Book reviews

John Fallon, Tim King and John Zeitsch, 1995. *Exchange Rate Policy in Papua New Guinea*, Discussion Paper 64, Institute of National Affairs, Port Moresby, ISBN 9980 77 256 5, 137pp.

Herb Thompson and Scott MacWilliam, 1992. *The Political Economy of Papua New Guinea*, Journal of Contemporary Asia Publishers, Manila and Wollongong, ISBN 9718 63 905 5, 206pp.

Desh Gupta, 1992. *Political Economy of Growth and Stagnation in Papua New Guinea*, University of Papua New Guinea Press, Port Moresby, ISBN 9980 84 038 2, 227pp.

Exchange Rate Policy in Papua New Guinea

This is a useful contribution to the analysis of macroeconomic policy in Papua New Guinea. It is also timely, since it follows the new macroeconomic policy options opened up by the wage flexibility provided by the 1992 decision of the Minimum Wages Board (MWB) and the abandonment of any attempt to target either the nominal or the real exchange rate, caused by the government's recent lack of fiscal discipline.

The authors, John Fallon, Tim King and John Zeitsch, put their technical arguments carefully, impartially and, in most cases, precisely. One, perhaps inevitable, consequence of this is that the message for Papua New Guinea's policymakers (and for their critics) can be lost in the many qualifications of all options—some examples are cited below.

A big plus is the consistent emphasis that the real exchange rate, not the nominal exchange rate, is the appropriate concern of macroeconomic policy. Moreover, the concept of the real exchange rate is explained clearly. The authors also stress that the real exchange rate cannot be targeted effectively simply by manipulating the nominal rate, explaining that 'it is only feasible to use the exchange rate to achieve real targets when changes in the nominal exchange rate have a different impact on the relative prices of tradeable and non-tradeable goods' (p7) and 'it is no use changing the nominal exchange rate in order to change the real exchange rate unless the underlying determinants of the real exchange rate have changed in a consistent manner' (p54).

They also point out, positively, that if adjustments are combined with appropriate settings of other macroeconomic policy instruments, then

> ... a nominal exchange rate change can be effective in achieving the required real exchange rate that would have taken much longer to be realised through normal market processes (p54).

The evidence cited for these statements, including that drawn from Edwards (1986) and on p48, is very helpful. All of this is a refreshing change from the vast array of second-rate analyses which have suggested that a nominal devaluation was a 'magic cure' for Papua New Guinea and many other economies. There has never been any doubt that after the wage rises of the early 1970s, real wages and hence the real exchange rate in Papua New Guinea were way too high. It does not follow that a nominal devaluation can always be effective in fixing that problem.

As the authors point out, exchange rate policy needs to be part of a 'package' of macroeconomic policies. But they miss the opportunity to clarify that the appropriate settings within such a package will change with political and institutional circumstances. Nor do they try to spell out in one place what kind of package would be appropriate to Papua New Guinea in its current circumstances. As in a good mystery novel, all the ingredients can be found somewhere in the text, but policy-makers do not have time to piece these things together.

It is interesting to note that the authors confirm the analysis of Garnaut and Baxter (1984) that the assignment of the nominal exchange rate to sustaining a combination of stable low inflation and a stable real exchange rate was appropriate in the mid-1970s and early 1980s, when

- changes in the nominal exchange rate could have very little influence on relative prices within Papua New Guinea, due to a combination of wage indexations and the large share of imports to total demand
- international inflation rates were high and unstable and, importantly,
- total demand was managed effectively by appropriate fiscal and monetary policies.

Where their analysis weakens is their glib rejection of assigning policy instruments to policy targets (p64). Saying that assigning policy instruments to targets is simplistic since 'fiscal policy needs to pursue multiple objectives' is a recipe for poor policy. The correct approach is to separate fiscal policy into as many components (for example, the allocation of spending, the pattern of taxation and the overall public sector borrowing requirement) as needed to achieve all of the accepted targets of all aspects of fiscal policy. If that proves too hard, then it is better to drop some targets than to invite policy confusion.

