PNG’s Economy 2012 – past, present and future prospects

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Economic performance: Papua New Guinea’s positive economic growth has now been sustained for a decade, commencing in the early 2000s at, or marginally above the population growth rate, but strengthening progressively. GDP growth has remained above 6% since 2007, even during 2009, when much of the world was embroiled in the Global Financial Crisis and associated economic recession. The PNG economy suffered only a relatively modest dip during the GFC, thanks to strong bank liquidity, partial immunisation from global financial markets, active ongoing capital investment, and continued strong demand and prices for some of the country’s major export products during the crisis, notably gold (but also, for rural communities, products like cocoa).

GDP growth swiftly rebounded after the 2009 dip, fuelled by buoyant demand for prevailing export products, particularly from the stronger Asian (notably Chinese) economies, and development of associated major new resource investment projects. The growth rate for 2012 was revised upwards by the Treasury to a robust 9.9%, or 10.4% for non-mineral GDP, forecasts for 2013, however, suggest growth slipping back to 3.8%, with mineral and agricultural commodity prices having slid back over recent months, the construction phase for the major PNG LNG project winding down from its August 2012 peak and several of the country’s current major resource projects (including Kutubu oil) in late maturity. The official forecast for 2014 is stronger growth (6.5%), with the PNG LNG project scheduled to come on-stream late that year, rising to just over 21% in 2015, the first full year of production, before tailing off to a more sustainable 5% thereafter, (well below forecasts, e.g. the ACIL-Tasman study, envisaging a more than doubling of GDP). It should be noted that whilst the extractive industries are dominant in terms of export and revenue, in terms of GDP contribution the renewable resources sector remains on a par with the extractives, with the former’s role much
more critical in terms of household income generation. It must also be recognised that GDP is a record of total economic activity, with GNP better reflecting the level of activity and benefit retained within PNG, after repayments and remittances are made by international investors and staff; a figure which is markedly lower than GDP for a country like PNG, with its relatively small domestic capital market and continued (and undoubtedly excessive) dependence upon overseas skilled labour.

After two decades of lacklustre economic performance in the 1980s and 90s, with growth routinely trailing the rapid population rise, but including a period of wildly fluctuating growth rates during the 1990s, the more robust growth of the past decade is a reflection largely of the strong international demand for PNG’s export products and some associated investment. This externally-driven economic boost is reflected also in the strong results in other resource rich nations, from Australia to many hitherto ailing African economies.
PNG’s development paradox is that it is a land of relatively abundant natural resources, and yet over the years (despite multiple large extractive industry projects) its economic performance has been poor and, even after a decade of positive economic growth, it has failed to provide the level of expected broad-based economic and social opportunities for the majority of its population, retaining some of the worst social indicators in the Asia-Pacific region. The challenge is to take advantage of its resources and utilise them to generate broad-based economic opportunities, notably through empowering its citizens and micro-small-medium businesses, particularly. The mining and hydrocarbons sector play a valuable role in generating economic activity and providing core revenue for the State to perform its functions, but PNG LNG, employing some 600 or so staff once in production, and even mining, still only play a relatively modest role in direct employment and household income generation, which depends substantially upon the effectiveness of public expenditure by the State and the multiplier effect from minerals activity.

Despite the country’s relative resource wealth, PNG is also constrained by geographical factors, which raise total and unit costs of establishing and sustaining infrastructure, service provision and market access to a widely dispersed population. Performance has been undermined by poor economic management, governance and coordination, with deficient expenditure and accountability of spending on core public goods, notably transport and other basic infrastructure, and particularly its maintenance, but also on effective service provision in law and order, education and accessible health services. Unreliable and costly transport infrastructure, core utilities and services raise the costs of business and investment, whether by large corporate investors or micro-enterprises, such as smallholder farmers, who provide the majority of agricultural production, including a substantial portion of agricultural exports. Undercapitalised, unduly politicised and under-performing state-owned enterprises, often enjoying major monopolies, held back utilities and various services to business and consumers alike.

Complementing the more positive international market conditions, the improved economic performance of the 2000s resulted partly also from improved fiscal planning and management and some structural reforms early in the decade to improve markets and governance, leading subsequently to greater private investment and competition in some industries. This included industries formerly dominated by poor performing public monopolies or local monopolies, notably in banking and ITC (commencing with competition in mobile telephony from mid-2007), and thereafter provided openings for broader-based economic growth and benefits. The improved prices covered a broad range of commodities, including agricultural, extending benefits beyond the enclave industries and main cities, to rural households with access to land and markets, although continued poor core transport infrastructure and market access, including deficient provision, standards and competition in shipping services, and weak law and order, education and training and related services all combine to undermine opportunities for broad-based economic opportunities and capacity to contribute to the economy.

2012 has seen renewed uncertainty in global markets, driven by the festering debt crisis in the Eurozone, uncertain and stalling recovery in the US, in turn undermining market demand for exports from East Asia. Even the formerly buoyant ‘BRIC’ economies have been faltering, with India verging on recession after seemingly deficient structural and market reforms and China too slipping below their psychological 8% growth yardstick. Over the next weeks there will be considerable reading of tea leaves by market analysts, grabbing all economic and market data nervously to find signs of
recovery, or otherwise, in the latest figures on sales, employment, debt, new loans, investment and stocks. The outcome and the duration of economic uncertainty may be determined substantially by the level (or otherwise) of international economic cooperation and determination by governments and central banks. It will also be determined by prudent economic management, based upon well researched evidence, over, for example, tight fiscal restraint versus further boosting aggregate demand, with emphasis on growth, including whether further debt and use of tools such as quantitative easing are constructive or counterproductive in the longer term. In any case, if it is not effectively addressed internationally, this time round Papua New Guinea will not be able to slip out relatively unscathed, as before, particularly if it drags in PNG’s new market outlets in Asia more directly, and with less immediate prospects for domestically driven recovery. It is also critical that there is no reversion to protectionism in the face of possible shortages of staple foods (from US/Ukraine etc) and that PNG doesn’t encourage reciprocal countermeasures by arbitrary application of heavy tariffs to promote selected domestic industries.

