PNG's economy 2023 – past, present and future prospects

'Weak governance and non-adherence to PNG's extensive laws lie at the bottom of PNG's poor economic and human development performance'

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Overview

Economic Performance and Issues: Papua New Guinea enjoyed 15 years of almost uninterrupted, if fluctuating, economic growth from 2003 until 2017. Since 2016 growth has been subdued, erratic and, for 2018 (with a major earthquake) and 2020, with the Covid19 pandemic, negative, with non-mining growth sluggish since 2015.

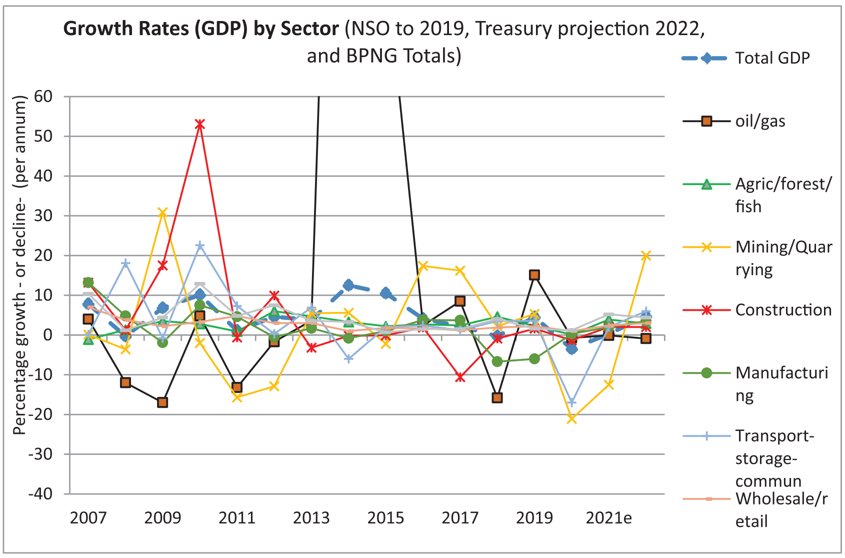
Formal sector employment has been subdued. In some years since 2012 growth has been negative, except for the minerals and construction sector, which saw strong growth until 2014, notably during the construction phase of PNGLNG. Mining employment picked up in 2018, only to fall back in 2020 with the combined impact of the pandemic and the closure of the Porgera mine, the country's third largest operating mine.

Following the calamitous earthquake centred in Hela in 2018, recovery in production and economic growth recommenced in 2019,. This was then forestalled by onset of the pandemic in 2020, with the associated shrinkage of global demand and major fall in most commodity prices, especially for energy and substitute agricultural products, such as vegetable oils. However, prices appreciated for gold, as a secure haven.

It was unfortunate that PNG's industry was prevented from achieving its full potential of shoring up economic activity, revenue and export earnings through the pandemic period, as a result of the enforced closure of the Porgera mine from April 2020. Production has yet to recommence over 2 ½ years later, despite arrangements for its resumption having been negotiated.

Despite attempts to downplay the health impact of Covid19 on PNG, it did impose a large health effect on many communities and the country more generally, including extensive mortality, but far from entirely impacting the elderly and others at higher risk, albeit that data was not systematically recorded; poor health awareness and susceptibility to vaccine skepticism contributed to very low vaccine rates, and no doubt to the rates of mortality. Climate conditions and perhaps extensive outdoor existence and other factors may have helped mitigate the outcomes.

The PNG economy took a major hit from the pandemic, but not to the extent of many other countries, including in this region, which were more dependent upon a few hard hit industries, including oil and tourism.



Source: INA

Apart from gold, the price of which strongly appreciated in 2020, and has remained strong since, albeit at a more subdued level, some of PNG's main agricultural export crops, including coffee and cocoa, also maintained firm prices as market demand largely held steady. This helped to sustain household incomes from agriculture.

PNG took sound initial measures in early 2020 to restrain and thereby prepare for the inexorable entry of the Covid19 virus into the country. Authorities recognised that it was not realistic to lock down communities and the whole economy for extended periods, as occurred in various neighbouring countries. The inability to engage in production and other economic activities, including in the informal economy, would have been more catastrophic than the impact of even a devastating pandemic, in the absence of any state social protection system.

From late 2021, most Covid restrictions that prevailed in PNG were discontinued, although the final two quarters of the year saw some of the highest infections, morbidity and mortality rates experienced to date, associated with the more contagious variants.

