Economic survey

An update of recent events: the Papua New Guinea economy

Robert Harden and Craig Sugden

The Papua New Guinea economy has a record of economic instability triggered by fiscal imbalances. 1999 fitted the established pattern, with a failure to secure external funding risking currency and fiscal crisis by mid year. The Skate Government pursued extreme solutions to the problem, including an expensive Eurobond issue and the provision of diplomatic recognition to Taiwan. But the emergence of the Morauta Government saw a more conventional solution to the government's fiscal difficulties. Support from the international community appears to have avoided another round of macroeconomic instability, but much remains to the done by the government to lock in the IMF and the World Bank and to provide the economic environment required to stimulate a stressed private sector.

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Critics of Papua New Guinea's development experience rarely give sufficient weight to the fact that the modern concept of development has only been recently introduced. For many parts of the country the first contact with foreigners did not occur until the 1930s and independence arrived only in 1975. Moreover, previously unknown villages were still being 'discovered' in the 1980s and 1990s (Connell 1997).

Many other democratic states have taken centuries to evolve. So with independence only into its twenty-fifth year it is to be expected that Papua New Guinea's democratic system and supporting institutions are still in an early stage of development. As well, the difficulty of uniting and governing over 700 culturally separate groups should not be discounted. The concepts of nationhood and the national interest are still alien to many Papua New Guineans. For them, their local village continues to be the only relevant social unit.

As acknowledged some years ago by the Australian Parliament's influential Joint Committee on Foreign Affairs, Defence and Trade, the Australian colonial administration bequeathed Papua New Guinea with insufficient infrastructure at independence, particularly in relation to human resources (Parliament of the

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Commonwealth of Australia 1991:1). Millet commented that 'the surprise is not that Papua New Guinea ranks a lowly 126 out of 174 on the UNDP's scale (that is, the Human Development Index), but that it doesn't rank even lower' (Millet 1997:108).

The Papua New Guinea political system has evolved into one dominated by personalities and regional groupings rather than policies or political ideologies. Political loyalties are extremely fluid and votes of no-confidence against the sitting Prime Minister (outside the constitutionally determined indemnity period) appear to be the rule rather than the exception. In this environment, where the major pre-occupation is likely to be short-term political survival, long-term national issues such as economic planning are unlikely to receive the attention they deserve.

It is to be expected that such a social and political environment would create an unusually strong tendency for governments to overspend and for politicians to favour their own constituencies. The recent past has provided numerous examples of this tendency. For example, in 1998 'extra-budgetary' expenditure programs totaled around K80 million and included a substantial increase in the controversial 'discretionary funds' of Members of Parliament.

Much of the economic instability seen in Papua New Guinea over the 1990s can be traced back to high government expenditure, the most notable example being the currency crisis of 1994. (For a recent discussion of Papua New Guinea's experience with macroeconomic management, see Economic Insights 1999.) 1999 has provided further illustrations of the intrinsic difficulty of managing such a diverse and young nation, and also of the rewards that can be provided by sensible government.

The starting point—a difficult 1998

1998 was a tough year for the economy. The ongoing impact of the drought, a dramatic drop in logging prices and volumes because of the East Asian economic crisis and the general downturn in international commodity prices dampened activity.

The official view is that, for 1998 as a whole, real non-mining GDP declined by nearly 4 per cent. However, strong mining and petroleum growth is expected to have increased overall GDP by 2.5 per cent (largely due to the commencement of operations at a major new oil development, Gobe, and the return to full production of the Porgera and Ok Tedi mines). With the non-mining sector in a recessed state, formal employment growth remained flat, meaning that the estimated 50,000 to 55,000 persons who should have entered the labour force joined the semi-subsistence rural economy or the growing ranks of the urban unemployed.

Fiscal performance in 1998 set the base-line for the 1999 Budget. While the budget deficit for 1998 was not exceptionally high, the government had failed to draw down a US$120 million loan to be provided by a European banking syndicate. The loan was to be used to finance government expenditure in the final quarter of 1998 and help rebuild external reserves. As a result of the delay in drawing down this external loan, the government was forced to borrow directly from the Bank of Papua New Guinea (that is, 'printing money').