Construction boom in PNG’s major urban centres, in the footsteps of strong commodity markets, resource sector development and accumulating superannuation fund capital

During the first half of 2012 economic growth in PNG has been strong, despite the prevailing political tensions, which were in effect resolved with the mid-year National Elections. The Central Bank’s ongoing sample surveys record strong sales and employment growth. BPNG has also consistently discouraged major public infrastructure investment adding to an already well-heated market, to be deferred until PNG LNG commences laying off contractors and employees from mid-year, when spare capacity become available and potentially more affordable and the need greater.

Liquidity levels remain strong, partly driven by the build up of foreign exchange reserves. The Balance of Payments is officially forecast at a K1.1 billion surplus, with continued major foreign direct investment, particularly LNG capital investment. Projected foreign exchange reserves of US$4.3 billion provide 6.6 month of total import cover, slightly down from 2011, but an increase in non-mineral cover.
The K0.5 billion budget deficit in the first six months of 2012, following seemingly overly optimistic commodity price and mineral revenue forecasts, perhaps pressured by major expenditure commitments during an election year, sounds cautionary bells against the fiscal swings and troughs of the 1990s. It encourages the need for fiscal prudence, which was the hallmark of the 2000s, with the introduction of the fiscal and debt strategies and Fiscal Responsibility Act 2006, and particularly cautions against over-expectations, based upon LNG and mineral revenues and against pre-committing future revenue and building up debt levels and contingent liabilities again.

Although the money supply has continued to grow at over 10%p.a., headline inflation dropped away in late 2011 and 2012 (from 6.9% for 2011 to 1.4% for the first 6 months of 2012; forecast at 3% for the year) with the appreciation of the kina, even though import lower costs seemed to be passed on to consumers both belatedly and inadequately by many traders. By contrast, the kina’s higher value, driven up by large capital inflows, has been seriously undermining incomes, profitability and even viability of various export and import replacement industries, notably in agriculture, but also tourism and manufacturing, at a time when commodity prices had also been sliding. This further highlights the hazards of a dual or two speed economy, as also experienced less starkly in Australia, and the so-called ‘Dutch Disease’.

Dutch disease impacts are inevitable with major resource projects, especially in a relatively small economy, and can severely detract from potential benefits from major resource extraction or other boom industries. Many of the most successful economies have been those with limited natural resources, investing heavily in their human resources, whilst many resource rich countries have performed poorly. Countries, such as Nigeria, Equatorial Guinea and Chad, have demonstrated the negative economic impacts of major resource extraction, for example virtually losing their agricultural sectors, which, as in PNG, provided the bulk of employment. The impact can be mitigated, however, and positive lessons exist from both developed and developing countries, from Norway to Botswana, Malaysia, but even Indonesia, each demonstrating lessons in safeguarding the rest of their economy, utilising various monetary and fiscal measures, including in some cases use of sovereign wealth funds, but emphasising budget transparency (and tools such as EITI), effective investment in core infrastructure to enable broader opportunities and encouraging structural reforms to ensure more competitive markets and efficient service provision.

Papua New Guinea has the capacity to learn from these lessons from overseas and its own past, with strong cautionary messages over poor fiscal management and imprudent borrowing against future earnings. The SWF, as already legislated for PNG, can be a valuable tool, but, as with experience of the MRSF in the 1990s, will prove counterproductive unless managed scrupulously, with strong adherence to the Santiago principles for SWF management.
Employment: Formal sector employment grew firmly from 2004 until 2012, extending somewhat unevenly into all sectors and regions until 2008, and somewhat less consistently subsequently, according to BPNG’s sample survey. Some regions, provinces and cities, such as Morobe and Lae saw jobs increasing well above average, NCD, more slowly but steadily, but the Highlands region on average showed little growth since 2008, with that growth concentrated locally, notably around the LNG development in Hela Province. This is disappointing considering the size of the total population of the Highlands region, and occurred despite a strong year for coffee prices and yields in 2011.

The survey shows stronger growth in some industries, such as wholesale and latterly transport, with formal sector agricultural employment growing firmly, notably in oil palm in selected coastal provinces, but only mineral oil contracting (and individual crops, like cocoa in areas affected by CPB). After the strong expansion of construction from 2004-2008, the growth has tailed off, albeit at a steady and greater level since then, whilst financial sector growth has trailed behind the average.

Papua New Guinea’s formal sector remains small and, despite growth, inadequate to meet the needs and expectations of PNG’s rapidly growing population (est. at approx. 2.7% p.a.). The labour market suffers from intermittent bulges, such as LNG construction, where shortfalls of skilled labour are met by overseas staffing. It is never possible to precisely attune supply with the shifting skills required by employers, but creating improved investment conditions to generate increased and longer term formal and informal employment opportunities and better adapting the education and training capacity to meet the market needs with a suitable skilled and adaptable workforce will be critical over the next years. This will require labour market research and routine dialogue between government and the private sector, education providers and employers, and better partnerships in supporting technical and vocation training colleges and workplace training and apprenticeship.

Particularly with PNG’s high cost of living the phased increase in the mandatory Minimum Wage (over 2009/10) was overdue for low earning employees, but with the high costs of doing business...
(with poor infrastructure, law and order costs etc) and latterly appreciation of the kina, further wage pressure will also jeopardise the viability and prospects of various industries, particularly in some of the crucial activities which generate most work, like agriculture. It is important, therefore, that further wage appreciation in future is linked, where practical, to productivity gains, from skills development, and other measures to reduce production and marketing bottlenecks. It is also important that rules that are introduced are applied across the board, with those less-scrupulous or well-connected lokal or overseas)businesses sidestepping them, and undermining market competitiveness.

Demographic data is largely unavailable, outdated or unreliable for PNG. Although the quality of the 2011 National Census seems mixed, during 2000-2011 there seemed to be a substantial population drift towards urban centres and resource projects, including the proximity of mines, by people seeking employment and better basic services, partly following years of neglect of many rural areas.

The smallholder agriculture sector and informal economy continue to provide subsistence and income earning opportunities for the majority of the population, producing the majority of food and most of PNG’s export cash crops (such as coffee, cocoa, copra and large portion of the oil palm). They are ill-served with infrastructure and services, but a new Informal Economy Policy was launched in 2011, and recognises the critical importance of this sector to the whole economy. The policy emphasises access to suitable infrastructure, training and support services, and particularly financial inclusion and literacy.

