2019 PNG economic survey

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Abstract

Although official statistics show that an economic recovery is underway in PNG, the country's new Prime Minister has stated that the economy is "struggling and bleeding". Disappointing 2019 first-half-year revenue results and the re-intensification of foreign exchange shortages suggest that last year's (non-resource) recovery, which was based on unsustainable fiscal expansion, has not endured; that this year's growth statistics may need to be further revised downwards; and that the government's growth and fiscal challenges are once again intensifying. The new government's governance reforms are promising; but they are no substitute for reviewing exchange rate and fiscal policy, perhaps by turning to the IMF for advice and support to address the problems it has inherited, including in relation to arrears, guarantees, and state-owned enterprise debt.

1. Introduction

Prime Minister Peter O'Neill's eight-year reign came to an end in mid-2019 with his resignation on May 26, after it became evident that he had lost the support of a majority of Members of Parliament. Whereas O'Neill was, to the end, of the view that the PNG economy was doing well, the new Prime Minister (former Finance Minister) James Marape indicated immediately on his election by MPs as Prime Minister that the economy was "struggling and bleeding" (Marape 2019).

This survey addresses two questions that will be critical for the new Prime Minister and his team. First, to what extent is the economy actually "struggling and bleeding", and to what extent is it showing signs of recovery? Treasury statistics in fact show a recovery, indicating that the non-resource sector picked up from virtually zero growth in the period 2015-2017 to around 3% growth in 2018 and 2019, heading to 5.4% growth in 2020. Is recovery occurring, or has it been derailed? The current-year fiscal difficulties, revealed in a June statement by the new Treasurer suggests the latter, and that, with little revenue growth, large government arrears, increasing problems around public-sector debt and guarantees, and re-intensifying foreign exchange

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rationing, the improved growth of 2018 may have been a false dawn. Moreover, despite what economic growth there has been, jobs are not being created in the formal sector, perhaps due to a lack of long-term confidence.

The absence of jobs growth and the faltering recovery give rise to the second question: what reforms are needed to accelerate growth and development? We review macroeconomic and fiscal policy settings and outcomes, as well as other major policy initiatives and debates. We argue that five years on from the end of the resource boom in 2014, and various reform efforts to date notwithstanding, PNG is yet to put in place the fiscal and exchange rate settings required to support the required diversification and recovery of the economy. Instead, increasingly, the focus of government has been on protecting domestic industry and promoting local ownership, which is likely to yield limited or negative returns. The new government, which is currently, and rightly, focused on governance reforms also has an opportunity to revisit fiscal and exchange rate settings to provide stronger support for economic growth.

This survey reviews recent developments in the real economy (Section 2), the balance of payments (Section 3), the financial sector (Section 4), and fiscal developments (Section 5). Section 6 reviews major policy reforms and debates. Section 7 concludes.

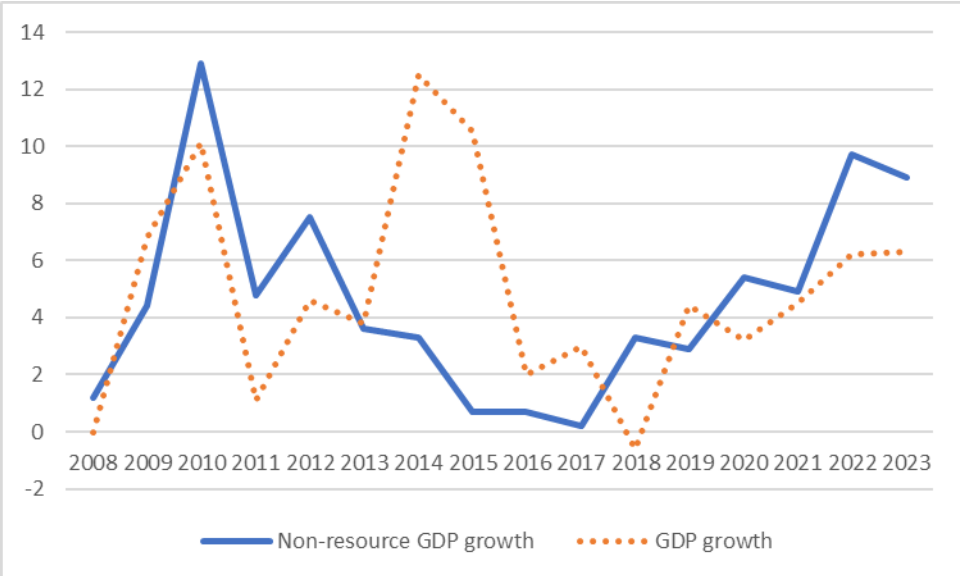
2. Economic growth

Based on the latest data from the World Bank, PNG is the tenth most resource-dependent economy in the world.[2] Gross Domestic Product (GDP) is normally used to measure economic performance, but PNG's large, capital-intensive and mainly foreign owned resource sector—mining and petroleum—means that the GDP can be a very misleading indicator of average living standards. Gross National Income (GNI) would be a better indicator, but an accurate measure of GNI is not available. The main measure of economic activity utilised in this paper is non-resource GDP (often referred to in PNG as "non-mining GDP", even though it excludes output from both the mining and the petroleum sectors).

[2] This assessment is based on the ratio of natural resources rents to GDP for 2016, excluding forest rents (so mineral, coal, natural gas and oil). This ratio is 19.3% for PNG. By comparison, Saudi Arabia's ratio is 20%. The world average is 1.5%. See http://wdi.worldbank.org/table/3.14#.

Official statistics suggest that the PNG economy—as measured by non-resource GDP—slowed post-PNG-LNG-construction until 2017 but is now in recovery (Figure 1). Different sources give different estimates for specific years, but all show that non-resource growth was very low (if not negative) from 2015 to 2017,[3] and then began to recover; and is projected to accelerate in the coming years.

Figure 1 Non-resource and GDP growth (%)



Source: Treasury (2018), Table 1 and Treasury (2019c); 2019 onwards projections.

This official portrayal of a recovery is at odds with the assessment of the new Prime Minister that the economy is "bleeding and struggling" (Marape 2019). It suggests, rather, that the economy was in trouble in the past, but has now started to recover. Where does the truth lie?

The overall GDP growth estimate for 2018 has been lowered from 0.3% to -0.6% due to greater-than-expected disruption from the 7.5-magnitude earthquake in early 2018, which caused a temporary shutdown in several extractive and mining operations (Treasury, 2019a). The resource sector is now estimated to have contracted by 13.7% in 2018. No update has been provided for the non-resource sector. Given the weak link between the resource and non-resource sectors, there can be no assumption that a contraction of the resource sector would lead to a non-resource recession. The main linkage is via government revenue, and resource revenue to the government increased in 2018. Nor is there any suggestion that the earthquake had a significant impact on the non-resource sector. A sharper contraction in the resource sector in

[3] National Statistical Office (NSO) data shows negative non-resource growth in 2015, but slightly higher growth in 2016.

2018 also means higher GDP growth in 2019 due to a greater recovery in resource output with Treasury increasing its 2019 projection to 4.4% (Treasury 2019c).

Other indicators confirm a recovery in 2018. Credit to the private sector which fell in 2017 by 2.1% increased in 2018 by 5.7% (BPNG QEB, Table 1.1). Imports, which fell for several years in a row, grew in both 2017 and 2018—an indication of better foreign exchange availability and stronger demand (Figure 5). As discussed in Section 5, government revenue grew strongly in 2018, with economy-wide taxes, after declining for three years in a row, growing by 3% above inflation. Government expenditure also grew strongly, increasing by 16% above inflation—again after three years of decline. With such a strong expenditure stimulus (and with government expenditure making up some 28% of non-resource GDP), it is not surprising that economic growth resumed in 2018.[4]

