

SURVEY ARTICLE



WILEY

2019 Papua New Guinea economic survey

Stephen Howes¹ | Rohan Fox¹ | Maholopa Laveil² |
 Bao H. Nguyen^{1,2} | Dek Joe Sum^{1,2}

¹Development Policy Centre, Crawford School of Public Policy, The Australian National University, Canberra, ACT, Australia

²Division of Economics, School of Business and Public Policy, University of Papua New Guinea, Port Moresby, Papua New Guinea

Correspondence

Stephen Howes, Development Policy Centre, Crawford School of Public Policy, The Australian National University, Canberra, ACT 0200, Australia.
 Email: stephen.howes@anu.edu.au

Abstract

Although official statistics show that an economic recovery is underway in Papua New Guinea, the country's new Prime Minister has stated that the economy is “bleeding and struggling.” Disappointing 2019 first-half-year revenue results and the reintensification of foreign exchange shortages suggest that last year's (nonresource) 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 International Monetary Fund for advice and support to address the problems it has inherited, including in relation to arrears, guarantees, and state-owned enterprise debt.

KEYWORDS

economic survey, exchange rate, pacific economy, Papua New Guinea, resource-dependent economy

1 | INTRODUCTION

Prime Minister Peter O'Neill's 8-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.

The authors thank the business people, officials, and experts who gave interviews for the paper, and also the paper's reviewers and editor (Prof. Ron Duncan).

This is an open access article under the terms of the Creative Commons Attribution License, which permits use, distribution and reproduction in any medium, provided the original work is properly cited.

© 2019 The Authors. *Asia & the Pacific Policy Studies* published by Crawford School of Public Policy of the Australian National University and John Wiley & Sons Australia, Ltd

Whereas O'Neill was, to the end, of the view that the Papua New Guinean (PNG) economy was doing well, the new Prime Minister (former Finance Minister) James Marape (2019) indicated immediately on his election by MPs as Prime Minister that the economy was “bleeding and struggling.”

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 nonresource 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, suggest the latter and that, with little revenue growth, large government arrears, increasing problems around public-sector debt and guarantees, and reintensifying foreign exchange 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 5 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 the 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 10th most resource-dependent economy in the world.¹ 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 would be a better indicator, but an accurate measure of gross national income is not available. The main measure of economic activity utilised in this paper is nonresource GDP (often referred to in PNG as “nonmining GDP,” even though it excludes output from both the mining and petroleum sectors).

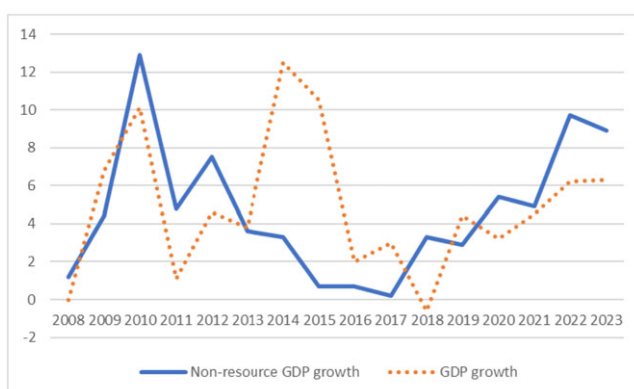
Official statistics suggest that the PNG economy—as measured by nonresource GDP—slowed post-PNG LNG construction until 2017 but is now in recovery (Figure 1). Different sources give different estimates for specific years, but all show that nonresource growth was very low (if not negative) from 2015 to 2017² and then began to recover and is projected to accelerate in the coming years.

¹This 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#>.

²National Statistical Office data show negative nonresource growth in 2015 but slightly higher growth in 2016.

FIGURE 1 Nonresource and gross domestic product (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 nonresource sector. Given the weak link between the resource and nonresource sectors, there can be no assumption that a contraction of the resource sector would lead to a nonresource 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 nonresource sector. A sharper contraction in the resource sector in 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 that fell in 2017 by 2.1% increased in 2018 by 5.7% (Bank of Papua New Guinea [BPNG] Quarterly Economic Bulletin, 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 3 years in a row, growing by 3% above inflation. Government expenditure also grew strongly, increasing by 16% above inflation—again after 3 years of decline. With such a strong expenditure stimulus (and with government expenditure making up some 28% of nonresource GDP), it is not surprising that economic growth resumed in 2018.³

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 had 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.” BPNG's employment data (Figure 2) pertain only to the formal sector, which employs only about 15% of the workforce (Jones & McGavin, 2015) but is still useful as a proxy for economic

³The 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).

