide a critical mechanism for dialogue between government, private sector and civil society on business impediments and other issues of public concern. Since 2003 an "impediments Committee"<sup>5</sup>, chaired by the Government's Chief Secretary, also addressed certain selected priority business impediments. The committee made sound if cautious progress in rationalising red tape, notably with respect to investment approvals, work permits and visas, and Customs procedures. Since late 2006, however, this valuable committee has been moribund, with the private sector currently urging Government to restore it.

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<sup>4</sup> Consultative, Implementation and Monitoring Council (CIMC)

<sup>5</sup> National Working Group on Impediments to Business and Investment, widely referred to as the Impediments Committee

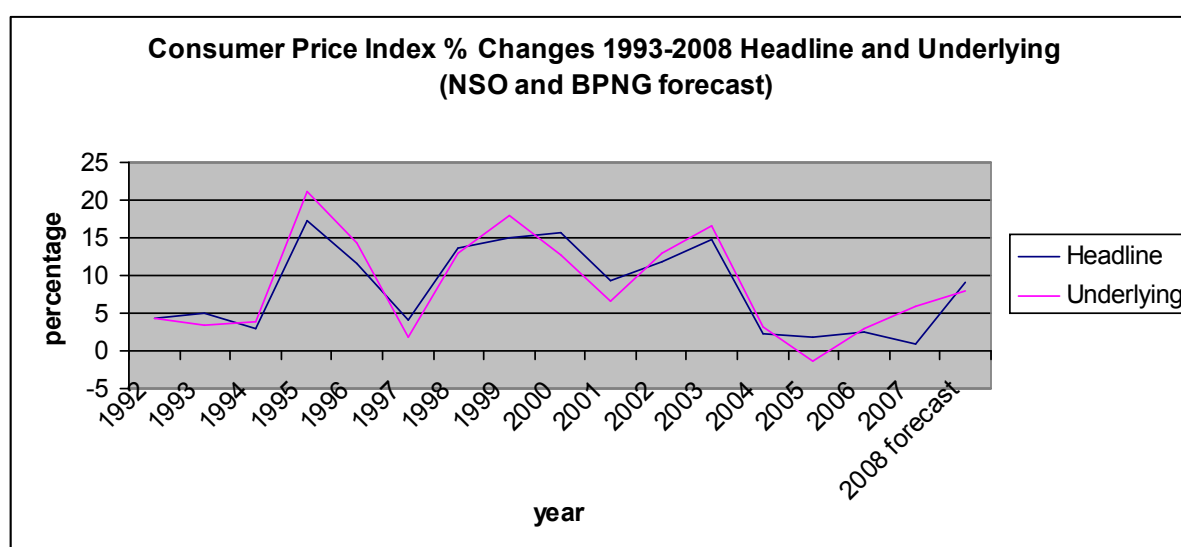
**Ranking of Hindrances to the Business and Investment Climate in PNG**  
(source: INA Private Sector Survey 2007)



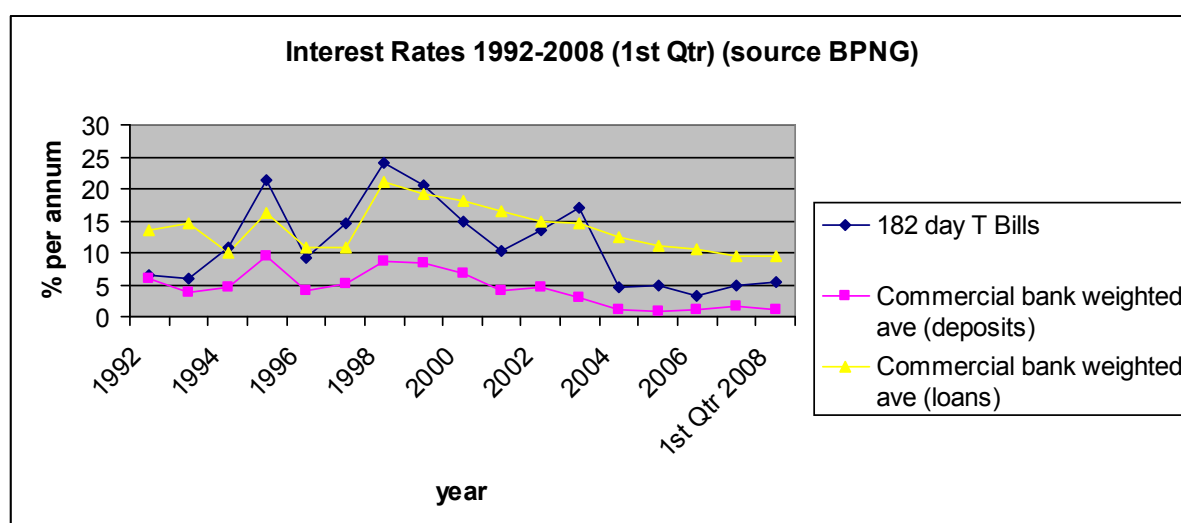
How far have the conditions for sustained economic growth, investment and business activity been achieved now?