Careful assignment of policy instruments to targets remains just as important with the end of wage indexations following the 1992 MWB decision. The authors point out, skilfully, that Papua New Guinea decisionmakers are now operating in a different environment, characterised by a considerable ability to alter the relative prices of tradables and non-tradables by changes in the nominal exchange rate and an international environment of low and steady inflation rates.

In such circumstances, they are correct to suggest that the nominal exchange rate can now be used, carefully, to bring about a steady reduction in the real exchange rate by eroding real wages, without destabilising the labour market, through modest inflation. Unfortunately, just as this option has become potentially available, Papua New Guinea can no longer pursue any exchange rate policy due to the failure of demand management.

Chart 3 demonstrates that a very large nominal devaluation since 1990 has been accompanied by an ever greater rise in the real exchange rate. A closer look indicates that the first devaluation, in 1990, did achieve the desired result: demand was reduced following the closure of the Bougainville mine, nominal wage increases were limited by the 1989 MWB decision and the real exchange rate fell with the nominal exchange rate. But as soon as government expenditure went out of control, the real exchange rate began to rise again, despite the complete abolition of indexations.

So, despite the relaxation of wage rigidity the real exchange rate remains out of line. Where should it be and how to get there?

In Section 5.1, the authors finally explain when the real exchange rate can be considered to be in equilibrium: when both external and internal equilibrium are achieved (the presence of twin objectives confirms that an equilibrium real exchange rate cannot be achieved by a single policy instrument). A good working definition of external balance is cited as

> the maintenance of currency convertibility at all stages of the international business cycle without resorting to external borrowings that are so large that their servicing requires absolute reductions in living standards at some future time (from Garnaut and Baxter 1984:38).

It is much more difficult to find a concept of internal equilibrium. The authors quote unemployment statistics repeatedly, but such numbers are meaningless in an economy like Papua New Guinea, even if census figures were reliable. The authors admit that it is difficult to be precise about where the real exchange rate should settle, but they point out, sensibly, that to guide policy for the foreseeable future, it is sufficient to know when it is clearly too high. The guideline cited from Williamson (1991) of poor export performance is useful. Papua New Guinea should seek to bring down its real exchange rate (not simply by nominal devaluations) until labour-intensive exports begin to do well.

The paper is somewhat confusing about the desirability of exchange rate stability. It is correct to say that the real exchange rate should not be rigid: its appropriate setting will change as international and domestic cost structures evolve. But it is overkill to say so in terms like '[t]here is often a mistaken impression that the real exchange rate should be stable' (p6).

This sits awkwardly with the fear of excessive volatility now the kina is floating (see p15 and pp92–3). It would have been more helpful to say, consistently, that rigidity is inappropriate, but the combination of macroeconomic policies should also be able to steer the real exchange rate away from perceived misalignments, while maintaining convertibility and avoiding excessive exchange rate fluctuations. That was what the much-maligned 'hard kina strategy' was all about.

The paper misses the opportunity to clarify the hard kina strategy, although it is defined in several of the sources cited (especially Garnaut and Baxter 1984). In many places the phrase is used, wrongly, to characterise inappropriate exchange rate policies such as excessive rigidity, neglect of exchange rate management or revaluations. It is not until p31 that the reader is informed that the hard kina strategy was in fact, a consistent application of the nominal anchor approach to exchange rate management up to the late 1980s, the preconditions for the success of this approach, as cited from Corden (1993), were all met in Papua New Guinea. As already noted, the authors themselves acknowledge that such a strategy was appropriate in the post-independence period.

The authors are correct to encourage Papua New Guinea to move towards a real targets approach in the new environment of wage flexibility. But this, by definition, implies the capacity to set and approach targets, which does require a 'hard' currency in the sense of being seen as convertible and reasonably predictable in value.

Papua New Guinea needs to escape from the 'swamp of soft currencies' into which it has strayed. Without regaining control over public sector borrowings the nominal exchange rate may well be flexible downwards, but still continue to deliver rising real exchange rates.

As Professor Hogan points out in his commentary at the front of the volume, the authors criticise the lack of any real ability to stabilise the exchange rate, but do not set out the preconditions for regaining control. Hogan, helpfully sets these out in paragraph 3.2 on p(v).