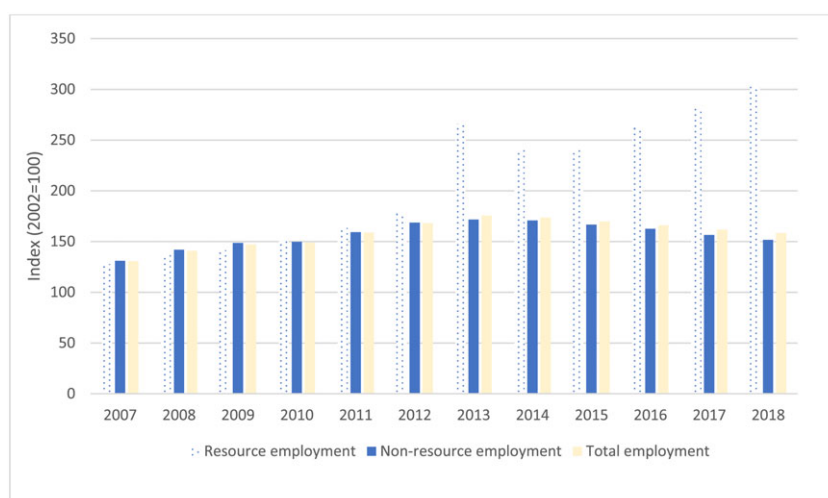


FIGURE 2 Employment: total, resource, and nonresource sectors, 2002 = 100. Annual averages as calculated by Bank of Papua New Guinea

Source: Bank of Papua New Guinea, as of March 2019 Quarterly Economic Bulletin, table 9.7

activity and welfare. Total and nonresource 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 nonresource sector has now declined for 5 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 nonresource sector employment were at 90% and 88%, respectively, of their 2013 peaks.

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.

Although 2018 seems to have been a relatively good year for the economy, the latest data suggest 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). Although 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 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 (2019c) 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 [nonresource] GDP growth in 2019.” In the same MYEFO or mid-year statement, Treasury reduced its projection for nonresource 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.⁴ It may be that 2018 was a bright spot in an otherwise gloomy economic period for PNG.

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

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.⁶ 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 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 nonresource sector has largely failed to keep up with the country's population growth from 2014 onwards (Figure 3). Over the full cycle (i.e., from 2003), annual average nonresource 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%.

Given the experience of the past, it seems unlikely that a reliance on resource projects will on its own lift PNG's nonresource 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 nonresource sector growth and jobs.

3 | BALANCE OF PAYMENTS AND EXCHANGE RATE

As discussed in last year's survey (Fox, Howes, Nema, Nguyen, & Sum, 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

⁴The volume of log exports fell by 11% in the first half of 2019, with weaker demand from China (Treasury, 2019c, p. 34).

⁵Their impact will also depend on the regulatory framework. Access arrangements for the undersea cable are still unclear.

⁶On July 26, the new Petroleum Minister, Kerenga Kua, was reported as saying that he would be recommending changes to the agreement (Stapczynski, 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 2 weeks to conclude (Post Courier, 2019a).

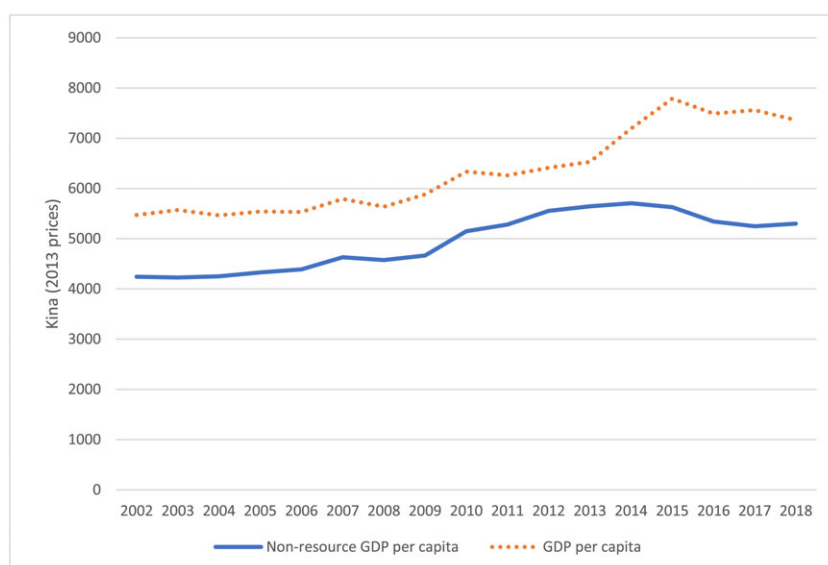


FIGURE 3 Resource gross domestic product (GDP) and nonresource GDP per capita (inflation adjusted)

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

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 depreciation 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 International Monetary Fund (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 underestimate. However, there is little support for exchange rate depreciation, and most commentators are opposed (Lea, 2018).

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 2018.⁷ These loans, together with some improvement in commodity prices, resulted in a growing inflow of foreign exchange. The Central Bank released US\$695 million from reserves in 2018, compared with only US\$227 million in 2017 (Elisa, 2019). According to the BPNG (2019), the outstanding backlog in foreign exchange declined significantly from K1.7 billion

⁷In 2018, PNG secured concessional budget support loans from the World Bank and the ADB of US\$150 and US\$100 million, respectively, and a sovereign bond of US\$500 million at an interest rate of 8.375%. It also took out a US\$500 million loan from Credit Suisse in late 2017, the second tranche of which it received in 2018.