A sign of the imbalance within the economy was the fall in external reserves from US$380 million at the end of 1997 to US$195 million at the end of 1998, substantially below the budget forecast of US$330 million (Figure 3).

The combination of high imports, in part because of the drought, and the limited ability of the Bank of Papua New

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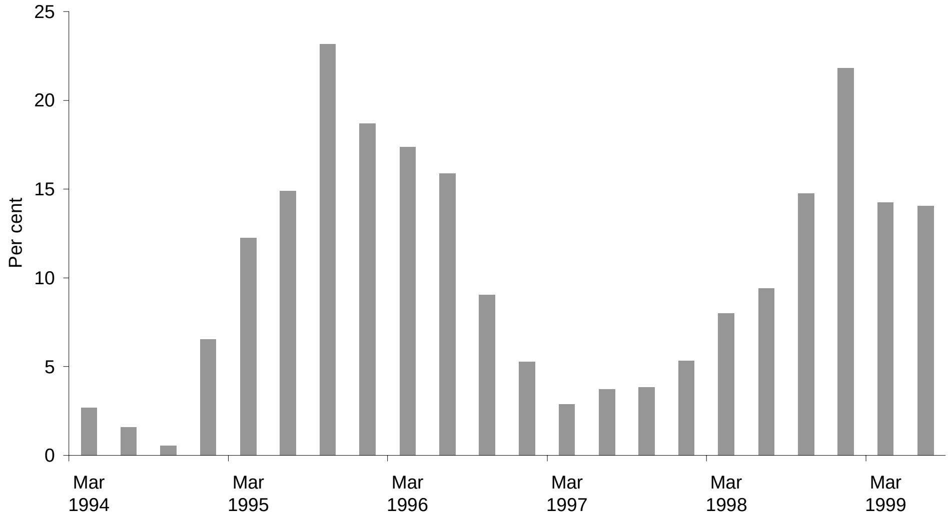
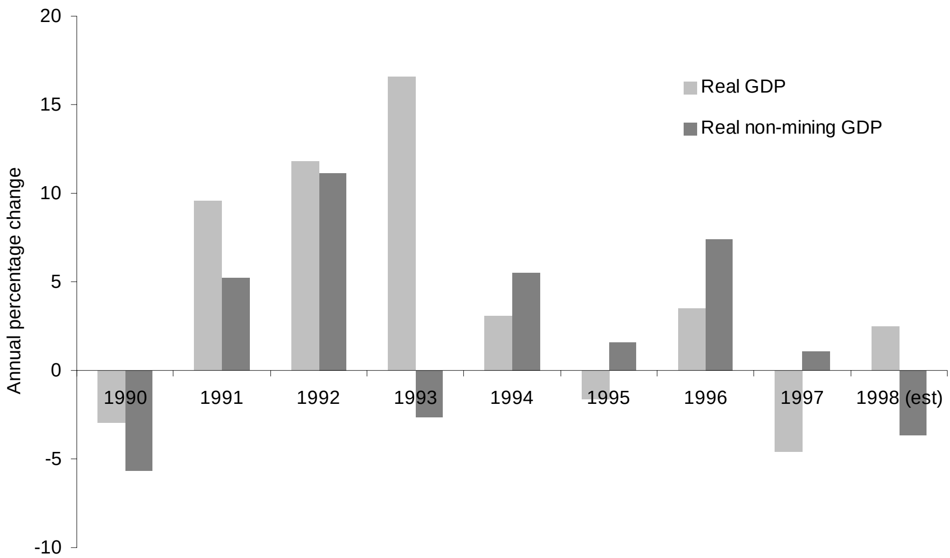
Figure 1 **Papua New Guinea: annual inflation rates, 1991–99** (per cent)



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, Port Moresby, various issues.

Figure 2 **Papua New Guinea: real GDP growth, 1995–1998** (percentage change)



Source: Papua New Guinea, *Economic and Development Policies,* Budget Papers, Volume 1, Department of Treasury and Corporate Affairs, Port Moresby, various issues.