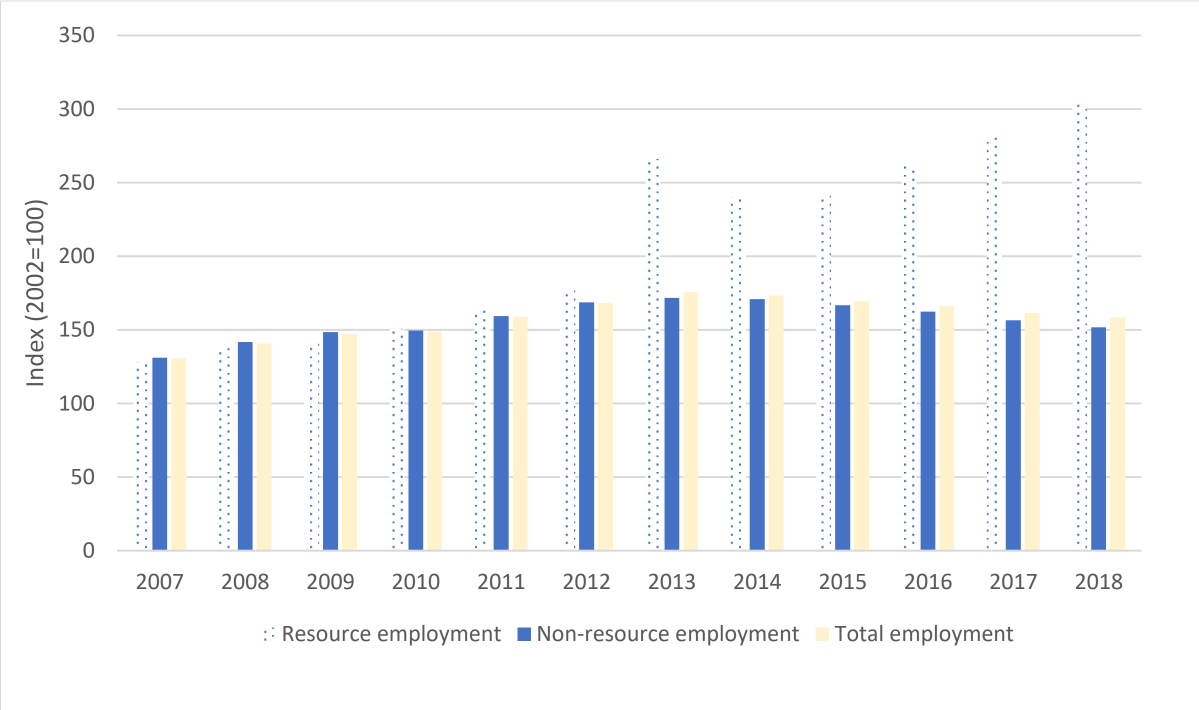
Credit rating agency Moody's, which in 2016 had downgraded the PNG government's sovereign debt rating from B1 to B2, and in early 2018 downgraded the outlook from stable to negative, in early 2019 upgraded the outlook back to stable, citing improved foreign exchange inflows and reserves due to the successful sovereign bond issue in late 2018, and higher commodity prices for key exports (Moody's 2019).

One scenario that reconciles a growth recovery with a struggling economy is that of "jobless growth." Bank of Papua New Guinea's (BPNG) employment data (Figure 2) pertain only to the formal sector, which employs only about 15% of the workforce but is still useful as a proxy for economic activity and welfare. Total and non-resource employment in PNG's formal sector contracted by 2% and 3.1% respectively in 2018. The 2018 decline is particularly striking because government employment increased by 4,800 in that year (Treasury 2019d, Table 10)—an increase of 4.2% in government staff numbers and 1.4% in total formal sector employment.

Employment in the non-resource sector has now declined for five years in a row: ever since the PNG LNG construction concluded in 2013. Employment in the resource sector has continued to increase steadily and grew by 5% in 2018, driven by the additional labour required to assist with recovery in production. However, resource sector employment makes up only about 10% of total formal sector employment, and overall formal sector employment is clearly on a downward trajectory. In 2018, total and non-resource sector employment were at 90% and 88%, respectively, of their 2013 peaks.

[4] The government-dominated sectors of administrative and support services, public administration and defence, education and health together increased by 5.0% in 2018 after inflation (Treasury 2018, Table 1).

Figure 2: Employment: total, resource and non-resource sectors, 2002=100



Source: BPNG, as of March 2019 Quarterly Economic Bulletin (QEB), Table 9.7.
Note: Annual averages as calculated by BPNG.

PNG businesses were surprised by the downturn in growth from 2014 onwards, as they had expected continuing strong growth with the commencement of PNG LNG production. One CEO, Michael Kingston of KK Kingston, having been through that experience, said his company is "avoiding additional investment, reducing debt and looking to eke out more efficiencies and more productivity from the labour force, and the assets we currently operate" (James 2019a). Such a risk-averse approach, borne out of the recent boom-bust experience, could explain the pattern of jobless growth. Other explanations could be rising informality of the economy, and measurement issues.

However, while 2018 seems to have been a relatively good year for the economy, the latest data suggests that things may have worsened in 2019. Foreign exchange shortages are intensifying once again (Section 3). And in the first half of 2019 there was a significant shortfall in tax revenue (Section 5). While this might in part reflect one-off factors and poorer compliance, the Treasurer himself has conceded that this result is indicative of "subdued local business conditions" (Treasury 2019a). Moreover, as further discussed in Section 5, there is strong downward pressure on expenditure, from both the revenue shortfall and from financing difficulties. The stimulus from expanded expenditure in 2018 will not be available in 2019. Finally, government payment arrears are also a drag on business (Treasury 2019a, p.18).

The PNG Treasury has recently conceded that "The widening of the foreign exchange imbalance in recent months and the tightness in fiscal spending will also impact adversely on non-mining [non-resource] GDP growth in 2019" (Treasury 2019c). In the same MYEFO or mid-year statement, Treasury reduced its projection for non-resource GDP growth for 2019 from 3.1% to 2.9%. Further downward adjustments will likely be needed.

To conclude, without the stimulus from APEC in 2018, and more broadly from additional government spending in that year, economic growth has once again slowed, and indeed may be negative. After all, the fundamental problems of low revenue growth and a shortage of foreign exchange have not disappeared. The policy uncertainty around foreign investments (Section 6) is another negative for the economy, as are global trade tensions.[5] It may be that 2018 was a bright spot in an otherwise gloomy economic period for PNG.

Will things improve in coming years? Non-resource growth in 2020 is projected to improve to 5%, but the recent data reviewed above casts doubt on this optimistic projection. There are large infrastructure investments under implementation (Highlands Highway upgrading, undersea cable, electrification projects) that will boost the economy; but their impact will be greater in the long term.[6]

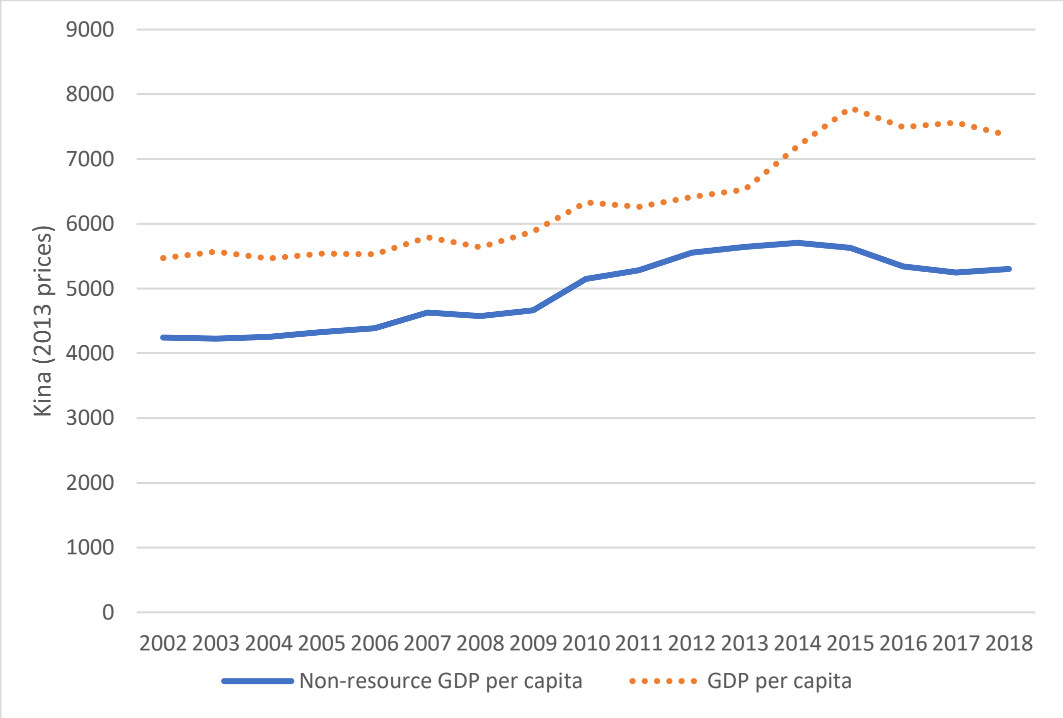
A major boost will come with the commencement of construction for the Papua LNG project, which, along with a proposed expansion of the existing PNG LNG project, will double the country's LNG exports. The agreement for this project was signed in April 2019, and construction was expected to commence in early 2021. However, the new government has decided to review the gas agreement, and this may push back construction.[7] The other mining project that was viewed as likely to proceed quickly, the Wafi-Golpu copper-gold project, has been delayed by a court challenge.