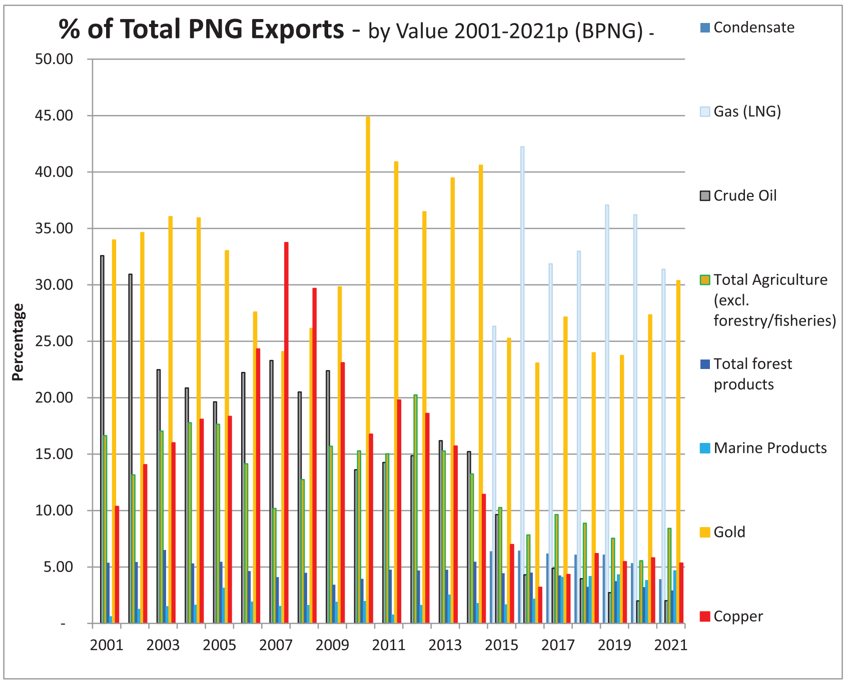
While the rest of the world lifted restrictions after having largely vaccinated their population, PNG also lifted most remaining restrictions and testing, despite one of the lowest vaccination rates worldwide. Riding on the back of a resurgence of commodity prices associated with both with a revival of the global economy, and a serious disruption in major global supply chains, it was envisaged that PNG would enjoy continued strong economic growth through 2022, with higher inflationary pressures expected to be subdued as bottlenecks in the global and local supply chains eased.

Economic and fiscal forecasts for 2022 and beyond were, of course, overtaken by events from February 2022, with Russia's invasion of Ukraine causing a far more serious disruption of global energy markets, and the markets for grains and other staple foods and fertilizer. This drove up prices for all products dependent on transport and energy, encouraging wider inflationary pressures which had already been fuelled by the massive economic and welfare stimulus packages funded by public borrowing and quantitative easing.

Although the rise in energy and food prices during 2022 negatively affected the global economy, and particularly some countries, including in this region, there are winners and losers. PNG certainly has gained substantially from a boost in gas and oil export value, and foreign exchange earnings, and the associated gain in revenue, via different platforms.

Although energy prices have slipped back in recent week , and are relatively erratic, they remain, for the time being, substantially stronger than at the start of the year. How these pan out in coming months will partly depend on the winter weather conditions in the northern hemisphere and on the duration of this unjustified but unpredictable war.

On the downside, other domestic industries and households, which suffered in many cases from the weak demand and supply disruptions during the pandemic, were able to look forward to better economic prospects. They are now further restrained by increased input costs and higher consumer prices, continued rationing of limited foreign exchange, and policy uncertainty, which are challenging the viability and prospects for extensive, but needed, foreign and local investment in business, as well as household welfare.



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'Economic growth over much of the past seven years has barely exceeded, and for several years failed to reach the population growth rate'

Various major economic challenges prevail:

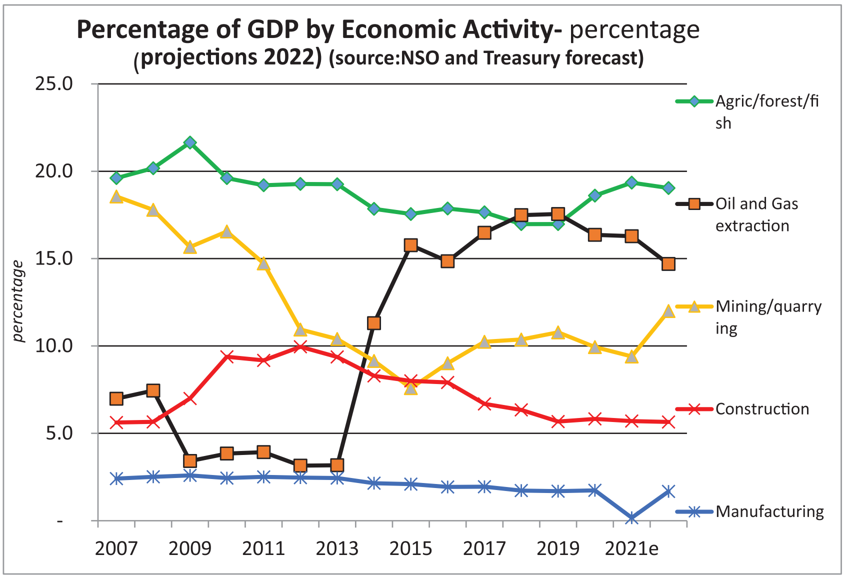
- Economic growth, and especially non-mining growth, and formal sector employment growth, have been relatively low (sometimes negative) over the past seven years. For much of that time has barely exceeded, and for several years failing to reach the population growth rate.
- Inflation rates have increased worldwide, including (largely imported inflation) into Papua New Guinea over the past year.

Together with associated higher international and local interest rates, as central banks seek to clamp down on inflation; this has acted to restrain the weak international and domestic economic recovery and is likely to result in another recession in many countries. This has pushed up PNG's costs of official and commercial debt service, and squeezed out other demands for limited foreign exchange.

- PNG's formal sector only employs about 1/6th of the prospective workforce, with the rural and urban informal economy having to continue absorbing the majority of those leaving school and colleges, as well as providing the hub for most of the existing workforce. This reflects the lack of formal sector investment, limited transition of micro, but also some small-medium enterprises, from the informal to the formal sector.

  It suggests continued high costs, including risks, and therefore inadequate viability of much prospective formal sector economic activity in PNG. Additional constraints include land availability, skills, including business skills and investment uncertainty, related to policy inconsistency and law and order issues. Many SMEs are also short-lived, such as those associated with landowner companies securing contracts during project construction phases.

- PNG is in the unusual position each year of sustaining a large current account surplus, with exports far exceeding imports, (at least until a further major resource project investment, such as Papua LNG, occurs). The country reportedly currently holds nearly a year's import cover in forex reserves, yet it retains a major unfulfilled backlog of demand for foreign exchange, accumulated largely by medium-major businesses.



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This reflects partly the level of accumulated debt and debt servicing obligations by the Government, as opposed to having placed saved over the years into a sovereign wealth and stabilisation fund, held largely offshore, as had been envisaged.

It also reflects the changing resource sector investment conditions in PNG, which became progressively more concessional to resource investors since the tougher conditions of the pre and post-independence years in the 1970s and 80s. This may partly reflect shifting global investment conditions, but it certainly reflects the nature and timing of PNG's benefit sharing and resource agreements, the States commitment to acquisition of state equity, rather than use of other fiscal revenue mechanisms available to the State. Exclusive concessions have been given to resource companies to hold offshore accounts, and the nature of the foreign exchange market administration, which is managed, rather than competitive, favours stability over market influences on exchange rates.

This, in turn, potentially discourages broader-based investment and trade, as only certain companies can automatically retain foreign earnings offshore, while others are restricted from doing so (legitimately) or restrained from remitting earnings or making timely payments offshore.

- The State continues to under-perform badly in delivery of its core functions, including the provision of reliable and affordable critical public utilities and services. The costly and substantially unaccountable public sector is divided into far too many – some 1,400 – public sector institutions from the national to local level, widely lacking capacity, transparency and governance requirements, and in many cases encroaching upon, or sidelining, the delivery of goods and services more effectively and competitively provided by the private sector.

  Failure to provide reliable and affordable power, water and sanitation, and reliable and affordable transport access, including ports, and restrictions on competition in other fields, including telecommunications, raises costs for business and households.

  The State's fixation with State equity in resource projects has resulted in increased upfront public expenditure and indebtedness, diverting funds from priority public goods, and deferring prospective revenue flows from gas developments, but also from some current mining projects, which were providing major revenue, employment and contracts and needed foreign exchange.