Guinea to intervene in the market saw the kina fall during 1998. Against the US dollar, the kina started the year at US$0.57 and ended at US$0.48, after falling to a low of US$0.41 in July.

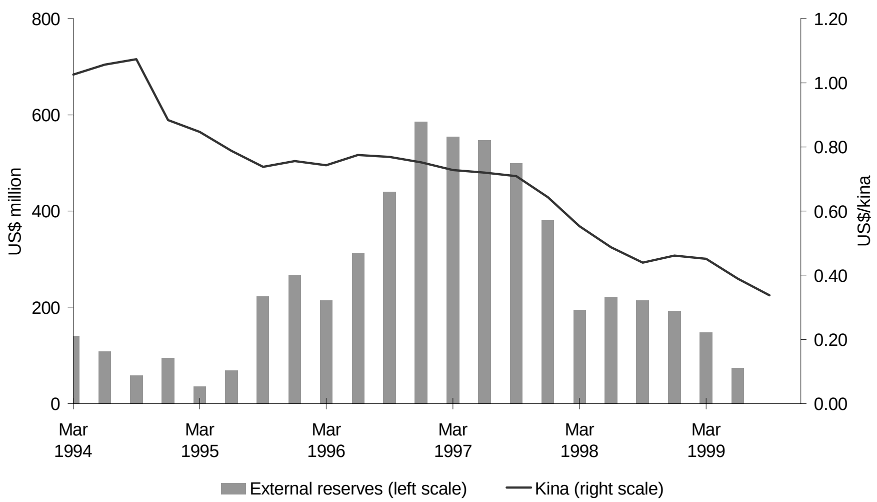
The 1999 Budget

The 1999 Budget appeared to have made a respectable effort to meet the key objective of macroeconomic stability. The principal parameter was a modest budget deficit (K80 million) which was expected to be financed comfortably by external concessional loans. On the basis of this fiscal framework, the government expected that macroeconomic stability would be consolidated over 1999 as reflected by budget forecasts of a stable exchange rate, declining interest rates and falling inflation.

A feature of the budget was a projected 17 per cent decline in the wages bill for national public servants, to be achieved largely by retrenchment. While cuts to the public service are a regular, but undelivered, part of PNG budgets, the planned scope was ambitious and the accuracy of the costing of the retrenchment package was subject to much dispute. At the same time as cutting the number of workers, the government had agreed to a 4 per cent public service wage increase backdated to January 1998 (although the 1998 Budget stated that there would be no public sector wage increases in 1998).

The PNG Government put much effort into promoting the budget as giving priority to public investment, particularly in the rural areas. A key selling point was the substantial rise in the development budget from K536 million in 1998 to K862 million (total government expenditure is around K2,500 million). But, as for previous years, the interpretation of the development budget was difficult. Numerous classification changes, the

Figure 3 **Papua New Guinea: foreign reserves and the kina, 1994–99**



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, Port Moresby, various issues.

impact of provincial government reforms and the non-uniform recording of donor-funded projects all hinder analysis.

The development budget attracted most attention because of the K139 million allocation to the newly established Department of Rural Development. The bulk of this money was to be distributed to Papua New Guinea's 89 districts with projects to be selected by various Joint District Planning and Budget Priorities Committees chaired by the local Member of Parliament. This allocation is additional to District Support Grants of K21.5 million administered directly by Members of Parliament.

Supporters and the government claimed that such allocations are the only means of ensuring that goods and services are delivered to the bulk of Papua New Guinea's population living in the rural sector. In contrast, critics argue that the increased allocation to rural development represents little more than a substantial increase in the so-called Members' slush funds. The same critics argue that at best the slush funds are wasted on non-priority activities and at worst are siphoned into corrupt practices.

On the revenue side, the 1999 Budget retained the commitment to introducing a VAT (which came into effect in the middle of 1999). A range of new revenue-raising measures was introduced, including asset sales of K65 million, an interest income-withholding tax and increased work permit fees. As well, the budget announced a 4 per cent levy on the mining industry as a means of offsetting a predicted loss of revenue (because of lower overall tax rates) under the VAT / tariff reform program.