With other resource projects also in the works, some are optimistic about the extent of the next boom in PNG. The new Treasurer in one of his two mid-year statements stated that "Papua New

[5] The volume of log exports fell by 11% in the first half of 2019, with weaker demand from China (Treasury 2019c, p.34).
[6] Their impact will also depend on the regulatory framework. Access arrangements for the undersea cable are still unclear.
[7] On July 26, the new Petroleum Minister, Kerenga Kua, was reported as saying that he would be recommending changes to the agreement (Stapczunski 2019). On August 5, the NEC (Cabinet) was reported as saying that it supported the agreement in principle but had a "shortlist of issues" that it should only take two weeks to conclude (Post Courier, 2019a).

Guinea is in the early stages of an unprecedented economic development phase based on the expansion of the mining and petroleum sector." (Treasury 2019a) However, looking back over the last boom-bust cycle is instructive. Growth in the non-resource sector has largely failed to keep up with the country's population growth from 2014 onwards (Figure 3). Over the full cycle (that is, from 2003), annual average non-resource per capita growth has been 1.4%, which is positive but slow, and well below the average annual GDP per capita growth of 1.9%.

Figure 3: Resource GDP and non-resource GDP per capita (inflation adjusted)



Source: Treasury (2018, 2019a), and earlier Treasury budget documents.

Given the experience of the past, it seems unlikely that a reliance on resource projects will on its own lift PNG's non-resource growth trajectory significantly, not least because of the complexity of project negotiations, as well as the government's stated intention to reform resource policy (which will inevitably lead to some project delay): not to mention the difficulties in translating resource sector growth into non-resource sector growth and jobs.

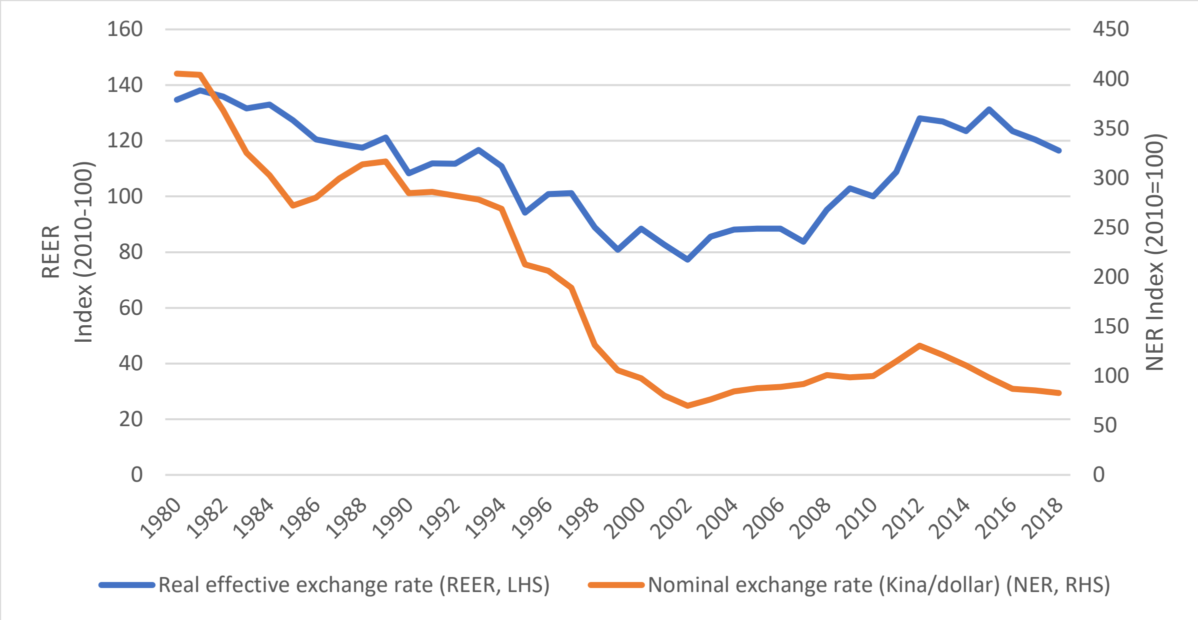
3. Balance of payments and exchange rate

As discussed in last year's survey (Fox et al 2018), PNG's current account has been in surplus since the LNG project commenced exports in 2014. The earthquake notwithstanding, the current account surplus increased again in 2018 to 32% of GDP, up from 27% in 2017.

The external surplus is driven by large resource exports but is also aided by the import compression; the result of a shortage of foreign exchange in recent years. The combination of foreign currency shortages and a large current account surplus is explained by an almost equally large deficit in PNG's financial account. Proceeds from LNG exports are largely used for debt payments and offshore dividend payouts, resulting in large capital outflows.

The main strategies adopted by the PNG government to deal with foreign exchange shortages have been the rationing of foreign currency and external debt financing. BPNG, the central bank, which sets the Kina-USD exchange rate, has been reluctant to allow much depreciation to lessen the need for foreign exchange rationing. Nominal depreciation has been modest, for example at an annual rate of 4% over 2018. The real exchange rate is still at an historic high and, in contrast to the real appreciation with the resource boom up to 2014, there has been only minimal real depreciation subsequently (Figure 4). Given that PNG is in a period of its economic cycle very similar to that of the early 2000s, the historical record, as summarised in Figure 4, suggests that the exchange rate is overvalued. The significant nominal and real deprecation over the late 1990s (when the exchange rate was floated) is in stark contrast to the much more modest depreciation seen in recent years. Analysis by IMF (2018) shows that a further 10-11% real depreciation is required to completely eliminate the currency overvaluation; but Figure 4 would suggest that this is an under-estimate. However, there is little support for exchange rate depreciation, and most commentators are opposed (Lea 2018).

Figure 4: Nominal and real exchange rate (2010=100)



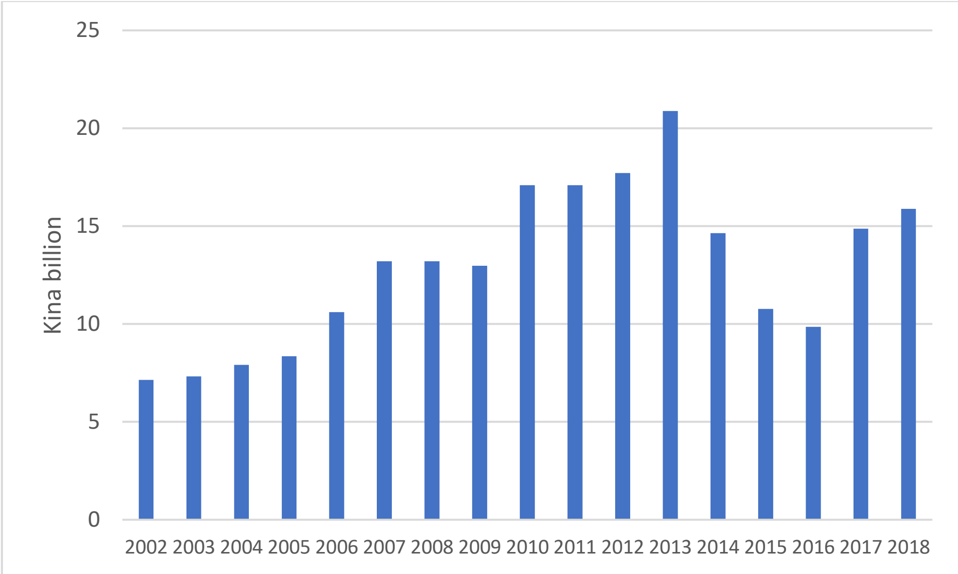
Source: World Development Indicators and International Financial Statistics

Notes: The real effective exchange rate is s the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. The nominal exchange rate is the annual average of the Kina/USD exchange rate.