**Inflation** has been low and steady since 2004, but started pushing up in 2007 and now forecast by the Central Bank to reach 9% for 2008 (annual headline inflation) <sup>ii</sup>, driven by internal and particularly global inflationary pressures. Many industries and households have already experienced significantly greater cost increases. In addition to externally driven inflation, related notably to higher fuel costs and, during 2008, the surge in food prices linked to global grain shortages and other factors, strong local inflationary pressures have resulted from increased government expenditure (from windfall revenues), higher current demand from the private sector and some consumers and

forecast demand –notably from prospective LNG development, combined with limited supply, including of urban housing, various specialist skills, including engineers and various trades, and local food supplies, in the face of the country’s poor infrastructure and access by farmers to markets. Plans have been developed for addressing constraints, such as land for housing and boosting professional and skills training, but few plans have yet make significant headway in implementation, whilst more attention is needed to restraining ill-planned and unproductive public expenditure (including under the District Support Improvement Program and National Agriculture Development Plan<sup>iii</sup>).

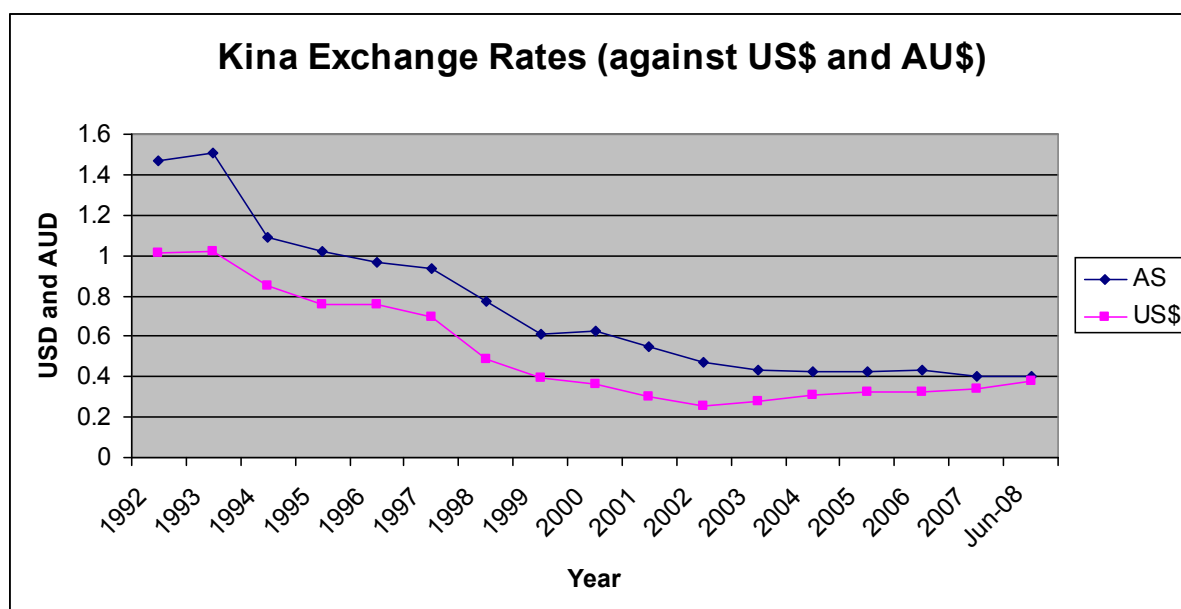


**Interest rates** have also remained low since early 2004, but the higher inflation rates have forced the Bank of PNG into tightening monetary policy, (some would say belatedly) nudging interest rates up and absorbing some of the increased liquidity in the system. The broad money supply (MP3) is estimated to have grown by 32.2% in the first six months of 2008<sup>iv</sup>, but rapid or excessive expenditure, notably on locally supplied goods and services adds to inflationary pressures.





