Policy dialogue

Creating skills hubs to attract foreign investment to Papua New Guinea

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Business development is once more at the forefront of the agenda for Papua New Guinea. After a decade where drought, political instability and violence marred the fortunes of the country, relative stability has encouraged politicians and development experts alike to renew support for business development activities. In its Medium-Term Development Strategy, the Government of Papua New Guinea has nominated private-sector led economic growth as its 'number one' priority, emphasising the need for entrepreneurial activity. The business community in Papua New Guinea is enthusiastic about the recognition and focus it is now receiving, but is understandably cautious about the ability of the government to implement real and sustained changes that can create a dynamic business environment.

The unholy trinity of law and order, lack of infrastructure and persistent corruption are often blamed for the lack of business activity (outside the resource extraction sector) in Papua New Guinea. While these present significant disincentives to entrepreneurs, both domestic and foreign, they are features of many emerging markets and fail to explain why business thrives in some countries experiencing similar constraints, such as the Philippines and Indonesia, and not Papua New Guinea. The Philippines is a particularly notable example regarded by many business-risk assessment agencies to be far more problematic than Papua New Guinea (AON 2005), it is fast becoming a significant investor in the fishing and canning industries in Papua New Guinea. The Philippines and Mexico are regularly nominated as dangerous countries in which to do business, as are many Central and South American countries (AON 2005), which nonetheless attract far more foreign investment and business interest than Papua New Guinea (Table 1). It seems that many of the issues generally thought to be hindering business development in Papua New Guinea only partly explain the economic stagnation of Papua New Guinea. There is a deeper question of why, outside the resource extraction industry, business fails to be interested in Papua New Guinea, and what can be done about it.

In response to this question, I recently completed a series of discussions with managers and business owners engaged in small and medium sized business in Papua New Guinea. Qualitative in nature, this interview-based study was developed for

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Table 1 **Total FDI inflow to developing economies, 1990–2003**

	Total FDI inflow (US$ million)	Percentage of total developing country inflows (per cent)	Rank
Developing economies	2,019,515	100.0	
China	484,270	24.0	1
Hong Kong (ROC)	199,285	9.9	2
Brazil	181,187	9.0	3
Mexico	159,539	7.9	4
Singapore	133,383	6.6	5
Venezuela	33,120	1.6	13
India	28,606	1.4	14
Colombia	26,867	1.3	15
Philippines	17,539	0.9	20
Nigeria	16,283	0.8	22
Indonesia	13,594	0.7	23
Papua New Guinea	2,944	0.1	49
Fiji	533	-	95
Vanuatu	319	-	115
New Caledonia	109	-	127
Solomon Islands	75	-	130
Tonga	26	-	139
Kiribati	7	-	144

Source: UNCTAD Statistics of Foreign Direct Investment 2005.

AusAID and attempts to identify the most significant impediments to businesses outside the mining and forestry industries in Papua New Guinea. All the businesses studied had significant foreign investment, and many commented on the fact that it is now very difficult to attract foreign investor interest in Papua New Guinea.

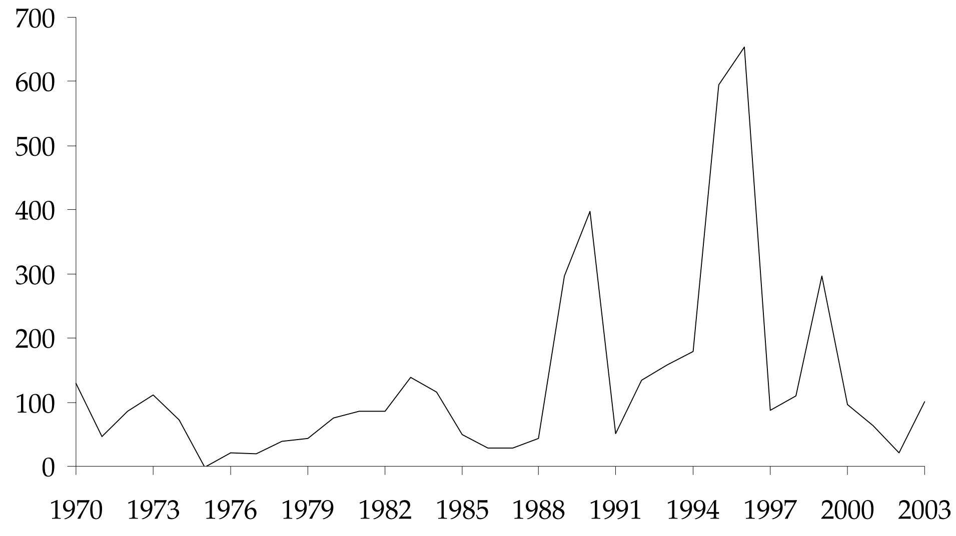
There is general agreement among economists that foreign direct investment (FDI) can be an important catalyst for economic growth. FDI allows a country to grow at a rate faster than would have been possible with domestic savings alone, as it mobilises capital that was not previously available in the community. Foreign direct investment has been shown to contribute to economic growth in a host country primarily through technology transfer, human capital development and the 'demonstration effect' (whereby domestic entrepreneurs model their operations on those of foreign investors, effectively creating a hub of competing industries).