The other strategy to ease foreign exchange shortages has been foreign borrowing, with the successful issuance of dollar-denominated sovereign bond and concessional, budget-support loans from the ADB and the World Bank in 2018.[8] These loans, together with some improvement in commodity prices, resulted in a growing inflow of foreign exchange. The Central Bank released $695 million from reserves in 2018, compared to only $227 million in 2017 (Elisa 2019). According to the BPNG, the outstanding backlog in foreign exchange declined significantly from K1.7 billion at the end of 2017 to K230.1 million in February 2019 and the average waiting time for a foreign exchange order to be served has fallen from 5 months to less than 3 months over the same period (BPNG 2019). Foreign exchange reserves increased over the same period, reaching $2.2 billion by the end of 2018—up from below $2 billion from 2015 to 2017 (BPNG 2019). Strong import growth over 2017 and 2018 supports the claim that import compression was less of a problem over this period (Figure 5).

[8] In 2018, PNG secured concessional budget support loans from the World Bank and the ADB of $US150 and $US100 million respectively, and a sovereign bond of $US500 million at an interest rate of 8.375%. It also took out a $US500 million loan from Credit Suisse in late 2017, the second tranche of which it received in 2018.

Figure 5: Nominal value of PNG imports (Kina billion)



Source: BPNG, as of March 2019 QEB, Table 8.1b

However, while there clearly was an improvement in 2018, foreign exchange shortages still exist and, in fact, have recently worsened again. One recent survey reported that only 5% of PNG businesses were getting foreign exchange when they need it. 73% said they had to wait three weeks of more (Business Advantage PNG 2019a). Another survey of CEO's indicates that foreign exchange was no longer business's top concern, but it was still in the top four (Business Advantage PNG 2019b). Getting foreign exchange to send dividends offshore (as against to pay for imports) is still said to be extremely difficult if not impossible. The Central Bank Governor himself has estimated the backlog in foreign exchange orders to have risen by mid-this-year back to Kina 1 billion (Vari 2019a).[9] As of mid-2019, foreign exchange reserves have fallen back below the US$2 billion benchmark.[10]

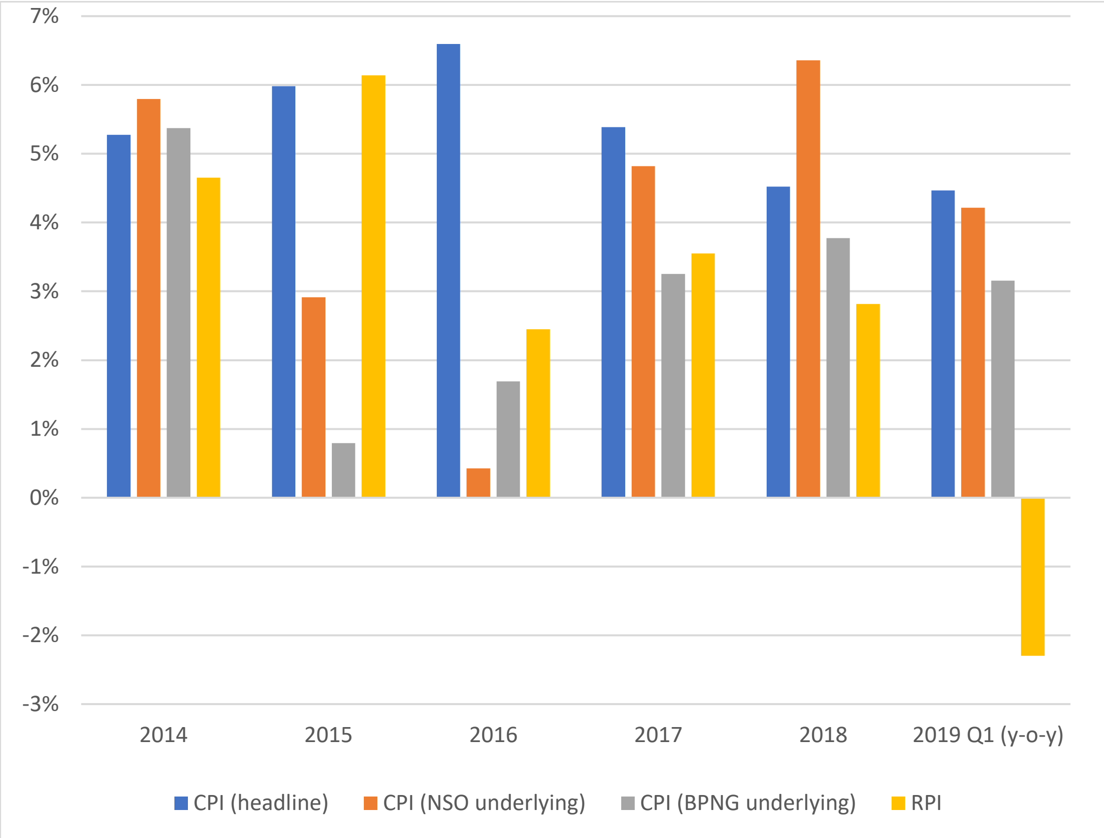
4. Inflation, monetary policy and the financial sector

One of the main reasons that the Bank of PNG is reluctant to depreciate the kina exchange rate is a concern around imported inflation. Various measures of inflation indicate that it is currently moderate (Figure 6), though there was a large (20.1%) increase in the price of medical supplies in 2018, related to a surge in demand. Prices for fresh fruits and vegetables fell last year. These commodities are excluded from underlying CPI measures, which were therefore higher in 2018.

[9] Some private sector estimates of the foreign exchange backlog are much higher, at US$ 1 billion.
[10] US$1.9 billion as reported at the end of July (Vari 2019b).

Whereas CPI data is collected by the National Statistical Office, RPI data is collected by BPNG. RPI shows deflation in the first three months of 2019, with prices for a range of goods (healthcare, communications and alcoholic beverages, tobacco and betelnut groups) declining year-on-year (Fitch Solutions 2019).

Figure 6: Inflation (% change in consumer price indices)

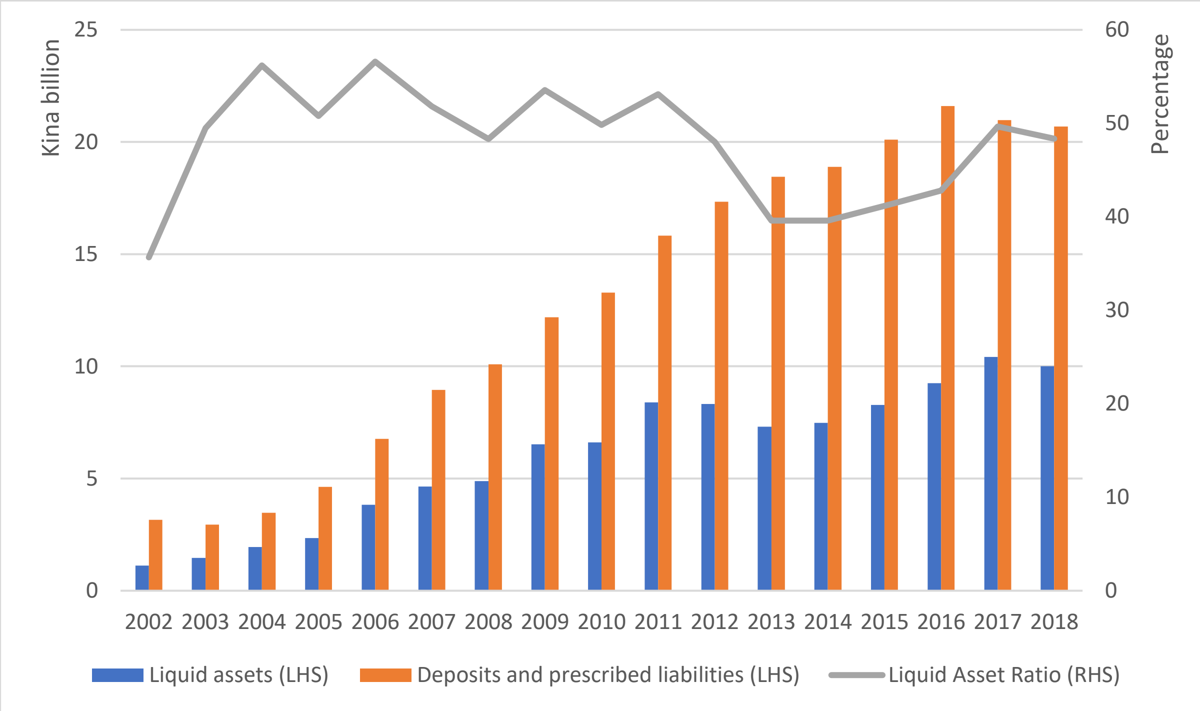


Source: CPI from BPNG, as of March 2019 QEB, Table 9.1; RPI from BPNG Monthly Economic Reviews.