![Formal Sector Employment Growth 2001-2012 (BPNG Employment Survey)](image)
Commodities and markets: Commodity prices for PNG’s exports largely regained or exceeded their high levels of mid-2008 (in US Dollar terms), by the first two quarters of 2011. With the appreciation of the kina against the US dollar (and most currencies) the strong recovery has been marked, if less dramatic. Since mid-2011 most of PNG export commodities, both mineral/hydrocarbon and agricultural, have taken a sharp downward adjustment, as with copper, or in some cases severe battering, as with cocoa and some vegetable oils like coconut oil, especially when reinforced by the kina’s appreciation. Largely prices remain significantly stronger than during the mid-2000s commodity price hike, but for some products, including cocoa, also facing severe disease outbreaks (CPB), it is undermining both new investment, but also survival of remaining estates and smallholder production.

As a primary producer, Papua New Guinea, almost uniquely in the East Asia and Pacific region, was a net beneficiary from the high commodity prices, including oil, and with the majority of the population still engaged in agricultural production. Various industries and households within the community have been winners, from these high prices and suffering from their recent decline and appreciation of the kina; others, such as urban households on fixed or low incomes and suffering from recent astronomical living costs, were losers from these high commodity prices, especially as PNG enjoys no formal social protection arrangements. These households, however have benefited from the recent currency appreciation, including lower energy costs. High commodity prices and weak governance have also fuelled speculative land and resource grabbing (termed SABLs), marginalising the rights of customary resource owners, but also restricting options and potentially undermining genuine investment and resource management initiatives. Lack of rigorous process, entailing customary landowner consultation and free and informed consent, invariably undermines prospects for successful project development, which requires adequate investment in thorough groundwork. Land and ILG laws have recently been amended to facilitate genuine land-based development, embracing the local community, but aimed at eliminating land and forest grabbing under false guises. Time will tell whether these reforms will be effective, but that will also be influenced by how far it is resourced and supported.
China’s role in commodity markets has increased greatly in recent years, reflecting its size and rapid economic growth. It accounts for over 40% of global base metal demand, 23% of agricultural commodities and 20% of energy, with growth still a fair way to go before stabilising. Although much demand is for re-exporting of manufactured products to (currently troubled) western markets, its domestic market is vast and growing, even if on a declining basis in the face of domestic market stresses and some overheating and even local property bubbles. Although a substantial supplier of some commodities China is heavily dependent on imported metals, much of its energy and substantial food quantities and has been actively seeking to improve access, security and, in some cases, ownership of supply sources. Even with uncertain global markets and problems from Europe to India, and a subdued Chinese market, barring major new supply sources, (e.g. of shale oil), with the level of potential sustained demand it is unlikely that commodity prices will be depressed too low or for too long.

For PNG increased East Asian demand poses opportunities and risks, and, as with resource extraction investment and supply contracts with any market, it is crucial that PNG is well advised and negotiates rigorously and professionally for its best interests, rather than readily conceding uncompetitive or concessionary investment conditions, for example with extended tax holiday or exemptions to local employment conditions or environmental standards. PNG should develop its resources progressively but unhurriedly, ensuring local benefits, including local employment and capacity building, are maximised, whilst it is crucial that extraction is not at the expense of its relatively pristine natural environment, which provides the livelihood for the majority of the population and a unique basis and opportunity for economic development, marketing goods and services to consumers in already heavily polluted countries.
Commodity Exports - Quantity 1999-2011
('000 tonnes or specified) (BPNG & Treasury)

PNG Export Destinations -1976-2011
(value K million, BPNG)
Production and Trade: Despite strong commodity prices in recent years, except for oil palm (and logs), this strength has not been reflected in increased output, either in the mineral or agricultural sector. Major new investment and reinvestment has occurred in oil palm, which also achieves premium prices on the basis of its certification as ‘sustainable production’ under RSPO. The PNG oil palm industry, the country’s most successful agricultural activity in recent years, however remains sensitive to price and factors which raise domestic costs and reduce kina returns, such as currency appreciation, which jeopardise its competitiveness. It is a concern that recent increased agricultural earnings gained from the production and export (or import replacement) remain attributable largely to improved prices, with limited supply response or further direct investment. Some positive initiatives are being taken to encourage agricultural production and access to niche markets, but poor access to markets, credit, training and institutional support, and local law and order and land security problems reduce farmer incentives. The kina’s recent appreciation and lower commodity prices jeopardises prospects further, whilst limited support to the sector from development partners remains disappointing.

The increased log exports reflects both stronger prices, weak oversight, but especially easy access in recent years to new forest resources, widely obtained by some interests under special agricultural and business leases (SABLs), purportedly for agricultural projects. With 5.2 million hectares, obtained over the past six years as SABLs, largely without the owners’ free and informed consent, this back door mechanism largely to obtain timber, sidestepping the requirements for forestry projects under the Forestry Act, has been subject to a Commission of Inquiry in 2011/12, and undermines both sound forestry practice and genuine agricultural investment.
In the case of minerals and hydrocarbons, the improved market (and since the early 2000s, investment) conditions resulted in increased investment in exploration and several major and smaller-scale projects being formulated and in a few cases developed, or plans for existing projects such as Ok Tedi, to be extended or enter phases. Mineral sector output remains dominated by a few, largely aging, operations, notably Ok Tedi, Kutubu oil, Porgera plus the somewhat more recent Lihir gold mine. The mines overtook agriculture for export earnings in 1984 and have dominated export earnings since. Mining and petroleum have also provided a major, though volatile portion of total tax revenue, depending greatly upon prevailing prices and profitability. Some projects have enjoyed extended tax holidays which has deferred contribution from mining tax, although royalties and, where the state holds equity, as with Kutubu oil and PNG LNG revenue is also gained through dividends. Although some mining operations have commenced production in recent years, albeit belatedly in the case of Ramu-Nickel, government revenue is likely to be very tight until 2015, when modest PNG revenue is gained, but merely replacing revenue from old mining projects. PNG LNG’s more substantial tax revenue will not be available in substance until next decade, and in the meantime the State must focus on more targeted and efficient use of revenue available, including investment in access, restoring and maintaining infrastructure and empowerment, including through PPPs and private investment in infrastructure and services, without driving up debt by borrowing heavily against future earnings.