'Tax revenues from extractives is estimated by Treasury to have leapt nearly five-fold this year"

- Tax revenue from the extractive industries was higher in the mid-2000s (2006-2008) as a proportion of total revenue at around 40%, than since 2012, when mining and petroleum/gas taxes has provided less than 12%, and for several years since 2015, 5% or less. Similarly, mining and petroleum taxes and dividends, which provided 23% of total revenue in 2011 have been at or below 12% since 2012, and nearer 5% in the mid-2010s.

  With the higher global energy prices in 2022, combined with a reduction of project financing debt, the portion of total revenue has been estimated as leaping to 22% in 2022, although industry sources are suggesting it might end up well above that level.

  Tax revenue from the extractives is estimated by Treasury to have leapt nearly five-fold from 2021 to K3 billion in 2022, which has been critical as revenue from many other key sources are forecast to be well below the Budget forecast for 2022, and below 2021 levels, in the face of the cost inflation and a fall in most other commodity prices in 2022.

  It should be noted that these figures undervalue the economic and fiscal contribution of the resources sector, which also provide major revenue from salaries and wages tax, especially in the mining sector, with its generally larger workforce than oil and gas operations. It also excludes the extensive contribution from contractors and other suppliers, including those from the informal economy, supplying fresh produce and other goods and services to projects and their staff and contractors.

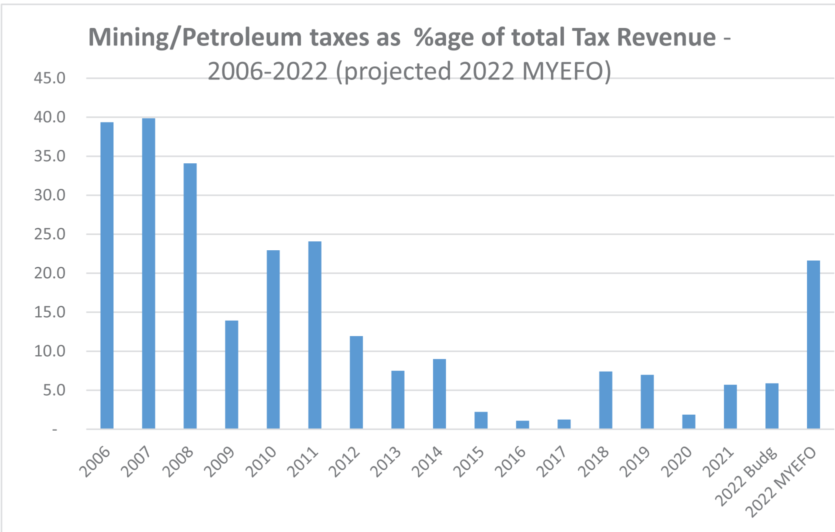
- PNG has a relatively low rate of revenue collection relative to GDP. During periods of stronger economic growth, the higher GDP is neither translating favourably into local benefits or to increases in government revenue, as needed for providing essential and reliable public goods.

  It is a relatively expensive country to deliver public goods and services, partly by nature of its geography and aspects of its history. While public expenditure restraint is weak, and public funds should be better focused on priorities, it is clear that core infrastructure, education, health and law and justice services, and resource management and protection, require additional funding, with more staff and suitable conditions and standards. Investing adequately in these functions, plus governance oversight, are critical for the country's economic, social and political development. So, when it comes to public sector reform rightsizing is required, rather than downsizing, per se.

- Over-optimistic revenue forecasts through much of the 2010s, particularly associated with LNG revenue, encouraged expansionary expenditure commitments, partly intended as fiscal stimulus measures, but included some relatively unproductive urban infrastructure projects, led to continuous budget deficits from 2012. This, in turn, resulted in a growing cost of debt servicing and rising total debt.

  The borrowings through the mid-2010s were particularly sourced from domestic and international commercial loans, with increasing non-concessional export-import financing for projects with SOEs (notably from China EXIM bank under the Belt and Road Initiative).