The paper makes sensible use of the general equilibrium model developed by the National Centre for Development Studies, explaining the limitations of such short-term comparative static analysis as a guide to exchange rate policy. They are correct to stress that the important benefits of getting the real exchange rate closer to an appropriate level will come from allowing a broadening of the base of production and exports, rather than from any short-term reallocation of resources among existing sectors. The overview of a model which allows for 'new goods' (pp55–8) is a valuable part of the paper. Allowing Papua New Guinea to move into producing tradeable labour-intensive products without protection is strategically much more important than making the production of unprocessed commodities more profitable.

Finally, some questions for future analysis raised by the paper. While the adoption of indexations may have been necessary to put a ceiling on real wages in the mid-1970s when urban formal sector employees had a disproportionate influence on politics, indexations had outlived its usefulness by the early 1980s. Why was it not possible to end it earlier? And how effective has it proved in reducing actual urban wages, as against the legal minimum wage? These are important questions for policy makers in other Pacific Island economies.

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The Political Economy of Papua New Guinea

Herb Thompson and Scott MacWilliam adopt a Marxist approach to analyse Papua New Guinea’s post-independence transition. They identify economic stagnation and political crises as the basic feature of the transition in the 1980–90 decade. Prominent among the political crises, is the Bougainville revolution, which began in 1989 and was instigated by the Bougainville Revolutionary Army.

Some economic reductionism is evident in the analysis, with the Bougainville rebellion (Chapter 1) attributed to the failure of benefits from the copper mine to trickle down to the people of Bougainville. Other economic variables are noted—the increased desire by villagers for consumption at the expense of savings and incompetent management of the Bougainville Development Corporation.

Thompson and MacWilliam attribute the Bougainville crisis to economic rather than political and historical factors. The issue of separation, however, gained prominence as far back as 1974 before Papua New Guinea acquired its independence. This is a historical factor which found continuity in political channels such as the Bougainville Revolutionary Army and even the North Solomons Provincial Government. The economic determinism employed to explain the Bougainville rebellion results in a methodology lacking historical perspective.

Chapter 2 continues with an emphasis on economic determinism. Shifts in class power involving fractions of capital are argued to have ultimately determined the exercise of state power. The behaviour of the post-colonial state is then influenced by the struggles between fractions of capital, and the hegemony that a fraction or an alliance is able to exercise.

To some extent such an assertion is valid, but shifts in class power need to expose the specific fractions of capital involved. For instance, the peasant class, involvied as landowners in major resource projects, has been a vociferous group demanding compensation, a fair share of mining royalties, infrastructure and economic development from multinational corporations as well as from the state. Since 1980, numerous landowner groups have sprung up and have actively entered into the bargaining process with the state and multinational companies.

Land ownership has been transformed into enormous political power, capable of forcing the state yield to specific demands. For instance, the landowners of the Ok Tedi mine are beneficiaries of the lower Ok Tedi/Fly River Development Trust set up by Ok Tedi Mining Lease (OTML) in the latter 1980s. The Trust funds are used for various village, business and infrastructure development projects. In the life of the mine, from 1984 (when production began) to, say, 2010, OTML will have spent mining capital in the order of 80 billion kina on landowner plus mine-affected communities in the western province. Peasant landowners have emerged as a powerful class in the 1980s *vis-à-vis* state employees. Thus, if there is any shift in class power in the 1980s, it is the shift from the latter to peasant dominance *vis-à-vis* the state.

Chapter 3 accounts for indigenous class formation as a process following closely the global patterns of accumulation. The discussion emphasises the role economic factors play in determining national direction and state behaviour.

In the authors' argument indigenous capital made conscious choices to orient the Papua New Guinea economy to global capital accumulation. Historically, this is not so. At independence, sovereign decisions were made by the independent state of Papua New Guinea to integrate the national economy into the world capitalist system, thus becoming part of the global capital accumulation.

Independence is a historical reality. Sovereignty is embedded in this reality. The authors have ignored the relevance of independence and sovereignty in providing the political impetus for the post-colonial state to make conscious choices about finding Papua New Guinea a niche in the world capitalist system.

Chapter 4 discusses household production in the countryside. Household labour is subsumed by capital which follows the logic of accumulation and expansion of surplus value production. Government schemes to extend household production, although acquiring a welfarist gloss, are also subsumed by capital. Consequently there appears to have been little political debate regarding labour's subsumption by capital.