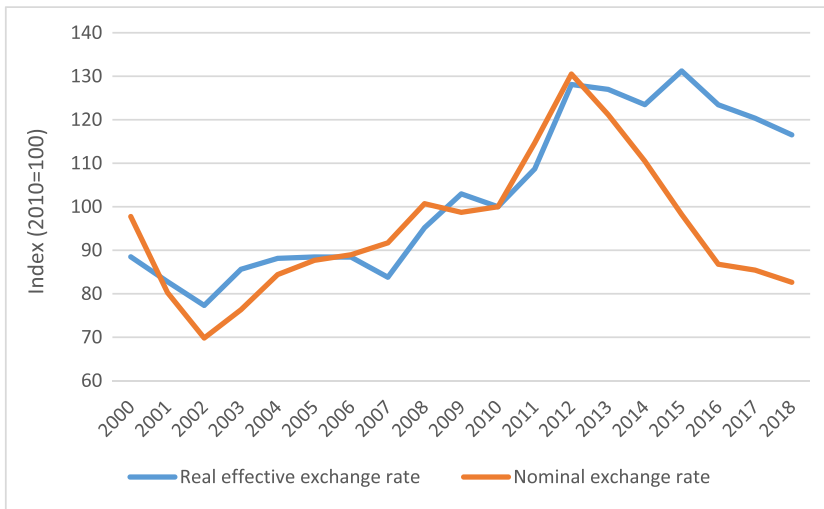


FIGURE 4 Nominal and real exchange rate (2010 = 100). The real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. The nominal exchange rate is the annual average of the Kina/USD exchange rate

Source: World Development Indicators and IMF International Financial Statistics

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. Foreign exchange reserves increased over the same period, reaching US\$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).

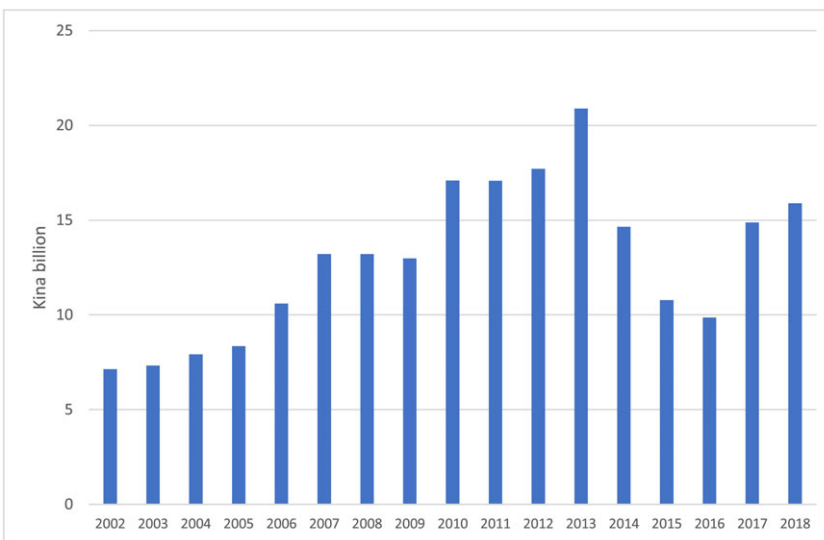


FIGURE 5 Nominal value of PNG imports (Kina billion)

Source: Bank of Papua New Guinea, as of March 2019 Quarterly Economic Bulletin, table 8.1b

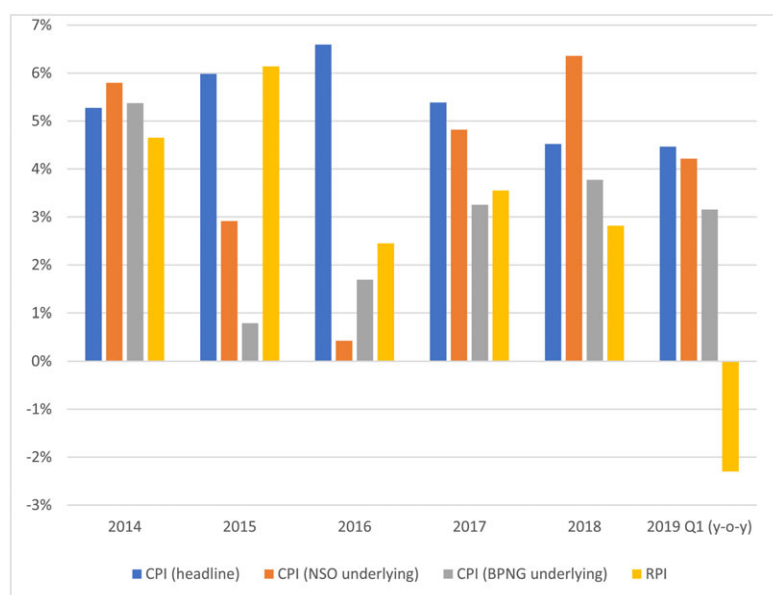


FIGURE 6 Inflation (% change in consumer price indices). NSO, National Statistical Office
Source: CPI from Bank of Papua New Guinea (BPNG), as of March 2019 Quarterly Economic Bulletin, table 9.1; RPI from BPNG Monthly Economic Reviews