![ Mining and Petroleum Taxes as % of Total Tax Revenue ](chart)

new oil palm plantings, Ramu valley, Madang Province
Whilst the minerals (including oil and quarrying) industry was calculated as only comprising 18.1% of GDP in 2011, and even forecast by the Treasury to slip to 14.9% in 2013 (prior to LNG production), rising to 27.6% in 2015, the full year of LNG production, minerals/oil provided 88% of export earning in 2007, slipping back to 78% in 2009 and 71% in 2011.

By contrast agriculture, forestry and fisheries are calculated at providing 32% of GDP in 2009, slipping to 30.5% in 2011 and forecast to drop to 24.5% in 2015, but only 19% of exports earnings in 2007, rising proportionately to 21% in 2009 and 26% in 2011, with the lower copper price and reduced oil exports. Apart from 2006-7, when copper prices rocketed, gold has been PNG’s premier export, closely shadowed by oil until 2008, when it dropped away. Gold comprised 45% of total export earnings in 2009, slipping back to 36% in 2011, against copper at only 17% in 2009 and 19% in 2011 (down from 34% in 2006) and oil with 14% in 2009 and 15% in 2011, against 31% in 2001.

The first six months of 2012, left gold, copper and oil with 35%, 18% and 16% of total exports respectively, with copper likely to slip back for the balance of the year, but export value overall declining parallel with other non-mineral commodities. Agriculture, forestry and fisheries together comprised 25% of exports for the first six months of 2012, and will be constrained if global prices, from palm oil to coffee remain depressed, and diseases, such as CPB fail to be addressed with rigorous new farm management systems. The major agricultural export crop, palm oil increased from 3% of total exports by value in 2006 to 9% (K1.5 billion - 572,000 tonnes) in 2011, but with substantially lower prices in 2012, this figure will be lower; (actual export value is higher when incorporating refined palm oil). Exports quantities will likely rise during this decade, assuming viability is sustained, even while the percentage of total exports is reduced commencement of LNG production. Some new oil palm schemes are also likely to commence, but other proposed schemes appear to be forest/land grabs rather than genuine agricultural projects. Coffee export value rose from 4-6% between 2009 and 2011 (from K460-K927 million -73,500 tonnes), on the back of higher prices, but these prices have fallen back sharply in 2012 and cocoa slipped back during that period from 3-2% (K338-320 million – 47,000 tonnes). The number of PNG households dependent for income and employment directly or indirectly upon these agricultural crops (in formal and informal sectors) far exceed those in the mining and oil sectors, with nearly half the households, and markedly more in the Highlands region, in coffee production alone.

After a further likely decline in gold and copper exports in the short term with aging projects, these metals are expected to pick up over the decade as new projects of different scale are commissioned, notably the major prospective Wafi copper/gold mine in Morobe province, and with Nickel-cobalt from Madang province, which commenced belatedly during 2012. From late 2014 LNG from the PNG LNG gas fields in Southern Highlands and adjoining provinces will become the predominant export earner by a long margin, perhaps joined later in the decade by additional gas exports from supplementary fields in Gulf province and elsewhere.

Global staple food prices have been rising with crop shortages in the Asian and US food bowls, and latterly lower than expected Australian wheat crop. This may drive up consumer prices and prices for some domestically produced products, but is unlikely to affect PNG’s agricultural export crops, unless exceptional (e.g. possible El Nino) conditions also affect main producing countries over the next year. Some of the major vegetable oil markets are now more integrated with mineral oil markets than their traditional food substitutes these days.
Overseas visitor numbers were recorded as rising from 52,000 in 2002 to 160,000 in 2011, but of this only 21% identified themselves as bona-fide tourists. Apart from statistical errors, despite strong growth in the market, associated with trekking and other adventure tourism, plus some cruises, this remains a very small number in relation to major Pacific tourism destinations, like Fiji, Vanuatu and Samoa. Despite the country’s immense natural and cultural appeal, it still remains largely off-limits for the tourism trade, owing to high costs, limited tourism infrastructure and services and perceived risks in some centres and localities.

The world’s major remaining tuna resource lies in the West & Central Pacific, largely in PNG and adjoining waters. It is harvested largely by offshore-based international licensed vessels, although since the mid-1990s several operations have based part of their fleet in PNG and processed and exported some of their catch onshore, for export particularly to the EU market under an interim EPA’s preferential access. Exports were recorded in 2011 at K259 million, but this greatly understates the value of produce harvested in PNG waters, with the retained national benefits for much of the catch merely from license fees. Plans are afoot for establishing greater economies of scale for onshore-based operators, although the scheme is controversial amongst local village communities in Madang province. The locally-owned long-line fishing industry which grew in the early 2000s, suffered from high operating costs and related marketing constraints. The valuable tuna resource and industry, is dependent upon firm research and management of its harvesting, and upon ensuring the relatively undisturbed and unpolluted nature of the oceans in the PNG’s vicinity, with a need for extensive non-fishing, or marine protected areas, to protect marine stocks and habitats.

Log and processed timber exports leapt to K768 million in 2011 (4.5% of exports) from K410 million in 2009, a 170% increase in quantity to 3.5 million cu metres, substantially on the back of unsustainable forest clearance in the guise of agricultural development. With the industry notoriously prone to transfer pricing and its statistics problematic, these figures, based substantially on prices quoted by operators, will no doubt understate reality.

Economic Indicators and conditions for more sustainable development

Debt: Public debt to GDP was reduced from its peak of 72% of GDP in 2003 to 23.2% by the end of 2011, largely as a result of the growth in the overall economy, but also progressive debt repayments. Whilst the burden of debt has been dragging down various developed economies (notably in
southern Europe), at over 100% of GDP in Japan, Zimbabwe, and some European states, and over 60% in much of North America and the rest of Europe, in turn contributing to global economic uncertainty, many of the emerging markets and developing countries are below 50%, and in some cases less than 10%. PNG’s recent experience parallels that of many resource rich African states, benefiting from higher commodity prices, stronger growth rates and reduced debt levels over the past 10 years. However a budget deficit emerged in PNG in the first 6 months of 2012, and contingent liabilities have grown strongly, associated with acquisition of equity in resource projects, notably PNG LNG, wherein the risk is shouldered squarely by the State of PNG, with the upside retained by the creditor. Further proposed heavy non-concessional EXIM bank borrowing for a relatively unspecfic mix of infrastructure projects, secured against LNG and future LNG earnings, risks reversing many of the gains of the past decade’s prudent fiscal management. Whilst addressing infrastructure needs is high, emphasis needs to be on restoration and maintenance and accountability, including on effective mechanisms for routinely managing State assets at national and local levels, and complementing State investment with private investments and partnerships, plus competition where practical with private transport and communications services.