Thompson and MacWilliam mostly ignore the fact that in the early 1980s when more mining enclaves went into production, household production and labour were very much politicised. When Ok Tedi was established in 1981 and later began production in 1984, landowners and workers at the mine formed themselves into associations and a union and entered into the bargaining process with the state and OTML. Their success in negotiating wage increases and infrastructure developments in the communities is evidence of the bargaining leverage the landowners and workers were able to exercise on mining capital and on the state's decisionmaking process. The authors seem to have slighted the bargaining process that has eased the subsumption of labour and household production by capital.

The economic determinist argument continues in Chapter 5. According to Thompson and MacWilliam, mining capital and the mining industry, have contributed to the development of 'classes for themselves'. Factional struggles and interests will be fought out in the state and will determine the direction and degree of economic and political development. Such struggles will ultimately determine the character of the state's mining policy and its ability to respond to class interests.

Landowner groups have sprung up rapidly in association with mining activities, as have workers' unions. The state's mining policy is not shaped solely by the interests of local and international capital. It is, increasingly, shaped by landowners' claims for compensation, royalties, development-related activities and by workers' demands for improved employment conditions. The authors have ignored the democratic pluralism that has evolved in Papua New Guinea's domestic political environment since independence.

Chapter 6 argues that the environment in Papua New Guinea takes a secondary place in the overall process of development; that the state accords greater priority to economic development as required by international capital accumulation. Within a capitalist framework, therefore, environmental degradation is not normally an issue for consideration.

Here again, the authors have failed to look at the historical political context. In the 1980s and 1990s landowners associations' claims for development benefits and environmental conservation have become imperatives the state and capital owners cannot ignore. In early 1995, Ok Tedi landowners were able to get the state in Papua New Guinea and OTML to give serious consideration to the environmental problems of building a tailings dam following a massive compensation demand of over a billion kina for environmental damages.

Overall, because of the primacy of the market in their analysis, the authors have slighted the history of democratic pluralism in Papua New Guinea and how that has elevated the significance of landowner and wage earner demands on capital, and shaped the outcomes of interactions between capital, the state, and grassroots groups.

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Political Economy of Growth and Stagnation in Papua New Guinea

The economic difficulties facing Papua New Guinea in recent years have resulted in attention to policies and strategies addressing the problems the economy faces. Gupta's book was developed from a series of lectures undertaken for the Structure of the Papua New Guinea Economy Unit at the University of Papua New Guinea in the early 1980s.

Whilst difficult going at times, the book provides an analytical framework for the Papua New Guinea economy which goes beyond the neoclassical paradigm. It also provides a useful historical analysis of the economic and political structures of Papua New Guinea from pre-colonial times.

The book is, for the most part, a factual and descriptive account of the structure of the Papua New Guinea economy, including the development of its legal, political and administrative framework; labour supplies, wages and income distribution; international economic relations; the financial sector; manufacturing and secondary industry and trade policies; and human resource development (education and health). The final chapter covers savings and investment ratios, resource rent taxes, 'Dutch Disease' effects, and mineral exploitation in Papua New Guinea.

Students interested in the development and current structure of the Papua New Guinea economy will find much to interest them, particularly on the early colonial period. Those interested in policy analysis and impact assessment will also find something of value, but the treatment is uneven. Little attention is devoted to food crops, fishing and forestry, whilst descriptions of political developments are more detailed than needed. Subjects like public sector reform are given some treatment, but not comprehensively.

A major argument of the book is the adverse effect of Australian neo-colonialism, giving rise to an economy with high wages, overdependence on aid, and with foreign relations and trade dominated by Australia. There is, however, an acknowledgment that there are some worthwhile achievements, such as the broadening of the agricultural base and the relatively open economy. Other useful insights include comments on industrial development, highlighting the emphasis given to protectionist policies.

In Gupta's view the macroeconomic policies and the role of the treasury have generally been sound. The country has commendably diversified its resource base (even if most of these changes were initiated some time ago and there is little current activity which would suggest that more diversification is occurring). However, the so-called 'Dutch disease' effects combined with increasing government recurrent expenditure is of continuing concern.

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