However, although 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 3 weeks or 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 K1 billion (Vari, 2019a).⁸ As of mid-2019, foreign exchange reserves have fallen back below the US\$2 billion benchmark.⁹

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. Whereas CPI data are collected by the National Statistical Office, RPI data are collected by BPNG. RPI shows deflation in the first 3 months of 2019, with prices for a range of goods (health care, communications, and alcoholic beverages, tobacco, and betelnut groups) declining year-on-year (Fitch Solutions, 2019).

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 6 years.

⁸Some private sector estimates of the foreign exchange backlog are much higher, at US\$1 billion.

⁹US\$1.9 billion as reported at the end of July (Vari, 2019b).

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).

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 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.

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.

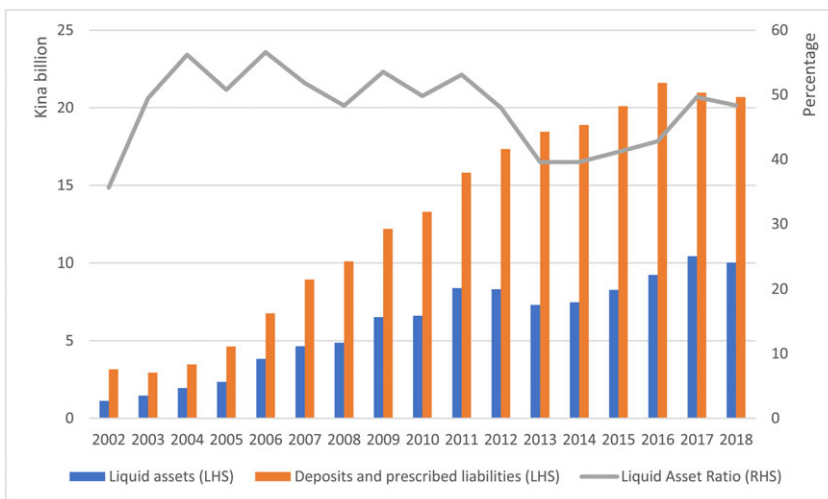


FIGURE 7 Commercial banks' total liquid assets and deposits, and liquid asset ratio

Source: Bank of Papua New Guinea, as of March 2019 Quarterly Economic Bulletin, table 3.13

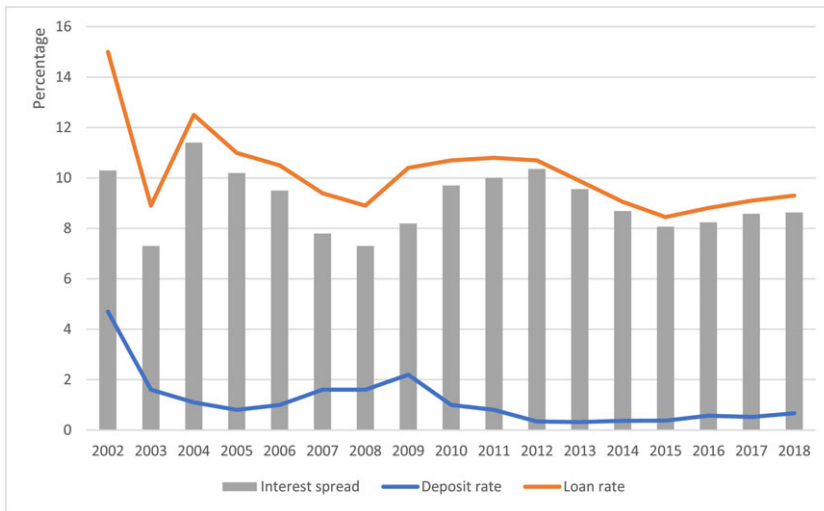


FIGURE 8 Interest rate spreads (%). The deposit and loan rates are weighted averages

Source: Bank of Papua New Guinea, as of March 2019 Quarterly Economic Bulletin, table 6.1