The **kina exchange rate** has, on average, also been steady since early 2002, on both a trade weighted basis and real effective exchange rate (REER), although appreciating against the (declining) US dollar since mid-2002, and depreciating steadily against the Australian dollar since the early 1990s, although virtually levelling out since 2003<sup>v</sup>.



**Debt:** A notable achievement has been the reduction of debt to GDP from about 70% of GDP in 2003 to an estimated 31.9% by mid-2008, albeit largely as a result of the growth in the overall economy, with relatively modest debt repayments. Overseas debt particularly has been reduced, and notably less concessional debt, with a greater portion of the total as domestic debt, carrying lower foreign exchange risk, particularly with respect to servicing costs. Total debt however, remains about 6.5 billion kina, needing to be serviced. This is manageable with a growing economy, but would remain a major burden if growth slowed, and commodity prices and the exchange rate weakened significantly. Further reduction of this debt level during good times, as now, (particularly with current capacity constraints to effective development expenditure) therefore provides a valuable investment for the future, to safeguard a more sustainable economy and consistent expenditure.

**Impediments:** The major impediments to business and investment, as identified in the INA Private Sector Survey 2007, still prevail, starting with poor law and order (notably in certain main centres), rundown infrastructure and services, corruption and excessive bureaucratic red-tape. Significant progress has been made since 2006, utilising improved revenue, to allocate more funds for priorities set in the Medium Term Development Plan<sup>6</sup>, particularly for transport infrastructure (including the major upgrade of Lae<sup>7</sup>, the country's main seaport, which carries more throughput than all the Pacific's other ports, outside Australia and NZ) and for health and educational services (including

<sup>6</sup> Medium Term Development Plan (MTDS) 2005-2010, Government of Papua New Guinea

<sup>7</sup> With ADB co-financing

through 2008 Amendment on Provincial Government financing<sup>8</sup>) and, with slowly addressing bureaucratic impediments, including customs and work-permits and visas. Implementation with implementing these plans remains slow, including implementing the recommendations of the 2004 Police Review (although some funds have been allocated), however much of the Highlands Highway is now in its best state for years, although this critical artery remains very vulnerable to extended disruption from severe landslides<sup>9</sup> and all infrastructure requires ongoing maintenance once repaired.

The relative political stability since 2002 has enhanced needed policy stability, and reinforced business confidence over recent years and months, when combined with the improved market conditions and growing expectations of major LNG development (following the demise of the gas pipeline to Queensland scheme<sup>vi</sup>).

**Prospects:** The prospects for sustainable and balanced economic (and social) development are dependent upon: -

- continued fiscal prudence,
- (more) effective utilisation of current (and potential) increased revenue (particularly in the light of prospective LNG development) in reversing the long-standing infrastructure decline (particularly of rural access roads),
- undertaking immediate and long term public sector capacity building (including improved management, milestone and reporting and through contracting out services and Public-Private Partnerships),
- right sizing the public sector (which means effecting reforms to tailor the public sector to the needs of the economy and wide community, in some cases by trimming back staff numbers and overheads, but in other cases building up numbers and calibre to meet the needs of a growing population and economy),
- providing a genuine commitment by the leadership and practical measures to address the critical law and order and governance problems plaguing the country, including both high level and petty corruption, improving natural resource planning, management (including land and natural resource allocation), transparency and oversight, by strengthening the official watchdog institutions, and empowering the private sector and wider community to oversee planning and implementation processes,
- encourage investment and free and fair competition (starting with information and communication technology –ICT- and communications )to provide improved, more reliable

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<sup>8</sup> Based upon recommendations of the National Economic and Fiscal Commission (NEFC), following their cost of services study and review of sub-national governmental financing