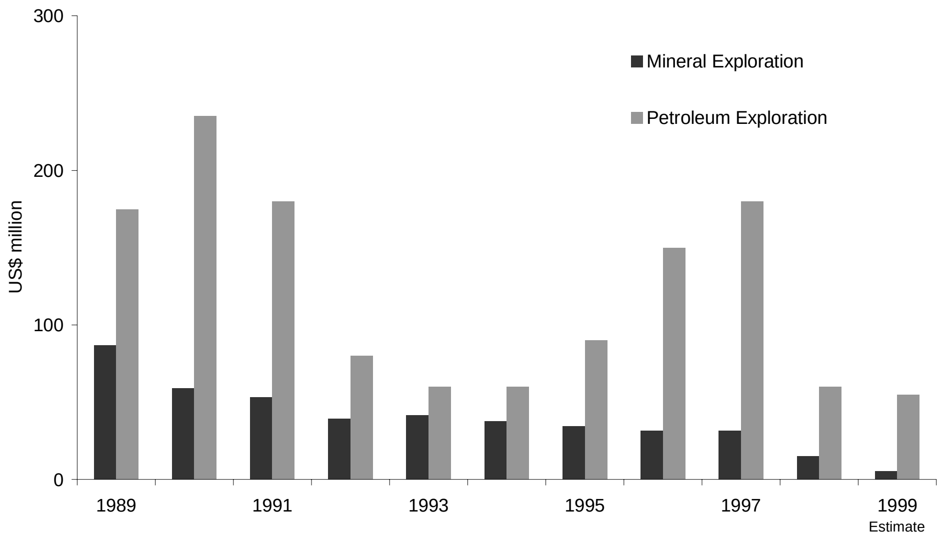
The mining industry expressed considerable concern over the impact of the interest-withholding tax and the new 4 per cent levy. The industry claimed that the 4 per cent levy would not be revenue neutral (when combined with the VAT / tariff reforms), but would represent a substantial additional revenue impost. The mining industry has repeatedly raised the issue of the damage done to Papua New Guinea's investment environment from constant changes to the fiscal regime for the sector and of other government interventions in the 1990s. Changes to the policy regime constitute a 'changing of the goal posts' and add to the risk of investing in Papua New Guinea.

While mining and petroleum operates largely as an enclave with few direct linkages to the rest of the economy, the sector is by far the single most important revenue earner for the government. With two substantial projects in prospect—the PNG / Queensland gas project and the Ramu Nickel project—it seemed the government should have paid more attention to improving the investment environment. It is also important to appreciate the long lead times in mining and petroleum projects, with most potential today the result of exploration efforts of the 1980s and earlier. Exploration expenditure has trended downwards over the 1990s, potentially eroding the long-term prospects for one of the economy's most important activities (see Figure 4).

The bottom line—financing the 1999 Budget

The main limitation of the budget was its financing. In assessing the macroeconomic impact of the budget there is often a tendency to focus on the budget deficit or surplus position. For Papua New Guinea financing the deficit and the government's debt commitments are equally important. Domestic debt tends not to be a major concern as government securities held by domestic banks can normally be rolled over easily. For external debt it is a different story. Macroeconomic stability can be

Figure 4 **Exploration expenditure in Papua New Guinea** (US$ million)



Source: PNG Department of Mining and Petroleum and the PNG Chamber of Mines and Petroleum.

placed under stress if sizeable external loans are falling due and new external loans cannot be put in place. By the middle of the year, difficulties in raising budgeted external financing had led to a serious risk of a currency crisis.

In the past, the Papua New Guinea Government's capacity to retire foreign debt had been assisted by its direct earnings of foreign currency from mining and petroleum taxes and Australian budget support. Because of the ongoing shift to program aid, as of mid 1999 Australian budget support was projected to be of relatively minor significance compared to that of a few years earlier. While sizeable foreign-exchange backed mining and petroleum receipts are normally available, they were much lower than expected in the first half of 1999.