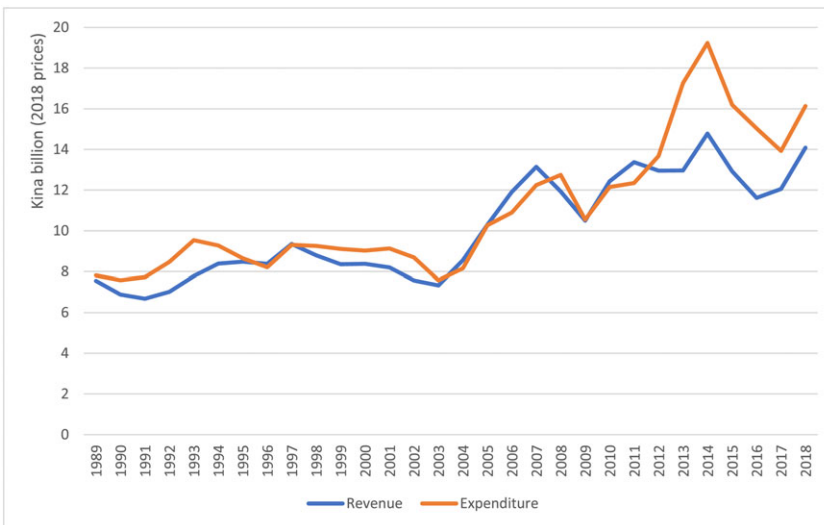


FIGURE 9 Revenue and expenditure, adjusted for inflation (Kina billion)

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

In 2018, revenue increased by 17% after inflation, the second highest single-year increase in the last three decades. Revenue from nonresource 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 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 nontax, nonresource revenue. The new policy forcing statutory authorities

¹⁰The so-called PMMR policy: Implementation of the Public Monies Management Regularisation Act of 2017.

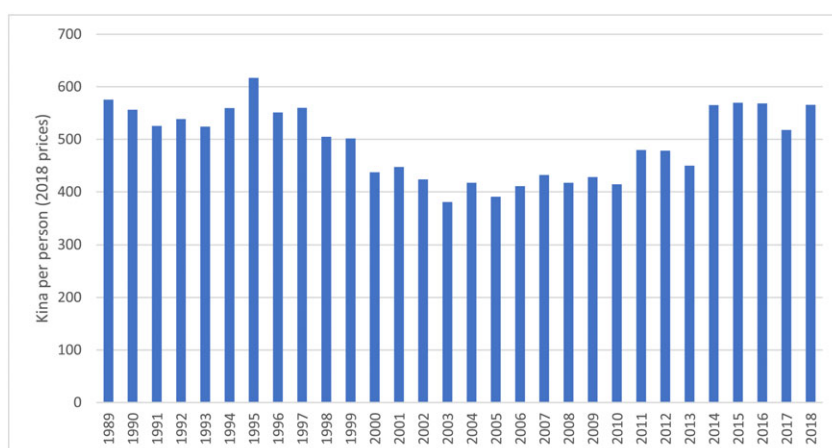


FIGURE 10 Papua New Guinea government staff costs per citizen. Excludes donor-grant-funded staff. Note that employee costs of statutory authorities are excluded from this graph

Source: PNG Budget Database

to hand over most of their cash balances to government raised K655 million for the year.¹⁰ 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 3 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 90s 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.

The fiscal picture in 2019 is very different to that in 2018. Both expenditure and revenue are projected to increase relatively modestly—by about 8% and 5%, respectively (before inflation and excluding donor grants) (Treasury, 2019c). The revenue target will be very difficult to reach. In the first 5 months, Internal Revenue Commission collections were 8% below target and Customs 17% below target (Treasury, 2019a, p. 6).¹¹ 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 was 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 2020.¹² The motivation for this shift is to lengthen maturities and lower interest expenses (given the uncompetitive nature of PNG's financial sector, as

¹¹ Customs is responsible for taxes on international trade, and IRC for all other taxes.

¹² A modest share of the 2018 foreign borrowing was used to retire domestic debt (Treasury, 2019c, table 19).

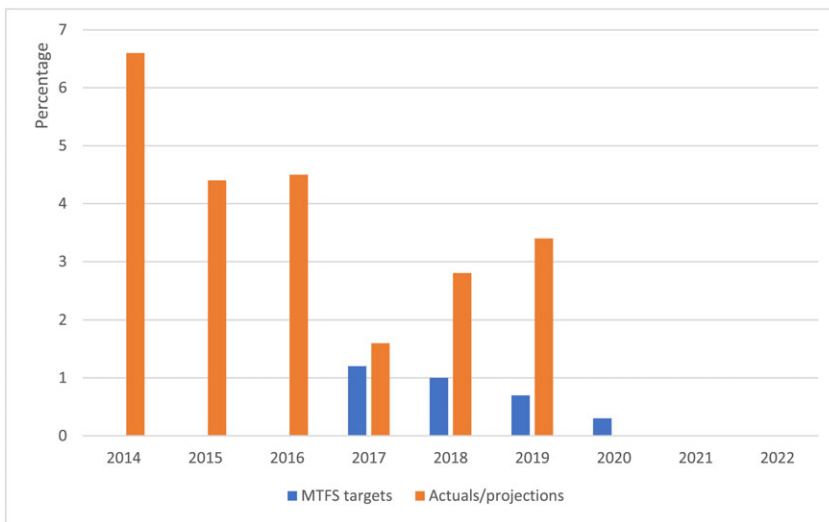


FIGURE 11 Government deficits—performance against targets. The deficit measure is the nonresource primary balance as a percentage of nonresource gross domestic product, which is the measure targeted in the Medium Term Fiscal Strategy (MTFS; Abel, 2017). The targets for 2021 and 2022 are zero. Actuals and the 2019 projection from Treasury (2019c) and World Bank (2019a, 2019b)

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, 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 reform performance.