  In 2018 the government secured finance through its first sovereign bond, but at an interest rate of around 8%. With public debt to GDP successfully reduced to below 20% in 2010, it rose to 32% by 2016 (after amending the ceiling under the Fiscal Responsibility Act), and, with the diminished pubic revenue and sustained expenditure during the



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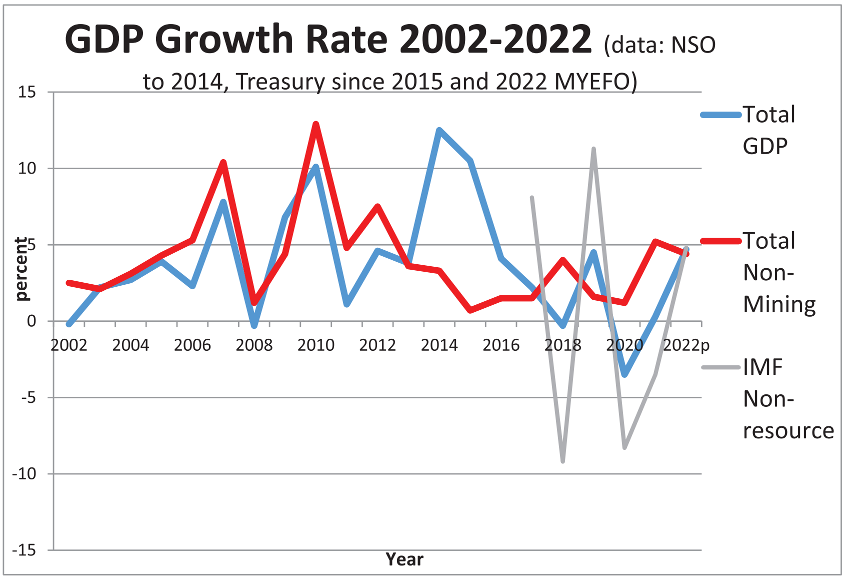
pandemic, debt rose to 51% of GDP by 2021, with debt servicing costs rising to K2 billion per annum since 2019 (and forecast at K2.3 billion for 2022), after some further amending of the permitted borrowing ceiling. This debt servicing cost has displaced public expenditure on other priorities, and substantially exceeds allocations for education, transport and law and justice in the annual Budget.

There needs to be "reconsideration of the model of relatively unaccountable resource State-Owned Enterprises seemingly operating parallel budgets'

- Debt to GDP has no rigid safe ceiling. The sustainable limit varies according to the economic and fiscal conditions prevailing in the respective country. For some, with diverse economies and lower economic volatility, and with a greater capacity to secure revenue from growth, a much higher level of debt may be sustainable. For other countries, including PNG, with its small formal sector and relatively low capacity to capture revenue even as the economy grows, a sustainable ceiling would be markedly lower.

Some countries, such as Germany, place far greater store on fiscal restraint and, as a result ,avoid debt entirely. For PNG, the current debt recorded at 50% of GDP should ring strong cautionary warnings, if not alarm bells, necessitating a greater focus on the composition of expenditure, its effectiveness, waste and duplication, and necessitating improved and diversified revenue arrangements.

This includes reconsideration of the whole model of relatively unaccountable resource SOEs seemingly operating parallel budgets, and to progressively shift to a transparent and well-run sovereign wealth and fiscal stabilisation fund, as a vehicle for more predictable fiscal management (and in due course to replace aspects of prevailing debt).



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- The two positive aspects of public borrowings and debt management during the pandemic were, firstly, that, working with the IMF, the debt records were made more transparent and comprehensive then hitherto, drawing in borrowing from state entities and contingent liabilities and Court rulings. This raised the recorded figures for PNG's debt, but enhanced trust in the data set, which is critical for debt management.

Secondly, the government was able to displace all overseas commercial borrowing and some domestic commercial borrowing with more affordable concessional loans, which stabilised and even reduced the cost of debt servicing, even while the total level of debt increased. However, in the face of rising global interest rates and a potentially weaker kina, the costs of borrowing have been appreciating, and, although this trend may prove short-lived, there certainly are risks stretching into the future. Unless the economy grows steadily and more rigorously, revenue is enhanced, costs prioritized and restrained will public expenditure become more effective.

The 2022 national election were the worst conducted and one of the most violent on record… public trust and confidence needs restoring'

Two final issues need to be raised during this year of the PNG elections and the COP27 Climate Talks in Egypt, as the world seeks to operationalise its prior commitments to reducing greenhouse gas emissions and transitioning to greener economies, energy sources and lifestyles.

- Elections, Politics and Governance. PNG's 2022 elections were the worst conducted and one of the most violent on record. The attraction of gaining political office has become so great that the integrity of the whole election process has been severely hijacked by money politics and increasingly systematic electoral abuse, including electoral fraud. Trust in the process has been severely undermined, electoral rolls severely deficient, and free and fair voting by citizens has been widely replaced by various forms of block voting determined by deals reached with candidates and parties.