**Inflation:** The decade to 2002 was marked by extreme volatility and extended periods of high inflation. Inflation was reigned in in the years to 2006, but leapt up to 10.8-13% (according to
differing official figures) in 2008, with the rise of commodity prices (including fuel and food) and revenue and weakening of fiscal and monetary restraint, including under the leaky and poorly utilised government trust funds. Inflation fell back in 2009 to below 6%, but then fluctuated at a higher level until 2011, driven by boom sectors, major investments and supply shortages particularly in certain centres, combined with continued loose financial control over District grants and so-called ‘windfall revenue’ held in trust funds; (a supposed stabilisation and investment precursor of the sovereign wealth fund, but highlighting why the SWF needs to be managed markedly more scrupulously for managing and sanitising a portion of major resource revenue flows and fluctuations).

The Consumer Price Index started to fall in late 2011 and into 2012, largely as a result of the appreciation of the kina against all PNG’s major traded currencies, but also reduced external inflationary pressure from lower global prices for food and oil, (which make up a significant component of most production and marketing costs), and the removal of school fees from household costs under the ‘free education’ policy, introduced by the O’Neill/Namah government after gaining power in August 2011. So, despite continued high levels of monetary growth, major investment at the peak of the construction phase for PNGLNG, and despite increased public expenditure (including on free education) particularly during the 2012 Election year, nevertheless the headline inflation rate was recorded as falling to 1.4% in the first 6 months of 2012, and expected by BPNG to remain at 3% for the year. This has been achieved despite the apparent reticence of many traders to pass on the benefits from the currency appreciation fully or in a timely manner to consumers.

Some domestic and external factors may impose inflationary pressures over coming months, including following poor grain harvests, notably with drought conditions in some major global food bowls during recent months, perhaps impacting wheat and some other staple food prices; a situation made worse in the event of protective practices being applied in producer or other States.

The representativeness of the Consumer Price Index has diminished with the long delay in updating the basket of items which compose the index to reflect the expenditure patterns prevalent in contemporary urban and rural PNG. Major expenditure items, such as mobile phone use, but also other electrical and electronic items, for example, are not incorporated or adequately reflected in the CPI, and the appreciation of the property/rental market is widely considered inadequately reflected in the CPI, especially during the years when these costs rose astronomically. The availability of competition in various industries, as in mobile telephony from mid-2007, also needs to be fully reflected, albeit with greatly increased adoption rates. The Household Income and Expenditure Survey (HIES) was finally undertaken in 2009, with results released in late 2012. These expenditure patterns should now be incorporated into a more accurate contemporary CPI. Although adoption of mobile technology and other electronic equipment has increased markedly since 2009, the HIES demonstrates the high ownership rate, for example of televisions in urban areas by then, and mobile equipment particularly in urban, but already extensively also in some rural areas.

High demand for accommodation in major urban centres (notably Lae and NCD) during the on-going LNG construction phase and following years of strong commodity-led economic boom, and apparent strong urban drift, led by both push-pull factors, combined with deficient land available on the formal market (i.e. not in customary title) has encouraged an almost meteoric rise in the cost of
rentals and real estate in these centres, to levels on a par or exceeding those of capital cities in rich developed countries. With the market responding to some degree, with extensive (largely top end) residential, hotel and office building, and the release of some customary land through informal and, in some cases, formal arrangements, it seems that the rental and property market has levelled off and is showing signs of slipping back, perhaps particularly as the workforce and contracts associated with the LNG construction diminish over the next months. As property investors’ books should not have expected unsustainably high rentals and valuations this should not unduly affect the market, except those who may have unwisely borrowed at the market peak and be negatively geared. On the other hand reduced rentals and prices would make an immensely positive effect on other households, businesses and whole industries, often unable to recruit or retain critical staff.

**Consumer Price Index 1992-2015 (proj)**

NSO and Treasury forecast (%)

- Headline
- Underlying
- Budget 2012

**Interest rates** have also remained low since early 2004, but the higher inflation rates forced the Bank of PNG into tightening monetary policy in 2008, nudging interest rates up, with the Kina Facility Rate raised to 8%, to absorb some of the increased liquidity and dampen commercial bank lending. From late 2009 the KFR was reduced to 7% until mid-2011 when BPNG progressively raised the Rate back to 8% in June 2012, over concern over the high level of liquidity in the banking sector, but the Bank eased monetary policy again in the 3rd quarter of 2012 following the low inflation figures for the first 6 months of the year. With a variety of internal and external factors with potential for driving inflationary pressures again, the Central Bank will be vigilant and ready to tighten monetary measures again. With some of these pressures resulting from loose fiscal control in the 1st two quarters, there is clearly a need for coordinated monetary and fiscal management over the balance of the year and into 2013 (including the Government better utilising BPNG in hosting and overseeing Deposits in public Trust Accounts).
The kina exchange rate depreciated heavily against all currencies in the 1990s, contributing to the heavy inflationary pressures, but also safeguarding the survival of agricultural industries, especially during a period of low commodity prices. Exchange rates during the 2000s have been relatively stable, appreciating briefly with the high commodity prices for PNG’s exports in 2008, but then appreciating against both the US and Australian dollars, and most other currencies (and trade weighted averages), through 2011 and 2012, by 8.9% year on year to the end third quarter of 2012 against the SU$ and 10% against the AU$. The currency appreciation reflected particularly strong foreign exchange inflows related to the PNG LNG construction phase, building up to its peak in August 2012, and firm commodity prices and export earnings, particularly in 2011.