This deflation prompted the central bank to exercise monetary easing by reducing the Kina Facility Rate (KFR) by 25 basis points to 6% in July 2019. There was another 50 basis point reduction in August – the first KFR adjustments in more than six years.

Whether monetary easing is justified or not, the KFR is ineffective as a monetary policy lever owing to the persistent excess liquidity in the banking system, which has resulted in the interbank market not being required by financial market participants (mainly commercial banks) to manage their overnight liquidity needs. The excess liquidity can be seen from the high liquid asset ratio in commercial banks, which has been above 40% since 2003 and peaked in 2017 at 49.6% (Figure 7). As the graph shows, domestic currency deposits have increased rapidly in tandem with the resource boom and foreign exchange rationing but the increase in lending has been far more modest due to the weak business environment. The liquid asset ratio declined marginally in 2018 following the government's retirement of domestic debt using the proceeds from foreign borrowing, and transfers from commercial banks to the central bank due to the government sweep of statutory authority balances (see Section 5).

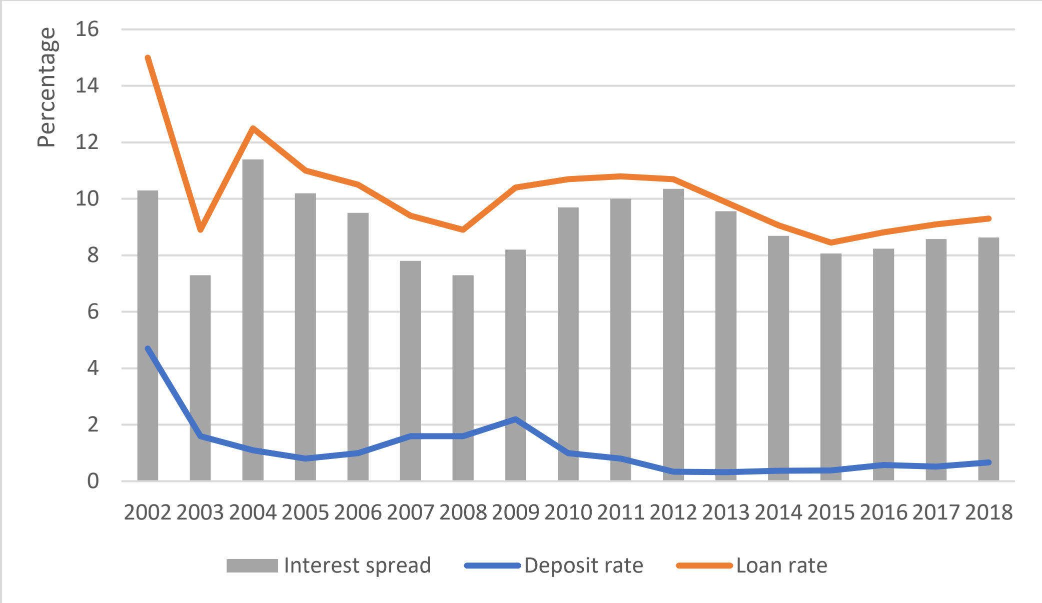
Figure 7: Commercial banks' total liquid assets and deposits, and liquid asset ratio



Source: BPNG, as of March 2019 QEB, Table 3.13.

BPNG introduced a new Intraday Lending Facility in 2018 and refined the repo facility by moving from uncollateralised to collateralised repo with the commercial banks. These changes will allow commercial banks to fund shortfalls in exchange settlement accounts at zero cost at the end of the business day, reducing liquidity risk in the absence of a standing facility with BPNG. However, these reforms, while welcome, will do nothing to address the more important challenges of increasing lending and reducing excess liquidity. Ultimately, the challenge is to reduce the interest rate spread between lending and borrowing rates (Figure 8). In fact, after declining from 2012 to 2015, this spread rose for the third straight year in 2018 to reach 8.6%--significantly above the East Asia and Pacific region average of 5% (World Bank, 2019a). Limited competition in the banking sector in PNG contributes to the persistently high interest spread and banking profits. Competition has been further curtailed by the acquisition of ANZ retail by Kina bank in early-2018, which has reduced the number of retail bankers to just three.

Figure 8: Interest rate spreads (%)



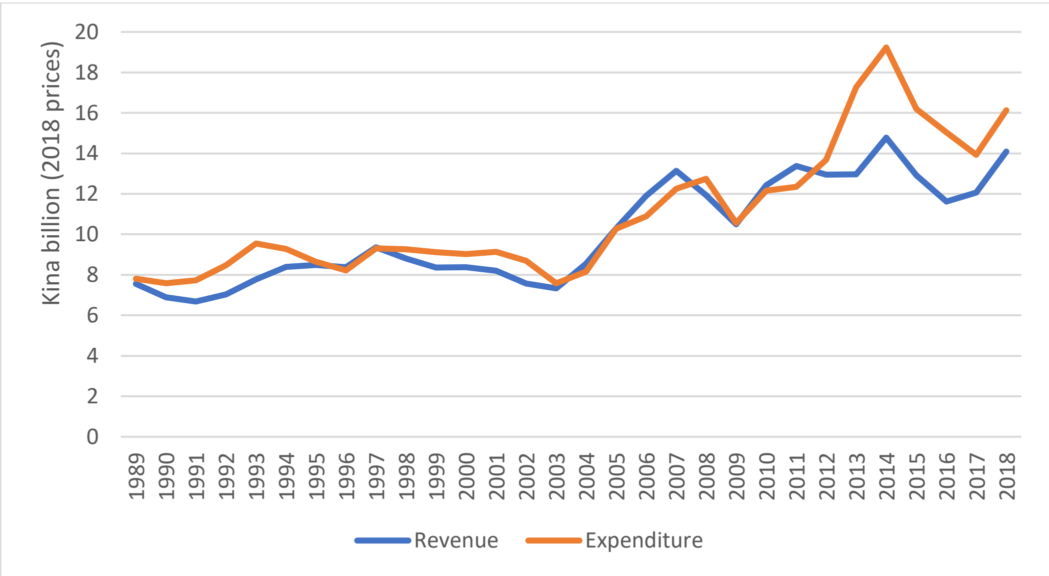
Source: BPNG, as of March 2019 QEB, Table 6.1

Notes: The deposit and loan rates are weighted averages.

5. Fiscal developments

2018 saw rapid growth in both government revenue and expenditure (Figure 9). 2019 looks like being a more difficult year. Overall, progress with fiscal adjustment is limited.

Figure 9: Revenue and expenditure, adjusted for inflation (Kina billion)



Source: PNG Budget Database (https://devpolicy.crawford.anu.edu.au/png-project/png-budget-database).