<sup>9</sup> As occurred in mid-2008 in the geologically unstable Sinasina/Dumun stretch of the Highway. The Highway restoration has been co-financed by the Government with AusAID and other donor partners, plus use of the Tax Credit scheme, with Porgera Joint Venture managing the major Sinansina landslide.

and affordable services to business and the community – including for educational purposes) whilst withdrawing State ownership from potential competitive commercial enterprise,

- ensuring adequate, more equitable and sustainable funding and other support for priority human resource development needs, notably, achieving universal primary education (but also greater secondary and more extensive and quality professional and technical education, including for prospective teachers) and accessible health services, medical supplies, and effective preventative and response/treatment programmes (particularly against HIV/AIDS and malaria, which threaten the country's economic and social prospects).

Now is a real turning point for the country; whether it puts boom and bust behind it, by pursuing firm reforms and consistent and sound policies, or whether it remains merely reactive to problems and continues business as usual.

Papua New Guinea is blessed with extensive but not unlimited natural resources. As required in the National Constitution, it must utilise them wisely in the interests of both current and future generations. Its substantial non-renewable resources provide an opportunity, as with development assistance, to invest in the country's infrastructural, renewable and human resources. If it fails to reach resource development agreements with some developers which are fair for the people of Papua New Guinea, fails to invest the proceeds from resource development prudently, particularly in enabling rural communities to access markets and essential services (potentially investing some funds in a secure futures fund, sanitised and well supervised and partly held in offshore investments to reduce inflationary – or other Dutch Disease pressures) or weakens fiscal and monetary management and permits inflation to run out of control or the exchange rate to appreciate excessively, or allows severe resource and environmental degradation, it will jeopardise the prospects for the renewable resources sector, including diversification into new crops, value-adding, and development of immensely valuable industries, such as tourism, and broader-based and more sustainable economic development.

It is doing many things right, but has the potential to achieve much more and be a role model amongst developing countries for sound economic and resource management and accountable government, if the will is there. The choices are there before the whole community now, and involve political, public service but also private sector leaders and the wider community. The impact of those choices will affect the country's whole community now and long into the future. In an increasingly globalised community, the decisions taken affect not only Papua New Guinea's population but also the global community, with, for example, one fifth of the world's valuable tuna stocks in PNG waters, and, with 20% of global carbon release, triggering global warming, calculated as emanating from tropical deforestation and degradation, and with PNG retaining one of the largest remaining areas of relatively intact rainforest.

Sustained and strong economic growth is necessary for PNG, not only to absorb the ever growing prospective workforce, but also progressively engage the large pool of underutilised, largely unskilled but widely disgruntled young people in villages or drawn by the allure of our towns, into both a growing private sector but also dynamic rural and urban informal sector (participating into a wider range of productive and more satisfying and legitimate economic activities).

Major challenges to address include: -

- immediate food security for vulnerable households/communities now, and particularly in future in the face of climate change and potentially more and greater periods of El Nino drought and cyclones, and
- properly preparing for potential LNG development, which if proceeding, as now expected, will have a massive impact upon the economy, potentially positive, at least partly, but also prospectively detrimental, if not seriously addressed, including during the construction phase, when providing relatively little revenue, but absorbing much of the country's technical capacity, away from other industries.



[The country's future depends upon the agriculture sector's continued capacity to provide food and other basic needs for a growing population, whilst agriculture and other renewable resources (including tourism) provide growing opportunities of meaningful employment and income earning. Particularly for younger people, who often feel shut out or disinclined to work in the sector.]

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<sup>i</sup> Private Sector Survey, Institute of National Affairs, 2008

<sup>ii</sup> Bank of Papua New Guinea, Monetary Policy Statement, July 2008

<sup>iii</sup> District Support Improvement Program (DSIP) allocation of K10 million for projects per District and National Agriculture Development Plan (DADP), Department of Agricultural and Livestock (DAL), 2007

<sup>iv</sup> Bank of Papua New Guinea, Monetary Policy Statement, July 2008

<sup>v</sup> Bank of Papua New Guinea, Quarterly Economic Bulletins and Monetary Policy Statement July 2008

<sup>vi</sup> a further shorter pipeline from gas fields around Western Province is now proposed