Although 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.¹³

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, not much higher than population growth) 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. Although deficits have come down from their highs of 5 years ago, the government's target is to eliminate the nonresource 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.

¹³All the claims in this paragraph are taken from the mid-year statement or MYEFO (Treasury, 2019c).

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 a historical (and appreciated) nominal exchange rate. They also exclude 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 threefold 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.¹⁴ Two reasons explain the fiscal reform failure. First, consistent with international experience, PNG has found fiscal adjustment difficult 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.¹⁵

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 via 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, Nema, et al., 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 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

¹⁴That 20% of government-funded expenditure is classified in the budget as “miscellaneous” also raises questions of transparency around government spending (Treasury, 2019d, table 26).

¹⁵Given space constraints, the discussion is selective. See also Government of PNG (2018) and World Bank (2019a, 2019b) for further coverage of key reform and development issues.

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 5-year agreement, assigning 25 ha 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 invoked), 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 by 2030, this would reserve all enterprises worth below K10 million to PNG nationals and companies that are more than 50% 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 3-year transitional period (Business Advantage PNG, 2019c).

The Foreign Investment Authority Bill was met with protests from industry. 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 small and medium enterprise 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 nonresource exports will remain extremely difficult 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,¹⁶ 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. 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 not 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).¹⁷ 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.

¹⁶This is not just domestic sentiment. The IMF (2017) has commented that “government revenue from the LNG sector has been very limited due to the generous fiscal terms of the [PNG LNG] agreement” (p. 18).

¹⁷This includes legislated concessions regarding thin capitalisation and additional exploration deductions.

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).

Although not part of the (nonrenewable) 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, 2015). 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, 2015). 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.

6.3 | Governance

The new government of Prime Minister James Marape has placed a heavy emphasis on governance reforms. Those proposed include the establishment of an anti-corruption commission, legislation to protect whistle blowers, and SOE reforms.

International data support 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 are 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.

PNG is once again listed as in a “fragile situation” by the World Bank.¹⁸ 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 Asia-Pacific countries annually for the quality of their policies and institutions to derive what is known as a Country Policy and Institutional Assessment (CPIA) score. Countries are regarded as fragile if they have a CPIA score of less than 3.2 (out of 5) when averaged across the World Bank and ADB assessments.¹⁹ As Figure 13 shows, PNG improved its CPIA score

¹⁸See <https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations>.

¹⁹Countries with a peacekeeping or similar mission are also counted as fragile states/situations regardless of their CPIA score.

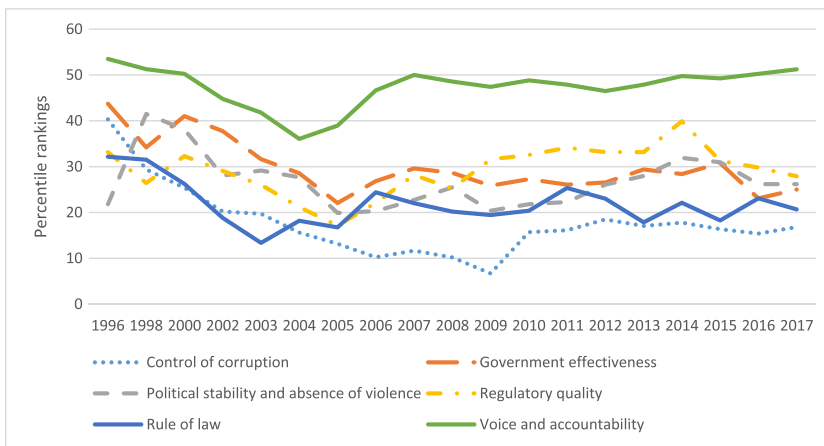


FIGURE 12 World Governance Indicators for Papua New Guinea over time: Percentile rankings

Source: Worldwide Governance Indicators: www.govindicators.org



FIGURE 13 PNG World Bank Country Policy and Institutional Assessments (out of 5). The red line indicates the cut off for being counted as fragile (3.25 or below for the overall score)

Source: World Bank Country Policy and Institutional Assessment data: <https://datacatalog.worldbank.org/dataset/country-policy-and-institutional-assessment>

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.

7 | CONCLUSION

Despite the earthquake, 2018 was a positive year for the PNG economy. However, it appears to have been a one-off, with improved nonresource 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 nonresource 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.