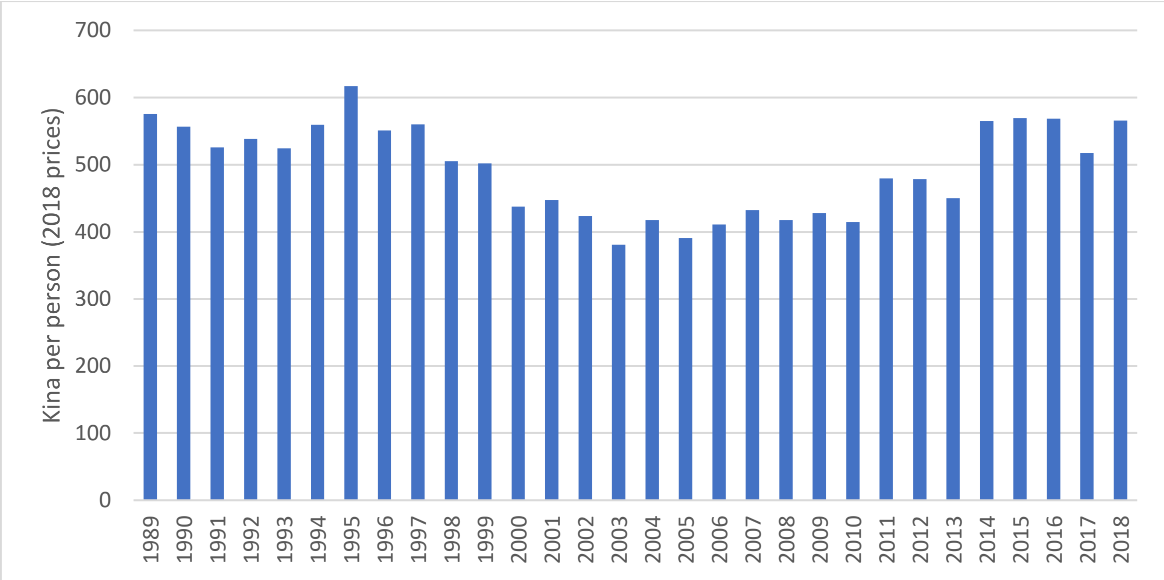
In 2018, revenue increased by 17% after inflation, the second highest single-year increase in the last three decades. Revenue from non-resource taxes increased by 3% after inflation. Resource revenue also recovered in 2018 (increasing by 88%) but is still low by historical standards at K1.3 billion. Grants from donors are also on an increasing trend and reached K1.8 billion in 2018 (a nominal increase of 27%), reflecting the 2018 earthquake and APEC. Most important for the large rise in revenue in 2018 was the increase in non-tax, non-resource revenue. The new policy forcing statutory authorities to hand over most of their cash balances to government raised K655 million for the year.[11] The National Fisheries Authority was the main contributor with K459 million (Treasury 2019d).

Expenditure increased in 2018 by 16% after inflation, the third largest increase since 1989, and the first real increase after three years of decline. All major expenditure areas showed an increase. The largest came from government employee compensation, which was 19% higher than the previous year after inflation, and 25% higher than initially budgeted for. This blowout of personnel expenditure made up 75% of the total difference of K1.4 billion between budgeted and actual expenditures for 2018. About K270 million of this was due to the payment arrears; but the bulk was the result of salary and staff increases. Despite efforts to control the salary bill, there are still reports of some 6,000 staff who are on the payroll but do not occupy a position (Post Courier 2019b).

Figure 10 shows how much is spent on government staff per citizen in PNG. The employee spend is historically high and has been difficult to reduce. There is a clear distinction between the post-boom years of the late nineties when there was a successful effort to reduce staff costs and the current period when there has been minimal to no adjustment relative to the boom years.

[11] The so-called "PMMR" policy: implementation of the Public Monies Management Regularisation Act of 2017.

Figure 10: PNG government staff costs per citizen



Source: PNG Budget Database
Note: Excludes donor-grant-funded staff. Note that employee costs of statutory authorities excluded from this graph.

The fiscal picture in 2019 is very different to that in 2018. Both expenditure and revenue are projected to increase relatively modestly—by about 7 and 8%, respectively, (before inflation and excluding donor grants). The revenue target will be very difficult to reach. In the first five months, Internal Revenue Commission collections were 8% below target and Customs 17% below target (Treasury 2019a, p.6).[12] Last year's sweep of public sector funds captured balances that had built up over several years and cannot be repeated; but seems to be assumed in the budget and mid-year estimates.

At the same time, the government is facing difficulty with its borrowing program. As discussed in Section 3, in 2018 it engaged in heavy foreign borrowing. This is in fact part of a broader strategy to increase the share of foreign debt in its portfolio. That share has already risen from 25% in 2016 to 37% in 2018, and is planned to reach 45% by 2020.[13] The motivation for this shift is to lengthen maturities and lower interest expenses (given the uncompetitive nature of PNG's financial sector, as discussed in the previous section), but it is predicated on an assumption that the exchange rate will not depreciate markedly. Indeed, the government is anticipating a real exchange rate appreciation due to forthcoming resource projects. The other risk with foreign borrowing is the uncertainty regarding timing. This year, PNG is aiming at borrowing from China, the World Bank and the ADB, and is also considering further commercial borrowing. However,

[12] Customs is responsible for taxes on international trade, and IRC for all other taxes.
[13] A modest share of the 2018 foreign borrowing was used to retire domestic debt (Treasury 2019c, Table 19).

none of these loans has been secured, and it is unclear whether and when they will be. In particular, borrowing from multilateral banks is conditional on economic performance.

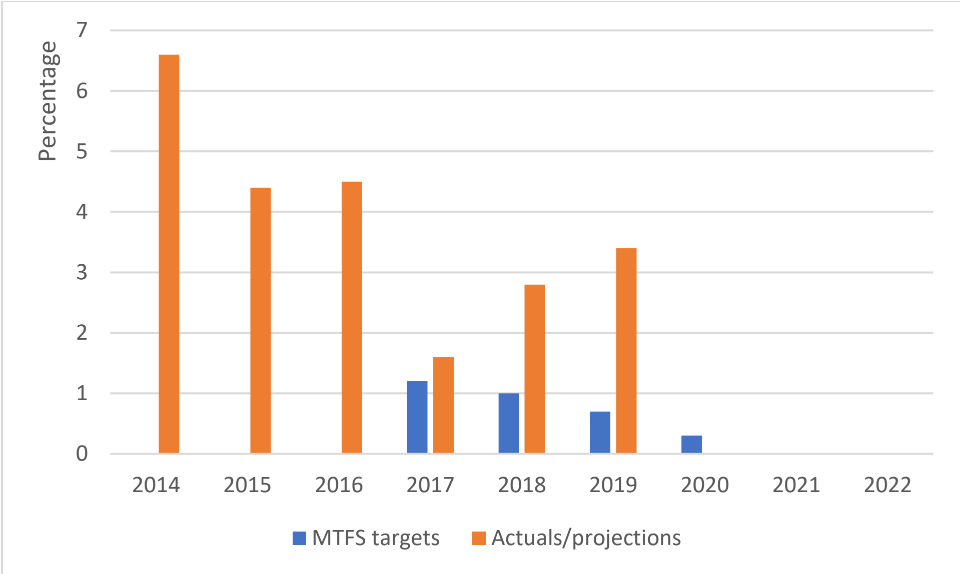
While revenue and borrowing difficulties are constraining expenditures, pressures are coming in the other direction from the salary bill. The budgeted 2019 salary allowance was about K1 billion below the 2018 actuals. This budget projection was clearly unrealistic. According to the mid-year statement, the salary bill was 9.3% above budget in the first half of the year. Utilities, rentals and interest payments have also been underbudgeted. Arrears are another problem. K1.04 billion in bills from 2018 were paid in early 2019, further squeezing the space for 2019 expenditure, and reducing the likelihood that 2019 bills will be paid.[14]

Longer term, the problem is one of weak revenue growth and poor expenditure control. There has been low revenue growth over the resource cycle (in real terms, about 3.7% on average from 2002 to 2018), and volatile as well: revenue in 2018 was still 5% below its 2014 peak. Interest and salaries, as well as the massive growth in MP-controlled district and provincial funding, have squeezed other spending areas.

Not surprisingly, in this context, it has been difficult to rein in borrowing. While deficits have come down from their highs of five years ago, the government's target is to eliminate the non-resource primary deficit by 2022 (Abel 2017). However, as Figure 11 shows, it has not been able to keep to its 2017 Medium Term Fiscal Strategy targets, and indeed is now heading in the wrong direction.

[14] All the claims in this paragraph are taken from the mid-year statement or MYEFO (Treasury 2019c)

Figure 11: Government deficits – performance against targets



Note: The deficit measure is the non-resource primary balance as a percentage of non-resource GDP, which is the measure targeted in the MTFS or Medium Term Fiscal Strategy (Abel 2017). The targets for 2021 and 2022 are actually zero. Actuals and the 2019 projection from Treasury 2019c and World Bank 2019a and b.

The debt/GDP ratio is calculated by the government to be 32.8% in 2018 (Treasury 2019c), and by the World Bank at 34.2% (World Bank 2019b). Both calculations (which use different GDP estimates) suggest that debt is stabilising within the 30-35% mandated range, but is still above the 30% target for 2022. Moreover, both are underestimates, because foreign debt is valued at an historical (and appreciated) nominal exchange rate. It also excludes K1.5 billion of government-guaranteed debt, which is now being serviced from the budget (Treasury 2019b). Adjusting for these two would push the debt stock close to or above the 35% upper limit. Even adjusting for inflation, interest payments have increased more than three-fold since 2011.