An important attraction of foreign direct investment to governments of developing economies, as opposed to other types of capital inflows, is the stability of foreign capital. The main alternative source of private capital inflow, portfolio investment (investments made in financial products, such as shares, bonds, money market instruments and derivatives), is typically made in smaller quantities, and is quickly and easily withdrawn when economies show signs of weakness. Portfolio investors are looking for returns from financial products like bonds or shares, and are more concerned with short-term profits than long-term operations. As a result, the investor has no incentive to leave money in the host country when economic difficulties strike. Foreign direct investors take a strategic interest in their investments. Such investments often includes plant and equipment, which is difficult to liquidate at short notice. As longer-term investors, they have goals that make short-term economic instability less important to them. Foreign direct investors are unlikely to withdraw their investment unless things get extremely bad and they decide to leave a market for good.

As a result, foreign direct investment is a much more stable source of capital for developing countries than portfolio investment. Albuquerque (2003) shows that while long-term financing inflows to East Asia fell by 22 per cent in the wake of the 1997 crisis, FDI inflows fell only 5 per cent. Similar results for Latin America (1980s) and Mexico (1994) indicate that FDI provides security for emerging market countries in terms of investment funding. Further, falls in foreign direct investment inflows appear to recover quickly—inflows to Mexico had fully recovered within three years of the 1994 debt crisis. FDI inflows are more stable and less prone to capital flight, and this is particularly so for emerging market economies. As a result, it is important for developing economies to maximise their opportunities to attract FDI and create an environment conducive to investment.

FDI in Papua New Guinea has been erratic over the last three decades, with the fairly steady growth observed between 1976–83 replaced by a series of peaks and troughs (Figure 1). Papua New Guinea, with its rich natural resources, is the only Pacific island country to receive significant FDI inflows, but while the amount of capital has increased over the period, it has failed to keep pace with the overall rate of growth in inflows to developing countries. Global foreign investment flows have grown significantly since

Figure 1 **FDI inflows to Papua New Guinea, 1970–2003** (US$ million)



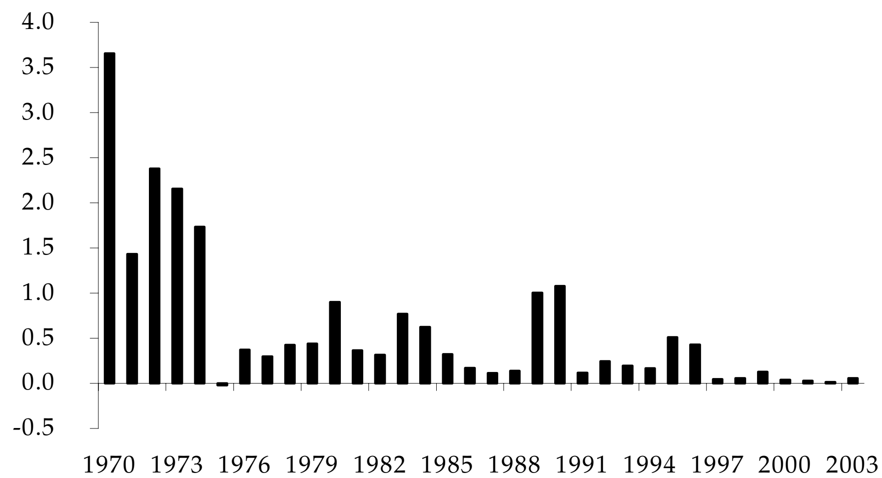
Source: UNCTAD Statistics of Foreign Direct Investment 2005.