Facing a budgeted external debt commitment of K298 million (US$134 million), the government had assumed it would be able to borrow K220 million from the World Bank and IMF as part of a further structural adjustment program. But relations between the Skate Ggovernment and the IMF and World Bank soured in 1998 and remained poor in 1999. Rather than be tied to the economic restructuring programs sought by these institutions, the Papua New Guinea government sought to raise funds offshore on commercial terms.

Accordingly, steps were taken to increase the country's profile in the global financial community, most notably by engaging the international credit agencies to provide a credit rating. With a view to raising funds on the Eurobond market, a high-profile financial roadshow was established to 'sell' Papua New Guinea as an investment option.

One of the major issues for public policy raised by the Eurobond issue was its potentially high cost. Table 1 compares the likely cost of issuing Eurobonds to a

Table 1 **Differential cost of the Eurobond option** (US$ million)

	Additional interest cost	
	Per year	Over 5 years[a]
Eurobond interest rate		
11 per cent	12.5	62.5
15 per cent	22.5	112.5

[a] Current prices

hypothetical financial assistance package arranged with the IMF and international donors. Based on prevailing interest rates and relevant administrative charges, it is conservatively assumed that the weighted cost of the latter assistance package would have been around 6 per cent per annum. A number of estimates were publicly discussed of the likely interest rate cost of the Eurobond option, ranging from 11 to 15 per cent.

Based on the publicly-canvassed loan sum of US$250 million (covering a period of five years with a bullet repayment of principal at the end of the five-year period), the Eurobond option could have cost an additional US$60 to US$120 million over a five-year period. This is substantial compared to Papua New Guinea's overall budgetary allocations. For example, at 11 per cent interest, the additional five-year cost of the Eurobond issue would have been equivalent to 75 per cent of the 1999 Budget allocation for health. At 15 per cent, the figure would have risen to 134 per cent. At 11 per cent interest, the five-year additional cost would have been equivalent to 34 per cent of Australia's annual aid program to Papua New Guinea. At 15 per cent interest, it would have risen to nearly 60 per cent.

In the event the roadshow met with little support and the bond issue was postponed. The Skate government then announced its intention to recognise Taiwan as an independent state. Although the full details of the relationship between the Skate and Taiwanese government were always unclear, recognition appeared to been intended to provide a large concessional loan. There was widespread international opposition to Papua New Guinea's position, most notably from China and Australia.

The Morauta Government and a fresh start

The election of Prime Minister Morauta on the floor of Parliament in July 1999 was met with the enthusiastic support of the business community, both locally and internationally. Given Morauta's undoubted economic credentials and his very public stand over the years against corruption and inefficiency, the change of government in itself led to a significant improvement in investor sentiment.

The immediate priority for the Morauta Government was to secure external finance. In order to guard against macroeconomic crisis, the link with Taiwan was rejected by the new government, along with proposals to borrow offshore at commercial rates. By the end of July 1999 the budget strategies were short of funds to the value of US$220 million (some of which was to be used to retire domestic debt). At the time, external debt commitments were perceived as substantially in excess of the level of external reserves, which were widely estimated at around US$90 million in mid July, raising the prospect of a severe financial and currency crisis before the end of the year.

Some short-term respite was provided early by the Australian Government through a decision to bring forward budget support payments. Then, in August, the Morauta Government introduced a conservative supplementary budget. This focused on providing a quick correction to fiscal imbalance, albeit while not pursuing the reforms many were looking for. A surprising revision made in the mini-Budget was a substantial downward adjustment to the level of external debt obligations. The revised estimate of around US$60 million external debt obligations over the remainder of the year was considered within the government's holdings of external reserves. The reason for the downward revision has not been explained by the government, but concerns about an imminent crisis eased.

Key elements of the August supplementary budget were

- a projected budget deficit for 1999 as a whole of K157 million (1.7 per cent of GDP), compared to the January to June outcome of a deficit of K217 million
- increased excise taxes on alcohol, cigarettes and gasoline, increased gaming taxes and increased export taxes on logs
- the removal of the interest-withholding tax on resource industries but the retention of the 4 per cent levy on mining operations (despite a compromise arrangement worked out with the previous government)
- reversal of the planned civil service redundancies, the restoration of funding for research bodies cut in the original budget and the clearance of accumulated arrears. Expenditure cuts were to fall mainly on the development budget (particularly road maintenance), but the 'discretionary funds' were largely left untouched.