There are also risks from state-owned enterprise (SOE) debt, which totals another K6 billion. The SOE sector as a whole is loss-making, and "in crisis", according to the new Minister of Public Enterprises (Post Courier 2019c). More guarantees are likely to be called.

To its credit, PNG has been attempting to improve its fiscal situation over the past few years through fiscal reform. However, it has been stymied by low revenue growth (except in 2018) and poor control over salaries. Moreover, PNG faces clear, but unquantified risks from apparently rising government arrears and poor use of SOE debt.[15] Two reasons explain the fiscal reform failure. First, consistent with international experience, PNG has found fiscal adjustment difficult

[15] That 20% of government-funded expenditure is classified in the budget as "miscellaneous" also raises questions of transparency around government spending (Treasury 2019d, Table 26).

in the absence of strong economic growth. Second, the lack of a narrative around the difficulties being faced by the economy has made it hard to enforce tough spending decisions. The next section considers the broader reform agenda, and the conclusion returns to the question of a narrative.

6. Economic and governance reforms

This section reviews the main reforms being pursued by the government and the major policy debates, under three headings: promotion of local industries; fiscal and resource policy reform; and governance reforms.[16]

6.1 Promotion of local industry

The government has sought to promote local industries in recent years by the provision of higher tariffs for domestic import-competing industries, and joint ventures. The government has also debated the provision of more protection to PNG-owned industries by reducing the scope of foreign investment, but it is yet to implement any such reforms.

In 2019, the PNG government continued on the protectionist path it started on in 2018 (Fox, Howes and Laveil, 2018). On top of the 250 tariff increases instituted in 2018, the 2019 National Budget introduced 73 new tariffs, with 19 tariff decreases. The purpose of these additional tariffs, according to the Customs Tariff Amendment (2019) Act, is to “provide relief to local pioneer industry and existing local manufacturers from cheap imports”. The Chief Executive of the Manufacturers Council has said that manufacturing investment has expanded as a result of the tariffs (James 2019b). The government is estimating a mild growth in manufacturing to date (3% in 2018), with more to come; but manufacturing remains a small sector of the economy (below 4% of GDP).

The government has also pursued various commercial and bilateral business initiatives. For example, the government has established a joint venture in dairying with the agribusiness farm Innovative Agri Industry PNG Ltd, to which it has provided debt guarantees and tariff protection. The PNG government and the Philippines government have also signed a five-year agreement, assigning 25 hectares to pilot a rice farm using machinery and expertise from the Philippines. The problems with such initiatives are: the cost to government (if guarantees are offered, and then

[16] Given space constraints, the discussion is selective. See also Government of PNG (2018), and World Bank (2019a and 2019b) for further coverage of key reform and development issues.

invoked), and the cost to consumers (if tariffs or other forms of market protection are provided), and the mixing of government with commerce.

There have also been proposals to protect national industries from competition with foreign capital via a proposed Foreign Investment Authority Bill. In pursuit of the government's target of 500,000 small and medium enterprises (SMEs) by 2030, this would reserve all enterprises worth below K10 million to PNG nationals, and companies that are more than 50 percent owned by a PNG national. Foreign-owned enterprises worth less than K10 million would also be required by the authority to cease operations within a three-year transitional period (Business Advantage PNG 2019c).

The Foreign Investment Authority Bill was withdrawn after protests from industry but is still under consideration. A more modest proposal is to revise the Investment Promotion Act to create a new "restricted activities" list, which could include minimum local ownership levels, and promote better compliance (James 2019c). This debate around foreign investment has been underway since at least 2016 when the PNG SME policy was released; and the more radical reforms proposed have been critiqued as likely to lead to a loss of employment (Nicholas 2016).

The one policy not put forward to support local business has been an exchange rate depreciation. As shown in Figure 4, the real exchange rate is at a historic high. Unlike raising tariffs, devaluing the exchange rate would help both import-competing and export sectors. Increases in tariffs and greater restrictions in foreign investments will in fact harm the agricultural, logging and fisheries sectors and are therefore at odds with the Prime Minister's vision to make PNG a major agricultural exporter. Expanding non-resource exports will remain extremely difficult while the exchange rate is overvalued.

6.2 Resources policy

In recognition of the strong sentiment that the terms of the PNG LNG project were too generous,[17] there was a push to negotiate the next LNG project, the Papua LNG project, to secure more favourable terms. Comparing the two gas agreements is a complex undertaking, and a full review is beyond the scope of this article. However, the initial analysis does suggest more favourable terms for the PNG government from this agreement than from the previous one. Most clearly, there is a new production levy, earmarked for the central government, at 2% of wellhead value.

[17] This is not just domestic sentiment. The IMF has commented that "government revenue from the LNG sector has been very limited due to the generous fiscal terms of the [PNG LNG] agreement" (IMF 2017, p.18)

The wellhead value (used to calculate royalties, and the development and new production levy) is defined in a more generous way for the government, and the production levy should ensure tax flows commence quickly. Papua LNG royalties will no longer be able to be deducted against corporate income tax payments. Other concessions received by the PNG LNG project remain in place, including tax concessions to the PNG LNG project estimated by Treasury to cost K500 million in 2017 (Treasury 2018).[18] Responding to concerns around foreign exchange availability, the project developers agreed to maintain a balance that is topped up to US$ 1 billion annually for domestic payments.

Given the controversies around the PNG LNG project and the complexities surrounding the taxation arrangements of a project of this size, a published review of the expected government revenue take for the Papua LNG project would be advisable.

Broader resource-sector debates cover a range of issues from the extent of local ownership and reliance on fly-in fly-out expatriate workers (James 2018). The government has again promised to bring in new mining legislation to address these issues. The mining Industry is generally opposed to the proposed changes and warns of "the serious and steady decline of exploration activities, particularly mineral exploration in PNG." (Aopi 2019)

While not part of the (non-renewable) resources sector as defined in this paper, PNG is also planning a major reform of the forestry sector next year, with a proposed ban on unprocessed log exports.

PNG's Sovereign Wealth Fund (SWF) was originally legislated for in 2012 and then restructured with further legislation in 2014 (Osborne 2014). However, it is still not operational. Resource taxes have not yet hit the threshold to be accumulated in the SWF stabilisation fund. But there is also a savings fund into which at least 25% of dividends arising from state equity shares from resource projects are meant to be paid, and then accumulated (Osborne 2014). However, no dividends have been paid in. Given the fiscal stress, this is hardly surprising, and suggests the need for a review of the intended savings function of the SWF. Moreover, there is no agreed dividend policy for Kumul Petroleum, which holds the PNG government's shares in the PNG LNG project. Legislative or policy change is required to bring the dividend distribution policies of government-owned resource companies under government control.