Without unforeseen factors, such as further major variations in commodity prices, it seems likely that the kina has now reached its ceiling, with the construction phase having peaked during 2012 and with weaker prevailing commodity prices and export earnings, at least until LNG earnings are scheduled to commence in late 2014. It will then be a priority to restrain further undue currency appreciation if particularly the non-mining/gas sectors (notably agriculture) are to maintain their competitiveness and broad-based employment and household incomes earning prospects safeguarded for the future. This is partly the function of the (onshore managed, offshore invested) sovereign wealth fund, if managed effectively, but is a task made easier by the fact that most of these LNG earnings will initially flow straight back offshore, notably to service debt and for dividends, with the relatively limited amount retained onshore, largely by government(s) substantially replacing revenue from other declining sources.
Balance of Payments: In general, PNG’s experiences a positive balance of trade in goods (with exports exceeding K15.5 bill p.a. since 2010, against imports of below K10 billion, until the major LNG related plant/equipment imports), which is typically countered by a deficit on services (of over K6.6 billion p.a. since 2010) and a deficit Income balance. Combined, these comprise the Current account, which enjoyed a few years of strong export-led surpluses until 2009, but since then, apart from a nominal surplus in 2011, has experienced a significant and in 2012 substantial deficit (forecast at just over K7 billion). This is largely a result of the trade deficit associated with the import of plant and equipment for the PNG LNG project, particularly during 2012, and the decline in export earnings over the past year. The current account deficit was offset by the larger inflows on the capital and financial account, notably in 2012 (forecast at K8.2 bill), related to LNG and other major new investments, leaving an overall balance of payments surplus rising to over K1 billion (forecast) for 2012. With the construction phase for LNG having peaked in 2012, and in the absence of any further hike in commodity prices, in the somewhat unlikely event of a hike in the global economy and demand, it is expected that the balance of payments surplus will decline in 2013, but remain in positive territory, and then start to pick up with LNG production commencing, leading to a positive current account in 2014, despite a build up in transfers and debt servicing out of the country.

Foreign exchange reserves, which had been exhausted on successive occasions in the 1990s, built up progressively during the 2000s, reaching K9.3 billion by the end of 2011, or 11.5 months of total import cover (or 16.7 months of non-mineral cover). By the end of 2012 BPNG is forecasting a slight decline to just over K9 billion (US$ 4.35 billion), comprising only 6.6 months total cover with the exceptional imports occurring in 2012, but building up again in 2013 and 2014 to over 10 months total cover, when capital imports will have resumed more normal levels.
Fiscal Management: Government revenue (excluding grants) peaked at 6.3 billion kina in 2007, before slipping back and recovering again by 2010 (at K6.9 bill), rising to nearly K8.25 billion for 2011, of which about 96% is from income taxes and 24% from mining and petroleum taxes. With a K513 million deficit in the first six months of 2012, owing to low tax revenues from over-optimistically forecast commodity prices, and high expenditure with the implementation of the free education, plus heavy (i.e. loose) expenditure during the Election year, the Government seems inclined to borrow domestically, thereby raising debt levels to GDP to 25.6%. This is well within reasonable debt levels except that it’s occurring at a time of solid revenue and economic activity, and prior to a couple of years of likely tighter revenue and when contingent liabilities have risen over the State’s equity acquisition in major projects. Plans are also afoot for major and largely non-concessional (K6 billion+) Exim bank borrowing with all the forex risk for major, but partly undetermined, public infrastructure, tied to future revenue, notably from LNG.

This appears to run counter to the principles of fiscal prudence under the medium term fiscal and debt strategies and the Fiscal Responsibility Act, which were substantially amongst the foundations for the economic recovery of the past decade. Whilst ensuring reliable transport (and other) infrastructure is a prerequisite for broad-based economic development, major borrowing of this nature also runs counter to the principles for having a sovereign wealth fund, to facilitate fiscal and monetary stability and ensure steady expenditure on real priorities, including infrastructure restoration and maintenance, whilst safeguarding viability for the non-boom sectors. Past Exim-bank borrowing (from other EXIM banks) has tended to provide uncompetitive contracting, with costs well above alternatives, and failed to provide opportunities for local businesses and local multiplier effects into the economy.

Tax revenue is expected to remain relatively stable, at least until 2016, barring major shifts in global demand and commodity prices, with mining and petroleum/gas taxes declining from their peak of nearly K2 billion in 2011 (still well below the peak of K2.3 bill in 2007, nearly 40% of total non-grant revenue). Dividend receipts from mineral (notably gas) projects are expected to partly make up the shortfall in mineral revenue by 2016, although more substantial revenue benefits from LNG will not be available until the end of the decade, notably when project debt levels have been reduced. Revenue from other sources, notably personal and company income tax and GST are forecast to provide the major growth over the next years, after the relative commodity lull until 2015, but this will clearly depend upon various external factors, related to the global economic climate, and internal factors, notably the capacity to boost or in some cases sustain the growth of business and investment outside the mineral sector, as well as proceed with the development of at least some other major mining operations.
Investment Conditions and Mechanisms for Addressing Industry Issues: Key impediments to business and investment in PNG were highlighted in the INA’s 2007 Private Sector Assessment, which ranked law and order problems, corruption, the poor state of infrastructure and utilities (such as reliable electricity provision) and political instability as the main concerns, closely followed by availability of skilled labour, exchange rate stability and access to secure land. (This survey is carried out by the INA every 5 years to coincide with the Election and formation of a new Government. A successor survey is being undertaken in 2012, but has not yet been concluded, largely as a result of an response rate, to date – 400 responses are sought. This is a valuable survey, the results of which are widely quoted and are designed to inform policy making by government, but also contribute to policies, programs and funding from development partners. Businesses which have not yet responded/or resent their questionnaires back to the INA are kindly urged to do so in the near future. It is recognised that filling questionnaires is time consuming and, when busy, readily put aside for a later date, or even disposed of in the bin, but you are all requested, whether large or small firms, overseas or locally owned, to complete this immensely valuable survey, which is essentially your survey. The individual responses are also strictly confidential).
Since the 2007 survey was conducted, business activity has grown immensely in many industries, costs of living and doing business have increased considerably in some centres, notably Lae and NCD, particularly with the high rentals/accommodation costs, certain skilled staff and contractors have become less available and costlier to access, at least for the interim during the prevailing LNG construction phases, the minimum wage formally has been increased and is likely to be reviewed again in 2013, infrastructure has not improved, except telecommunications (although internet remains exorbitant), domestic air and sea passenger services have been set back badly by a succession of major accidents and inadequate oversight and investment in rural infrastructure, 2011/12 saw considerable political instability, but this has passed without any serious disruption to the economy, there has been an effort to reform SOE capacity and by the ICCC to review industry competitiveness, there has been much talk but little action over public private partnerships, inquiries have occurred into land and financial malpractices, with little or no subsequent action, several pieces of legislation related to the private sector have been reviewed, technical and vocation education have received some new support, including through private sector inputs (notably by Esso Highlands), free education has been introduced, which will stretch capacity and highlight the need for parallel action on quality, and some action has commenced to review a wide range of government policies, including more emphasis on the districts and supporting sustainable industries and SMEs. The impact of these individual and combined efforts will remain to be seen, and the capacity of the new government to go beyond merely identifying corruption, but also to take meaningful and impartial action, rather than make notional statements, to address it and ensure that the agencies are adequately empowered and independent to tackle crime and corruption which have been increasingly undermining the country’s development prospects.