The increase in 'sin' taxes was predictable and a worthwhile measure and the new government's support for the VAT was positive.

The increase in logging taxes was also widely anticipated. However, whether or not the latter leads to an increase in revenue remains to be seen, as it may result in a downturn in log exports (as warned by industry representatives). As noted by the industry, Papua New Guinea's progressive log export taxes are expressed against the kina value of log exports whereas international prices are set in US dollars or other third currencies. Hence, as the kina depreciates, the effective tax rate expressed in US dollar increases. The marginal export tax rates are now higher than those applying in 1998 because the kina has been trading at a much lower value than the average for 1998.

Cuts in the development budget were justified on the basis of institutional capacity constraints (ie the inability to spend monies or at least spend monies effectively). This is depressingly familiar with past practice. While institutional incapacity is regularly presented as the reason for the under-spending of the Papua New Guinea development budget, it is important to appreciate that Papua New Guinea has successfully developed a number of world-class mining and petroleum projects in some of the most remote and difficult terrain in the world. It seems that the development budget remains an easy target for cuts when fiscal conditions are tight.

Prime Minister Morauta heralded the supplementary budget as the 'last chance budget.' But the tougher test for the new

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government will be the 2000 Budget, because it will need to include a concrete program of economic reform if the government is to secure the financial support of the IMF and World Bank.

The economy at October 1999

Early into its term the Morauta Government confirmed its intention to reinstate relationships with donors. Confirmation of the supportive attitude of the donors was provided by the establishment at the September APEC meeting of the ‘Friends of Papua New Guinea’, a group of seven countries committed to the provision of support. In early October the Australian Government committed a loan of US$80 million, essentially as balance of payments support, but the funds were only to be released after a ‘letter of intent’ was signed with the IMF and World Bank.

Negotiations were due to recommence with the IMF and the World Bank in late October with a view to establishing a new loan program but contingent on a strong program of economic reform. If agreement is reached, new IMF and World Bank loans should be available towards the end of the first quarter of 2000, further rebuilding international reserves. This in turn should improve the Bank of Papua New Guinea’s ability to manage the kina and provide for a relaxation of monetary policy.

Signs of consolidation are against a background of a firmer export sector (Figure 5). By the end of October there had been substantial improvements in world oil, gold, copper and logging prices. While most agricultural prices had eased over the year in US dollar terms, the lower kina had provided growers higher returns. Export quantities were generally high over the first half of the year (the latest data available is for the June quarter).

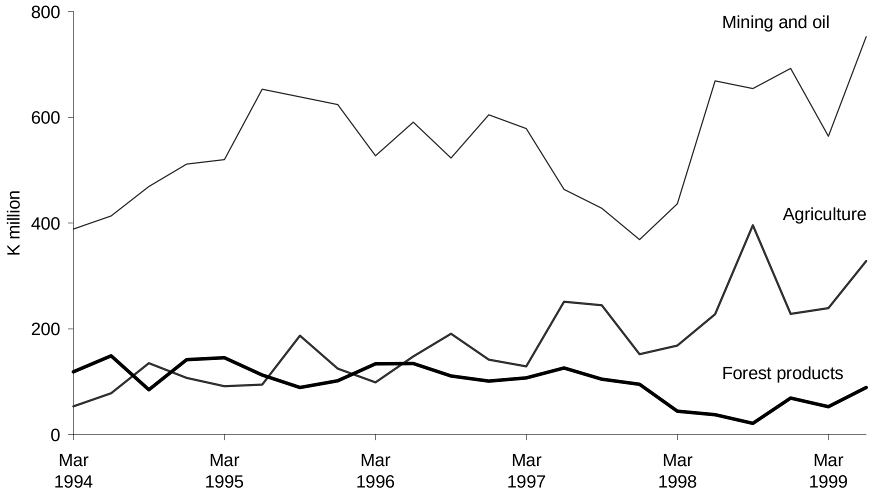
But the private sector was still suffering from the adverse impact of uncertainty created by political turbulence, the steady fall in the kina and extra costs imposed by high interest rates (Figure 6). Although the Bank of Papua New Guinea had reduced Treasury Bill rates to below 20 per cent by October, commercial bank lending rates had remained very high (in part because the Minimum Liquid Asset Ratio had been increased in September, requiring banks to keep interest rates high to maintain profits).