The election process is costly, but when the outcomes are so lacking in credibility, it is clear that serious reforms are needed to safeguard and shore up PNG's democracy, and electoral systems, to restore public trust and confidence, and to reduce the severe economic and fiscal costs and distortions associated with deficient, abused and sometimes violent electoral processes and outcomes.

- Independent observers, academics and commentators have recognised this, but so also have voters and most candidates and the Government itself, which has established a Parliamentary Committee to review the process and address needed electoral reform.

It is critical that this exercise is addressed seriously, together with failing governance systems throughout the public sector, including with the commitments to rolling out an effective independent anti-corruption commission (ICAC), implementing tough rights to information legislation, greater budget and contract transparency and to operationalise the whistle-blower legislation.

These reforms need to be tangible and cannot just be window-dressing, as it's widely recognised that weak governance and widespread non-adherence to PNG's extensive laws lies at the bottom of PNG's poor economic and human development performance.

- PNG is a country blessed both with a rich and biodiverse natural environment, agricultural, marine, renewable energy and mineral resources. As the National Constitution requires, the country must utilise and safeguard these resources prudently and for the best interests of the whole population and for future generations.

As the world attends another round of climate change talks and the COP on biodiversity, which highlight the severity of the climate situation and the overrun on commitments already made to sustain temperature change within the 1.5° limit. This also highlights the human impact on the world's biodiversity and wider natural environment (including from plastic pollution and resource over-exploitation).

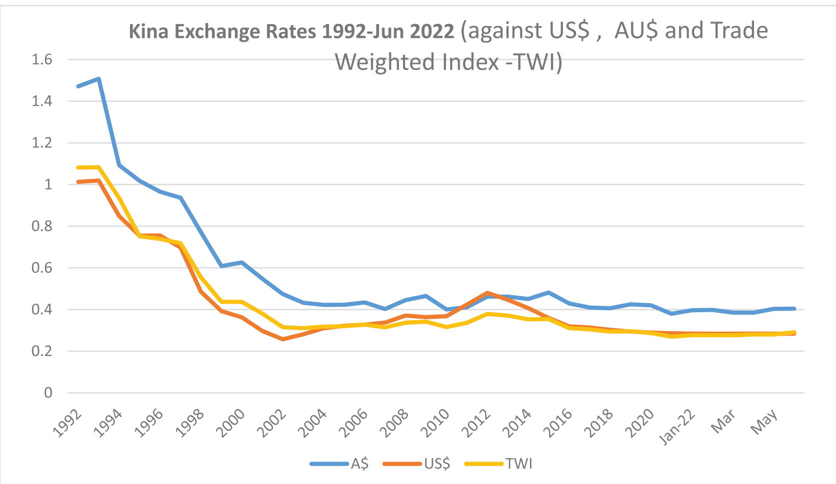
It is clear that much greater action is required by all players, developing, but also developing country governments, the private sector and consumers.

- PNG is fortunate to house some of the world's remaining extensive forest, mangroves and wetlands, as well as rich coral and other marine habitats and fish stocks. It also has amongst the most extensive renewable energy resources, and both valuable hydrocarbons (notably gas), and also minerals needed for the energy transition.

We are now far more aware of the fragility of the world's ecosystems, and the impact of malpractice, particularly on local ecosystems and communities, so the former cavalier approach to resource exploitation and waste management is no longer acceptable, whether in Europe, South America or PNG. Resource exploitation and economic development have inevitable positive and negative impacts, but where a negative impact is genuinely unavoidable, the 1+1 principle must be applied, notably that the impact is mitigated by 110% environmental offset elsewhere.

Many of the mining and energy companies do take their environmental responsibilities seriously, and are conducting valuable work with local communities, including in their biodiversity, environmental and community initiatives and engagements.

Nevertheless, in contributing to safeguarding PNG's rich natural environment and supporting rural communities in this endeavour, including in locations far removed from major resource projects, and considering the impact of resource extractive projects, in mining, hydrocarbons, but also forestry and fisheries, it is proposed that developers should make a fixed contribution, perhaps through a targeted export duty, to PNG's newly established and independently managed Biodiversity and Climate Trust Fund, to support PNG's network of protected areas (largely managed by their own customary resource owners).



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