International comparisons on ease of business transactions shown in the World Bank’s annual “Doing Business” survey 2013, has ranked PNG 104 out of 185, as against 105 in 2012, and well behind the region’s leaders, like Samoa, Fiji and Tonga on 57,60 and 62 respectively, and the regional average at 86. PNG continues to record a very poor ranking over enforcing contracts (166/185), dealing with construction permits (159), dealing with insolvency (125) and trading across borders (120), but surprisingly good rankings for getting electricity (25 -that’s registering, rather than necessarily receiving the power routinely), and protecting investors (49), and at 83 for getting credit, it has a long way to go, but it’s still a marked improvement from 135 in 2005.

The CIMC\(^1\) National (and Regional) Development Forums and Sector Committees continue to provide a critical mechanism for dialogue between government, private sector and civil society on business impediments and other issues of public concern, from infrastructure, to agriculture, law and order and family and sexual violence, to population, governance, accountability and skills and employment. There has been improved responsiveness by some government Ministers and Departments/agencies to ideas and recommendations, if still disappointing from some agencies and provinces, including over follow up action. Since the 2009 National Development Forum the National

\(^1\) Consultative Implementation and Monitoring Council (CIMC)
Working Group on addressing impediments to business and investment was restored, chaired by the Government’s Chief Secretary and comprising senior public servants and private sector representatives. It has been restored again in 2011, with a more positive title. It addresses selected priority business constraints, including related to work permits, visas, taxation, land, trade and training issues.

Prospects: PNG, as a country with well over seven million people scattered across a large land of mountains, islands and wetlands, needs a diverse economy, capable of generating both immediate and sustainable revenue, employment, income earning opportunities and the standard of public goods required by the people of a 21st Century nation. The same goes to some extent for the 21 provinces, especially those aspiring to greater autonomy. Some government and even some business leaders still have the notion that PNGLNG (and subsequent LNG developments) provide a panacea to meet PNG’s development needs. This has been misleading and even irresponsible, as, although PNGLNG has the potential to substantially enhance revenue in the medium term, beyond the construction phase, it provides few jobs directly or multiplier effects. It has the capacity, not immediately, but by the end of this decade to make a major medium term contribution to funding PNG’s core infrastructure, and with it some public and private sector jobs, so long as funds are used prudently, and complemented with revenue from other existing and new projects and sources, including further LNG development.

At the end of the day the PNG needs to diversify, not just as a primary producer of minerals or sustainably produced products, like agricultural and marine products, but also value-adding a wide range of products from the country from specialty foods and essential oils to carbon sequestration and payments for other environmental services (from forests and the sea), and through the service sector, which has proven the fastest growing sector in most countries for many years, including in high and lower skilled work, from ITC to tourism and hospitality, finance, insurance, education, utilities and supply and service industries, which in turn supply them.

What PNG needs to avoid is an unduly dual economy, where the operations of the extractive industry and the failure of the State to manage and utilise the proceeds from that extraction, actually undermine the prospects for the other sectors, as has occurred widely in developing countries with major resources, as with Nigeria, also generating great antipathies and sometimes conflict between regions and between the benefiting elite and large numbers of marginalised people, many with education and high expectations, but few jobs or access to affordable products and services.

The private sector has a major to play in this service delivery function, as many private businesses, including in the mining/petroleum field already do, working alone or in partnership with government and NGOs to provide a range of other quality local services. But there are many other businesses which are relative free-riders, seeing PNG as a brief destination to make good money but without putting much back, in terms of local capacity building, paying taxes or building infrastructure to last. Doing business in PNG can be challenging in that many of the normal public goods provided by the

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2 National Working Group on Impediments to Business and Investment, widely referred to just as the Impediments Working Group
State in other countries do not exist or barely function, so some businesses invariably feel that their costs are already high enough, with back-up generators, added security measures, maintaining local access roads and communications, without also being expected to provide local health, education and training functions or working with government to develop other local infrastructure and capacity.

The government has over many years, been deficient in performing its responsibilities to the wider community, but also to creating suitable investment conditions for the private sector to generate the range of activities and employment needed. PNG has amongst the worst social indicators in the Asia-Pacific region. It has a major catch up task to bring maternal and child mortality levels down to acceptable levels and to make education universally available, but also to extend literacy and numeracy widely to adults to empower the population to develop its own skills, talents and opportunities. The tasks of the new government and Parliament are extensive, if they are committed to making a positive difference during their term in office. They will only be able to perform this function if they are given guidance, partnership with the private sector and civil society and if they are also held accountable by an empowered community itself, with access to information and communications and demanding services and standards.

The churches and NGOs provide many health and education but also air services, especially in more remote rural areas, but the State cannot shirk its responsibility of providing the extra teachers, nurses, classrooms, school material etc, and in turn providing the quality education for these professionals, who then expect adequate standards of housing and other services for their own families if they’re to be located in remote rural areas, depending in turn upon reliable infrastructure, and not temporary logging roads whose bridges collapse after local resources have been extracted.