Although 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 International Monetary Fund for financing and support in developing a new reform program. This could help the current government deal with the serious problems it has inherited—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.

ORCID

Stephen Howes  <https://orcid.org/0000-0002-9562-3619>

Rohan Fox  <https://orcid.org/0000-0002-3384-0458>

Maholopa Laveil  <https://orcid.org/0000-0002-1570-8197>

Bao H. Nguyen  <https://orcid.org/0000-0002-0563-5158>

Dek Joe Sum  <https://orcid.org/0000-0001-8637-5329>

REFERENCES

- Abel, C. 2017. Medium Term Fiscal Strategy 2018-2022. Presented by Hon. Charles Abel, Deputy Prime Minister and Treasurer on the occasion of the presentation of the 2018 national budget, <http://treasury.gov.pg/html/national_budget/files/2013/budget_documents/Related%20Budget%20Documents/MEDIUM%20TERM%20FISCAL%20STRATEGY%20PAPER%20%202018%20-%202022.pdf>.
- Aopi, G. 2019. Address by the President of the PNG Chamber of Mines and Petroleum. 35th Australia-PNG Business Forum, Port Moresby, 18 June 2019, <http://www.pngchamberminpet.com.pg/images/misc/Ch19_-_Presidents_SpeechAPNGBF18.6.19.pdf>.

- Bank of Papua New Guinea (2019). “*Monetary policy statement*”, Bank of Papua New Guinea, 31 March 2019, <<https://www.bankpng.gov.pg/wp-content/uploads/2019/04/March-2019-MPS-3.pdf>>.
- Business Advantage PNG (2019a). Less than 5 per cent of Papua New Guinea businesses getting foreign exchange when they need it: Poll. Business Advantage PNG, 29 May 2019, <<https://www.businessadvantagepng.com/less-than-5-per-cent-of-papua-new-guinea-businesses-getting-foreign-exchange-when-they-need-it-poll/>>.
- Business Advantage PNG (2019b). The PNG 100 CEO survey: Papua New Guinea's chief executives expect a rise in profits in 2019. Business Advantage PNG, 25 February 2019, <<https://www.businessadvantagepng.com/the-png-100-ceo-survey-papua-new-guineas-chief-executives-expect-a-rise-in-profits-in-2019/>>.
- Business Advantage PNG (2019c). Papua New Guinea proposes foreign investment reforms. Business Advantage PNG, 6 February 2019, <<https://www.businessadvantagepng.com/papua-new-guinea-proposes-foreign-investment-reforms/>>.
- Elisa, P. (2019). K2.3bil supplied to forex market. *The National*, January 29. <<https://www.thenational.com.pg/k2-3bil-supplied-to-forex-market/>>.
- Fitch Solutions (2019). Economic analysis—Papua New Guinea's July monetary easing likely a one-off for 2019. Fitch Solutions, viewed 23 July 2019, <https://www.businessadvantagepng.com/wp-content/uploads/2019/07/Papua-New-Guinea-July_Monetary_Easing_Likely_A_OneOff_For_2019-Fitch-Solutions-19-July-2019.pdf>.
- Fox, R., Howes, S. & Laveil, M (2018). PNG turns protectionist in its APEC year. Devpolicy Blog, 13 August 2019, <<https://www.devpolicy.org/png-turns-protectionist-apec-20180813/>>.
- Fox, R., Howes, S., Nema, N. A., Nguyen, H. B., & Sum, D. J. (2018). 2018 PNG economic survey. In S. Howes, & L. N. Pillai (Eds.), *2018 PNG update: PNG in the year of APEC* (pp. 21–50). The Australian National University: The University of Papua New Guinea. <http://www.devpolicy.org/publications/reports/2018-PNG-Update-Book-Complete.pdf>
- Government of Papua New Guinea. (2018). Medium-term Development Plan III 2018–2022 (MTDP III), Government of Papua New Guinea.
- International Monetary Fund (2017). Papua New Guinea 2017 Article IV Consultation—Staff report and press release. International Monetary Fund Country Report no.18/352, IMF, Washington DC, <<https://www.imf.org/en/Publications/CR/Issues/2017/12/29/Papua-New-Guinea-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-45532>>.
- International Monetary Fund (2018). Papua New Guinea 2018 Article IV Consultation—Staff report and press release. International Monetary Fund Country Report no.18/352, IMF, Washington DC, <<https://www.imf.org/en/Publications/CR/Issues/2018/12/03/Papua-New-Guinea-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-46432>>.
- James, D. (2018). Papua New Guinea's mining sector concerned about revised Mining Act, Business Advantage PNG, 15 April 2019, <<https://www.businessadvantagepng.com/papua-new-guineas-mining-sector-concerned-about-revised-mining-act/>>.
- James, D. (2019a). The lessons we learned from Papua New Guinea's last boom. Business Advantage PNG, 3 July 2019, <<https://www.businessadvantagepng.com/the-lessons-we-learned-from-papua-new-guineas-last-boom/>>.
- James, D. (2019b). Government policies set a more optimistic mood for Papua New Guinea's manufacturers. Business Advantage PNG, 27 May 2019, <<https://www.businessadvantagepng.com/government-policies-set-a-more-optimistic-mood-for-papua-new-guineas-manufacturers/>>.
- James, D. (2019c). Investment Promotion Authority reveals guidelines for changes to foreign investment in Papua New Guinea. Business Advantage PNG, 1 May 2019, <<https://www.businessadvantagepng.com/investment-promotion-authority-reveals-guidelines-for-changes-to-foreign-investment-in-papua-new-guinea/>>.
- Jones, L. & McGavin, P. (2015). Grappling afresh with labour resource challenges in Papua New Guinea—A framework for moving forward. Discussion Paper No. 96, Institute of National Affairs.
- Lea, D. (2018). Counterarguments to the devaluation of the PNG Kina. Devpolicy Blog, September 21, <<https://www.devpolicy.org/counterarguments-to-the-devaluation-of-png-kina-20180921/>>.
- Marape, J. (2019). Opinion: ‘The richest black Christian nation on earth’, Business Advantage PNG, <<https://www.businessadvantagepng.com/opinion-the-richest-black-christian-nation-on-earth/>>.
- Moody's (2019). Rating action: Moody's changes Papua New Guinea's rating outlook to stable from negative; affirms B2 rating. Moody's, viewed 23 July 2019, <https://www.moody's.com/research/Moodys-changes-Papua-New-Guineas-rating-outlook-to-stable-from-PR_394268>.