One of the main issues facing the private sector is the process of adjusting to a lower kina. The fall in the kina has provided a substantial improvement in the economy’s international competitiveness. It offers an important stimulus to local industry, in particular to agriculture that provides the cash income of the large majority of the population. There are increasing signs of import replacement activity, for example in the increased presence of local fruit and vegetables, and as the more locally integrated manufacturers gain market share at the expense of more import-dependent competitors. But realising the potential benefits of a lower kina will require supportive government policy at both the macro and micro level.

Priorities for 2000

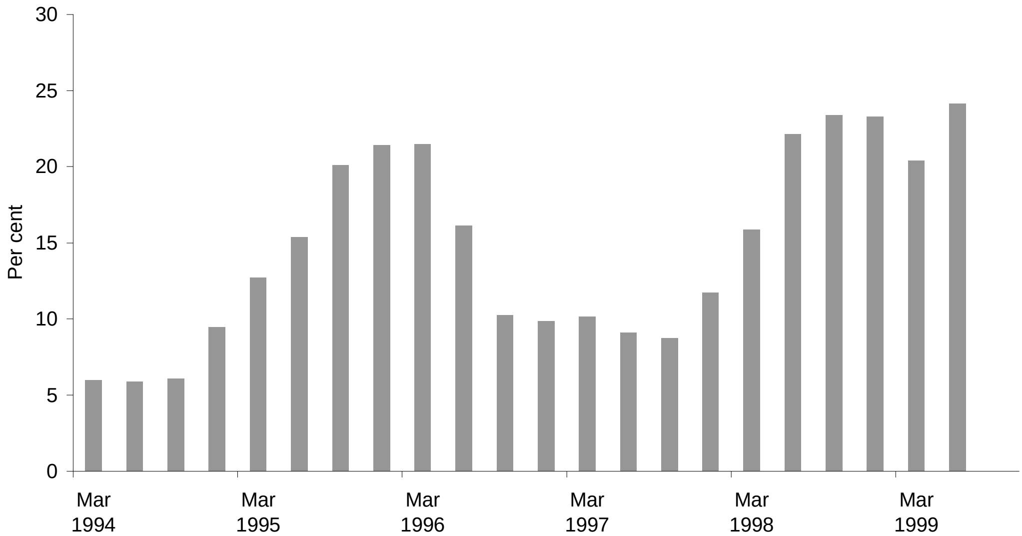
The short-term priority is to ensure that macroeconomic stability is secured. This appears likely if the government enters into an economic reform program with the support of the IMF and World Bank. Aside from the benefit of securing external funds on more favourable terms than that on offer in the commercial market, an IMF / World Bank-supported program would boost the confidence of private investors and is critical to ensuring the involvement of bilateral donors.

Figure 5 **Papua New Guinea: export revenue, 1994–99** (kina million)



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, Port Moresby, various issues.

Figure 6 **Papua New Guinea: interest rates on Treasury Bills, March 1994–June 1999** (per cent)



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, Port Moresby, various issues.

Over the medium term, economic performance will depend critically on the government's policy direction. Policy will need to be more vigilant in maintaining macroeconomic stability and in ensuring that Papua New Guinea's improved competitive position, largely attributable to the fall in the kina, is not forfeited. Increased attention to the needs of the mining and petroleum sector is warranted as are policies to ensure that the benefits of resource projects are directed to productive ends.

The pursuit of good government remains a priority. Good government entails the provision of primary health and education services, law and order, appropriate infrastructure, macroeconomic stability and the development of institutions essential to a democratic society. Ensuring these are in place remains Papua New Guinea's best chance of achieving sustained and broadly based development.

Note

This paper provides an update to the 1999 AusAID survey of the Papua New Guinea economy (Economic Insights 1999).

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