For government and the private sector to partner effectively requires trust and internationally accepted and verified standards, such as with ISO, RSPO in oil palm, forestry and fisheries stewardship certification, but also that the PNG government adopts EITI procedures for disclosure and verification of transactions and values in minerals, but also potentially other extractive industries. These are to raise standards and transparency for the benefit of the PNG public and landowners, but also for international consumers and other stakeholders, including authorities fighting transfer pricing and organised money laundering, etc.

The PNG Government must seriously, and not notionally, address the on-going corruption within political and public service ranks, which has seen the diversion of major amounts of public funds but also public (and customary) land and other public assets, from genuine priorities, like infrastructure restoration and maintenance and investment in education, health services, public parks and recreational facilities to unscrupulous individuals and businesses for their own gain. Mechanisms need to be made much more transparent, including use of electronic systems (as with customs already), and market-based transactions, rather than use of sole or even somewhat arbitrary discretion by boards. Board appointments must also be genuinely representative and not at the discretion of Ministers.

Long and medium term planning have a role, so long as the process is rigorous and based upon wide consultation with key stakeholders, to ensure accuracy, relevance and wide acceptance and sense of ownership.
The public watchdogs must be empowered, and given the necessary teeth, resources and independence to investigate and take action even against persons at senior levels where necessary, working with an informed community willing to whistleblow and demand greater accountability. Until penalties are applied there is little disincentive either for executive/high collar crime, or in turn for the junior officials making extortionate demands of businesses or members of the public. Some businesses and so-called businessmen and women also participate in this malpractice, to obtain, sidestep or leapfrog laws and procedures to secure licenses, permits, land and other benefits, or wriggle out of tax or other obligations, and they must also be prevented where possible through rigorous systems, but penalised when in breach.

On the other hand it is also the duty of the State to find ways to fast track legitimate processes and applications and minimise the temptation to sidestep procedures, by maliciously bottlenecking documentation and approvals. Deadlines must be provided for administrative tasks, and subject to independent scrutiny.

PNG’s resource extraction industries must play their part fully in applying and maintaining the highest social and environmental standards (as many already do), particularly as the majority of the population (and other sustainable industries) remains directly dependent, currently and for the foreseeable future, upon their unpolluted land, marine and fresh water resources. The mineral-based industries in PNG are dependent upon good local community relations, particularly with the unusual hybrid tenure system for extractive operations, entailing State ownership and approval but also usage rights effectively granted by customary landowners. Mechanisms for PNG’s sustainable and balanced economic (and social) development are dependent upon:

- continued fiscal prudence, and focus upon priority recurrent and development expenditure (particularly infrastructure maintenance, and sound and routine health, education and law order and justice services, human resource capacity building),
- (more) effective planning, coordination, utilisation and oversight of current and prospective revenue in addressing priorities, including the long-standing decline in national and local infrastructure, and building up a sense of ownership of public goods and social auditing,
- undertaking urgent and sustained public sector management/capacity building (including at the local and district levels, especially if they’re to receive greater funding), including for overseeing private contracting out and Public-Private Partnerships, and transferring non-performing Departments/agencies (like Petroleum and Energy, Lands and DAL) into more effective and accountable structures (e.g. authorities with representative stakeholder boards),
- right-sizing the public sector so that funds and resources are available for priorities, but rationalised for lower priorities or where there’s a need to merge multiple overlapping institutions, as in the transport/civil aviation field, or by using bodies such as Provincial Health Authorities with provincial health;
- strengthening all mechanisms to ensure greater accountability and stiff penalties for abuse, involving stakeholder partnerships, whistle-blower protection and incentives,
ensuring that the Sovereign Wealth Fund(s) are transparently and independently managed and supervised, to sanitise an appropriate and agreed portion of LNG revenue, to mitigate ‘Dutch disease’ impacts upon the rest of the economy, and perform other priority investment/maintenance funding functions, as determined, following the stipulated ‘best practice’ Santiago principles, with strong public awareness and ownership, arms length from ongoing political direction; also ensuring that the SWF is not undermined, as with the MRSF in the 1990s, by pre-committing its LNG/minerals revenue,

- encouraging investment in provision of traditional public goods, including renewable energy provision, and ensure free and fair competition (in ICT and other communications and goods and services) to enable improved, more reliable and affordable services to business and the community,

- continue to develop partnerships of all kinds, utilising available human and plant resources of private investors, including with the continued use of the tax credit scheme and other favourable tax treatment for service provision.

- ensuring priority attention to meeting the needs of the people of PNG, including both in the urban and rural areas, but also in the workplaces, addressing health, welfare and human resource development needs, but including cooperation in firmly addressing gender equality and other discrimination and family and sexual violence issues.

The new government has shown readiness to make some of the major reforms the country needs, through certain early actions; it has also made a wide range of promising commitments which it is hoped it will adhere to, but it (or some Ministers) have also made some more hasty, and in some cases perhaps ill-judged commitments with respect to raising tariff levels, possible levels of renewed overseas borrowing, commitments over some resource or other projects, including some which appear simply to entail land-grabbing and a license to print money from a trading monopoly. PNG’s economy needs to be efficient, competitive and public funds targeted stringently on real priorities. There is a long way to catch up in providing public and private goods and services and broad-based opportunities, without misallocating funds, driving up living costs and jeopardising food security (especially with monopolies or other deals on staple foods), enriching some businesses through costly and uncompetitive contracting etc.

It is often easier to make the right statements, but defer real reform, in the light of immediate needs and political expediency. It takes the strong support or pressure from the whole community to ensure that reforms and good governance occurs and not side-lined. PNG may have extensive natural resources, but extracting them comes at a cost and the country cannot afford to waste the opportunities provided, with poor investment conditions and deficient expenditure planning and governance, at both the national and provincial levels, as it has too often in the past, nor to encourage the boom and bust cycles of the past, which undermined wider investment confidence and public service operations. One can only repeat that, as with Botswana’s experience, a country benefits from its resources, not by waiting for the income to address governance issues and fund institutions, but by applying firm governance conditions from the start, so that when additional revenue is received the mechanisms will be resilient, with the proceeds invested and beneficial, rather than seductive and harmful. As required in the National Constitution, the country must utilise
its natural resources wisely in the interests of both current and future generations, without jeopardising the prospects of other industries and communities. That continues to be the obligation and challenge for now and the future.