- Nicholas, W. (2016). PNG's SME policy: The right aim, but dubious means. Devpolicy Blog, 18 July 2016, <<https://www.devpolicy.org/png-sme-policy-right-aim-dubious-means-20160718/>>.
- Osborne, D. (2015). Review of the legislation establishing the Sovereign Wealth Fund in Papua New Guinea. PNG National Research Institute Issues Paper #16, December, <https://pngnri.org/images/Publications/Issues_paper_16_Review_of_legislation_establishing_the_SW_fund_in_PNG1.pdf>.
- Post Courier. (2019a). NEC backs Papua LNG agreement. August 5.
- Post Courier. (2019b). Public service payroll over-runs. July 29, <<https://postcourier.com.pg/public-service-payroll-runs/>>.
- Post Courier (2019c). "Reports" SOEs K6 billion in the red. July 24, <<https://postcourier.com.pg/reports-soes-k6-billion-red/>>.
- Stapczynski, S. (2019). Total's PNG gas plan faces fresh test as deal changes proposed. Yahoo! Finance, July 26. <<https://finance.yahoo.com/news/totals-png-gas-plan-faces-083119033.html>>
- Treasury (2018). 2019 National Budget, Volume 1: Economic and development policies. Papua New Guinea Department of Treasury.
- Treasury (2019a). Treasurer's statement, January–May 2019 Fiscal Position. Papua New Guinea Department of Treasury, <<http://www.treasury.gov.pg/html/speeches/Speeches.html>>.
- Treasury (2019b). Treasurer's statement: Financing requirement of debt stock analysis. Papua New Guinea Department of Treasury.
- Treasury (2019c). Mid-Year Economic and Fiscal Outlook [MYEFO] report 2019. Papua New Guinea Department of Treasury, <http://www.treasury.gov.pg/html/national_budget/files/2013/budget_documents/Related%20Budget%20Documents/2019%20MYEFO.pdf>
- Treasury (2019d). Final Budget Outcome 2018. Papua New Guinea Department of Treasury, <http://www.treasury.gov.pg/html/national_budget/files/2013/budget_documents/Related%20Budget%20Documents/2018%20Final%20Budget%20Outcome.pdf>.
- Vari, M. (2019a). PNG's foreign currency exchange market stable. *Post Courier*, July 31. <<https://postcourier.com.pg/pngs-foreign-currency-exchange-market-stable/>>
- Vari, M. (2019b). Foreign reserve drops to US\$1.9b from US\$2.2b. *Post Courier*, July 31. <<https://postcourier.com.pg/foreign-reserve-drops-us1-9b-us2-2b/>>
- World Bank (2019a). *Slower growth, better prospects*, PNG Economic Update, January, <<http://documents.worldbank.org/curated/en/597161549016416469/pdf/134248311-2019-18-48-46-PNGEUJANfinalfinal.pdf>>.
- World Bank (2019b). *Recovery amid uncertainty*, PNG Economic Update, July, <<http://documents.worldbank.org/curated/en/534921562647834569/pdf/Papua-New-Guinea-Economic-Update-Recovery-Amid-Uncertainty.pdf>>

How to cite this article: Howes S, Fox R, Laveil M, Nguyen BH, Sum DJ. 2019 Papua New Guinea economic survey. *Asia Pac Policy Stud.* 2019;6:271–289. <https://doi.org/10.1002/app5.287>