1970. Between 1970 and 2003, foreign investment inflows grew around 170 per cent, with the developed world growing around 114 per cent. However, it was the developing world where the most growth took place—a massive 366 per cent increase. In 1970, FDI to Papua New Guinea made up 3.5 per cent of global FDI flows to developing economies—by 2003, this had fallen to less than 0.06 per cent (Figure 2). Even near the peak of investment in 1995, FDI to Papua New Guinea made up only 0.51 per cent of global FDI flows. The most significant investments, relative to other developing countries, were made in the four years before independence. Since then, the ratio has dropped significantly and other developing countries, particularly those in Asia, have taken the lion's share of investment.

While Papua New Guinea is still the most significant destination for foreign investment in the Pacific, it ranks 49 of 150 developing countries for total investment inflows between 1990 and 2003 (Table 1). It is also evident that the internal security issues often given as the cause of Papua New Guinea's lack of investment do not tell the full story. Indonesia, Venezuela, Columbia and Nigeria all have at least four times Papua New Guinea's investment inflows: all have more pressing internal stability issues than Papua New Guinea (AON 2005). While security is a disincentive to some investors, there is also substantial evidence that investors will invest in a politically and economically unstable country if the rewards are seen to outweigh the risks. Several managers commented that security is a cost to business, but one on which they plan—by hiring security staff, taking out insurance, and so on. While a major cost and concern, and certainly a negative in terms of lifestyle, this did not seem to be a reason to cease operations or to discourage new ones.

Of Dunning's (1993) four motivations for foreign investment, only two appear truly

Figure 2 **Ratio of Papau New Guinea's FDI inflows to developing economy inflows, 1970–2003** (per cent)



Source: UNCTAD Statistics of Foreign Direct Investment 2005.

active in Papua New Guinea: resource-seeking investment centred on mining, logging and fishing; and market-seeking investment, the aim of which is to market products to host country consumers. Of these two, resource-seeking investment overwhelmingly dominates.

But it is another motivation for foreign investment, efficiency-seeking investment, that underpins an export-led growth strategy. Efficiency-seeking investment aims to capitalise on the strategic advantages of a country, typically labour supply, technology and economies of scale, to produce goods for the international market. Host countries for efficiency-seeking investment need to have well-developed and open cross-border markets, with efficient transportation infrastructure that readily accesses the markets for goods being produced. The government's export-led growth strategy might therefore be regarded as an optimistic attempt to stimulate economic development. While the government is attempting to encourage domestic processing operations, it seems unlikely that these will eventuate without the presence of significant efficiencies in the Papua New Guinea economy. The greatest obstacles to efficiency-seeking investment are generally regarded as a poor supply of skilled and semi-skilled labour and high transportation costs.

While Papua New Guinea is far from the least open economy in the World Bank's (2005) survey, the impediments to trade are no doubt exacerbated by high freight costs and poor servicing, corruption within the freight management bureaucracy and overly bureaucratic processes designed to protect domestic industry. It will require significant structural reform for trade logistics to be able to compete with more cost-effective destinations for efficiency-seeking investment.[1]

Additionally, the skills base of Papua New Guinea has some structural problems that impede business activities. Numerous managers highlighted the problems caused by the cycles of the mining industry—in the words of Robert De Brouwere, of James Barnes PNG Ltd, 'mines blow everyone out of the water' (De Browere 2005). Skilled tradespeople are in high demand on mining operations: as a result, when the mining industry is experiencing a boom, manufacturing operations are unable to compete with the salaries offered and frequently lose key staff. When staff return from working at the mines, they anticipate similar wages to those paid by the mining companies. The inability, and/or unwillingness, of manufacturers to pay these rates creates frictions as the workers re-assimilate in the urban manufacturing environment. The pool of highly-skilled tradespeople is small: many were trained by the Bougainville mining operation that has since closed, and government training facilities are unable to provide graduates of the quality or quantity required at peak mining periods. Several managers commented on the poor quality of training provided by the technical colleges in Papua New Guinea. Additionally, a small manufacturing base means that there are few tradespeople with specialised skills in new technologies, requiring manufacturers to import staff, typically from Australia, at great expense. The lack of a self-sustaining manufacturing base means that efficiency-seeking investors are unlikely to locate to Papua New Guinea when it is far easier to find such staff in alternative Asian destinations. This merely exacerbates the skilled staffing problems for existing manufacturing businesses in Papua New Guinea.[2]

Considering the current profile of foreign investment in the country, it is possibly overly optimistic to envisage an expansion of the export base without a significant structural shift in the business environment. Export development must be based on a country's comparative advantages, and successful export-led growth strategies have taken place in countries with significant economies of scale that foreign investors are able to exploit. Export-led growth in East Asian countries, where it has been most effective, has typically begun in low-cost manufacturing and increased to high-technology production as the skill and technology base of the country increased. Japan, Korea, Taiwan and more recently China and Vietnam have followed this pattern, with manufacturing moving to more cost-effective locations as the skill and income base of the population rises.