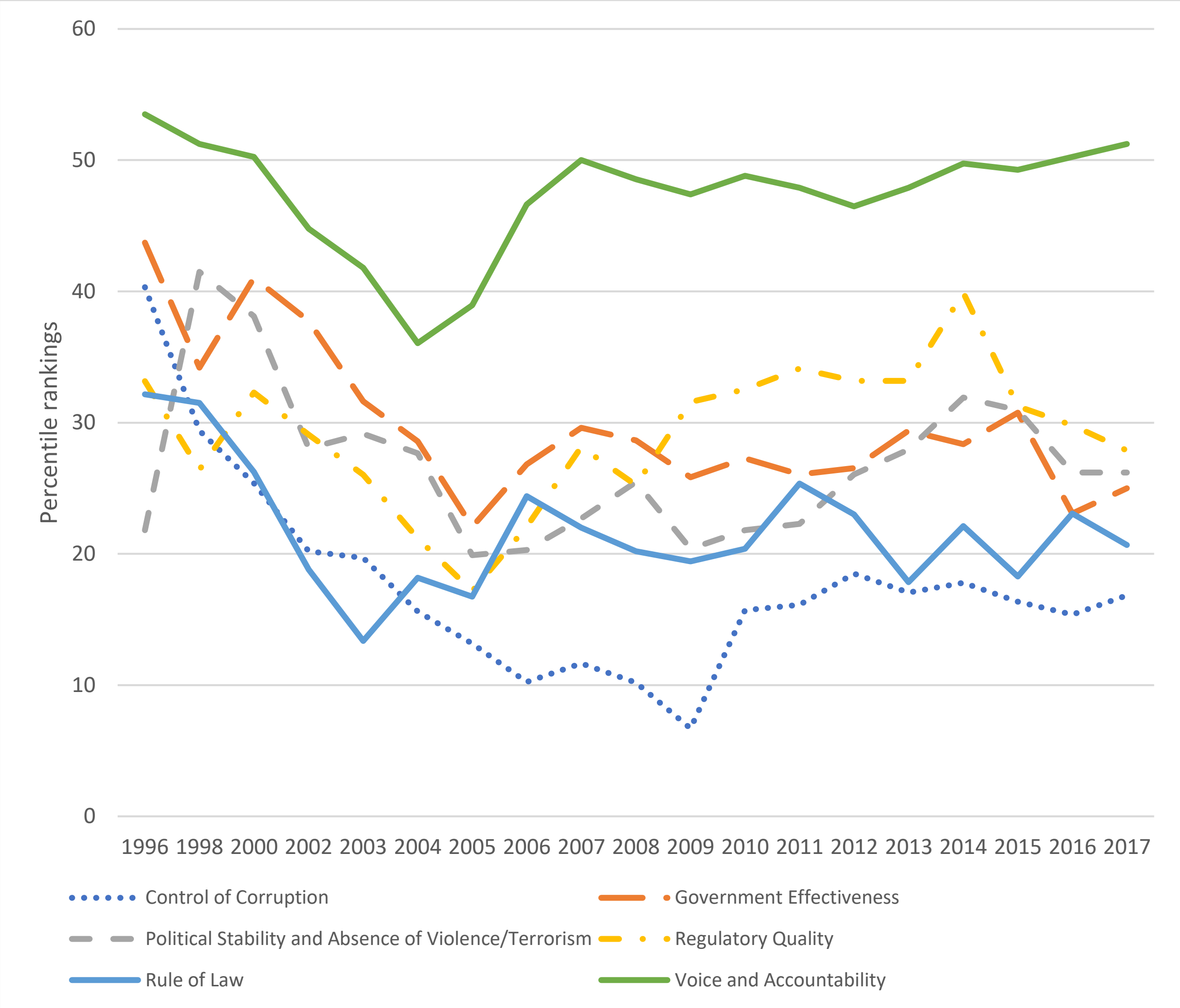
[18] This includes legislated concessions, as opposed to the project-defined concessions discussed above, regarding thin capitalisation and additional exploration deductions.

6.3 Governance

The new government of Prime Minister James Marape has placed a heavy emphasis on governance reforms. Those proposed by the new government, led by Deputy Prime Minister Davis Steven, include the establishment of an anti-corruption commission, legislation to protect whistle blowers, and state-owned enterprise reforms.

International data supports a focus on governance improvement, especially given the central role played by the PNG government as a redistributor of resource rents. PNG has the lowest score of all the Pacific countries for which data is available for four of the six Worldwide Governance Indicators, namely “control of corruption”, “political stability and absence of violence/terrorism”, “voice and accountability”, and “rule of law”. It is in the bottom quarter of all countries worldwide for: control of corruption (17th percentile), rule of law (21st percentile) and “government effectiveness” (25th percentile). Analysis of these indicators since the mid-1990s suggests stagnation or decline (Figure 12). With the exception of “voice and accountability” (a measure of democracy, the only indicator in relation to which PNG ranks in the top half of countries), the other five indicators, which were in 1996 in a percentile range of 32-44, are now within a range of 17-29. The indicator for corruption shows the largest decline, from the 40th percentile of countries in 1996 to the 17th in 2017.

Figure 12: World Governance Indicators for PNG over time: percentile rankings



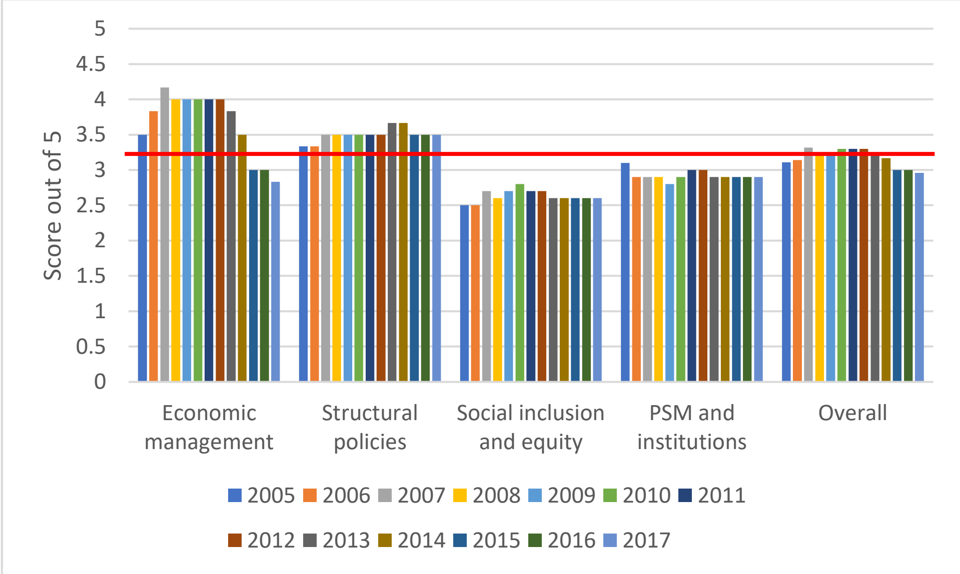
Source: Worldwide Governance Indicators: www.govindicators.org.

PNG is once against listed as in a "fragile situation" by the World Bank.[19] It was classified as such from 2006 to 2008 and in 2010, but was then removed from the listing until it returned in June 2016; and it has stayed on the list since (until the most recent, released on July 1 2018). The World Bank and ADB both assess countries annually for the quality of their policies and institutions to derive what is known as a CPIA (Country Policy and Institutional Assessment) score. Countries are regarded as fragile if they have a CPIA score of less than 3.2 (out of 5) when averaged across the WB and ADB assessments.[20] As Figure 13 shows, PNG improved its CPIA score around 2008 and 2009 with better economic management, but that score is now at an all-time low. Scores for institutions and social inclusion are in general more stable but also lower.

[19] See https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations

[20] Countries with a peacekeeping or similar mission are also counted as fragile states/situations regardless of their CPIA score. Only countries that are members of the World Bank and are eligible for concessional funding are examined.

Figure 13: PNG World Bank Country Policy and Institutional Assessments (out of 5)



Source: World Bank CPIA data: https://datacatalog.worldbank.org/dataset/country-policy-and-institutional-assessment.
Note: The red line indicates the cut off for being counted as fragile (3.25 or below for the overall score).

7. Conclusion

Despite the earthquake, 2018 was a positive year for the PNG economy, with improved non-resource growth, and higher government revenue and expenditure. However, 2018 appears to have been a one-off, with improved non-resource growth driven by a massive expansion in government spending, and by foreign borrowing that eased foreign exchange rationing. Both helped significantly in the short term; but both are likely to be unsustainable. The indications for 2019 are that expenditure growth has slowed if not halted; that foreign currency shortages are increasing once again; and that the recovery in non-resource growth has not been sustained. The Prime Minister's diagnosis that the economy is "struggling and bleeding" does indeed seem reasonable as a summary of the current situation.

What can the government do? Its interest in improving governance is welcome, as there is an urgent need to reverse the decline in PNG's governance indicators. The government also needs to prepare for the next resource project. The Papua LNG agreement does seem to be more favourable to the government than the PNG LNG agreement, but the SWF and related arrangements for managing resource revenue need to be both reviewed and operationalised. Given the evident difficulties involved with allowing the real exchange rate to depreciate, more effort should go into preventing an appreciation during the next boom. To avoid further falls in employment, policy changes that restrict foreign investment should be avoided, with preference instead given to better enforcement of existing regulations.

While all of the above is important, there is no getting around the urgent need to revisit current fiscal and exchange rate policy settings. Given that the policies and strategies put in place to date have not yielded the desired results, it would be sensible to try something new. It might be time to approach the IMF for financing and support in developing a new reform program. This could help the current government deal with the serious problems it has inherited—namely the current difficult financing situation, the foreign exchange problem, and various entrenched fiscal issues, such as staffing, arrears, and SOE debt.

The reforms PNG requires will not be easy to implement. Difficult decisions will only be taken and seen through if there is a commonly-shared belief that they are required by tough times. PNG's new government has the opportunity to build a narrative and consensus for reform, by explaining the "bleeding and struggling" that the economy is indeed experiencing, emphasising the need to address problems that built up under the previous government, and outlining the reforms required to address these. It is an opportunity not to be missed.

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