The concept of investment hubs has been used to good effect by a number of countries, most recently China, which created a number of 'export processing zones' which have since become the centre of Chinese trade on the east coast. Investment hubs, or clusters, are specialised concentrations of firms with operational synergies, able to take advantage of a pool of infrastructure and resources (both human and otherwise) that grow and strengthen as more companies join the hub. Spillover effects mean that there is significant long-term advantage to be gained by joining a cluster, and that accelerated growth is possible. Business studies have recognised clusters as drivers of innovation, facilitating business development by increasing the productivity of the companies in the cluster, and by stimulating new businesses (Porter 1998). Yehoue (2005) creates a model that suggests that the accelerated economic growth of some developing countries may be explained by clusters that have established organically, and proposes that policies directed toward the establishment of clusters could generate significant economic gains by host countries, both by attracting foreign investment and stimulating domestic enterprise.

However, a by-product of government incentives for industry development in Papua New Guinea seems to be a desire to replicate business successes as widely as possible—several interviewees repeated stories of bureaucratic visions of 'a tuna factory in every port',[3] mimicking the 'meat cannery in every town' scenario of the late 1980s that saw the establishment, and subsequent departure, of competitors to the previously monopoly-assured James Barnes PNG Ltd.[4] If an export-led growth strategy is to be pursued, it is likely that development hubs will be required if manufacturing business is to grow, diversify and remain viable. A manufacturing hub, most likely in Lae, with appropriate technical training support would be an obvious choice, and a canning hub is already evident in Madang. A more focused approach to the development of hubs with core competencies, well-trained skilled and semi-skilled labour and supporting infrastructure may assist in promulgating an export-led growth scenario. Certainly this would be preferable to an *ad hoc* development strategy seemingly designed for political purposes. Articulating and promoting a cohesive industry development strategy, incorporating plans for promoting an efficient logistics infrastructure and the development of a pool of technically skilled workers, would be an effective first step by the bureaucracy.

The outlook for the next few years is promising. Official inflation is low, and quarterly changes have been below 2 per cent since June 2003 (Bank of Papua New Guinea 2005), possibly a result of the Bank of Papua New Guinea following and 'inflation targeting lite' management strategy (Bowman 2006:6). Currency devaluation has made wages more competitive with neighbouring economies than in the past, and has stimulated import substitution and made some domestically produced products more competitive. Mining revenues are expected to improve the Government of Papua New Guinea's fiscal position, and give the Government an opportunity to implement reform programs. The immediate future represents an opportunity for Papua New Guinea to move forward: whether this promise can be fulfilled will depend on the determination of the government and its people.

Notes

1 Surprisingly, Papua New Guinea is included in the top 50 per cent of 155 countries surveyed in the World Bank 'Doing Business' surveys. At number 64 in 2005, it beat neighbouring business locations such as Indonesia (115), the Philippines (113) and Vietnam (99). Disturbingly, Solomon Islands is ranked higher at 53, and Kiribati at 45, which may cast some doubt on the usefulness of the measures employed in the survey, as while there may have fewer business regulations, business is far from thriving in either country.

2 One positive note: a number of business people employing large numbers of unskilled workers believe that their staff are as productive and cost-effective as any found in Asian countries. The widely held Australian belief that Papua New Guinea workers are unwilling or unable to compete with Asian workers, both in terms of productivity and work practices, may be more a matter of perception than fact. The decline in the value of the kina against Asian currencies has done much to improve this situation, and further devaluations of the kina should be regarded as beneficial to the business environment, particularly in terms of making wages more regionally cost-competitive.

3 There is already fish processing in every port: South Seas Tuna in Wewak, RD Cannery in Madang and Frabelle in Lae.

4 Having been awarded a 10-year monopoly, James Barnes PNG Ltd was surprised to discover that Huttons, based in Lae, and Ox and Palm, based in Port Moresby, were setting up operations before the first can had been produced by the Madang Globe factory (De Brouwere 2005). Huttons subsequently ceased operations.

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Acknowledgments

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