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DEFENCE AND TRADE

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JOINT COMMITTEE ON FOREIGN AFFAIRS, DEFENCE AND TRADE

Foreign Affairs Subcommittee

Tuesday, 12 September 2000

Members: Senator Ferguson (*Chair*), Senators Bourne, Calvert, Chapman, Cook, Gibbs, Harradine, Hutchins, Sandy Macdonald, O'Brien, Payne and Schacht and Fran Bailey, Mr Baird, Mr Brereton, Mrs Crosio, Mr Laurie Ferguson, Mr Hawker, Mr Hollis, Mr Jull, Mrs De-Anne Kelly, Mr Lieberman, Dr Martin, Mrs Moylan, Mr Nugent, Mr O'Keefe, M Price, Mr Prosser, Mr Pyne, Mr Snowdon, Dr Southcott and Mr Andrew Thomson

Subcommittee members: Mr Jull (*Chair*), Senator Gibbs (*Deputy Chair*), Senators Bourne, Calvert, Chapman, Ferguson and Schacht and Mr Brereton, Mrs Crosio, Mr Laurie Ferguson, Mr Hawker, Mr Hollis, Mr Lieberman, Dr Martin, Mr Nugent, Mr Price, Mr Pyne, Mr Snowdon, Dr Southcott and Mr Andrew Thomson

Senators and members in attendance: Senators Bourne and Hutchins and Mr Jull, Mr Nugent and Mr Price

Terms of reference for the inquiry:

Section 8F of the International Monetary Agreements Act 1947, as amended, requires the Committee to inquire into and report on the National Interest Statement (NIS) within two months of its tabling in the Parliament. The NIS was tabled on 28 August 2000.

WITNESSES

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Subcommittee met at 10.05 a.m.

DEL BUSTO, Mr Jorge Luis, Executive Level 1, International Finance Division, Department of the Treasury

SEWELL, Mr Mark Francis, Executive Level 1, Asia-Pacific Division, Department of the Treasury

HUNT, Mr Bruce, Director, Papua New Guinea Section, Department of Foreign Affairs and Trade

OLIVER, Mr John, Assistant Secretary, New Zealand and Papua New Guinea Branch, Department of Foreign Affairs and Trade

DILLON, Mr Michael, Assistant Director General, Papua New Guinea Branch, AusAID

CHAIR—Welcome to this hearing of the Foreign Affairs Subcommittee of the Joint Standing Committee on Foreign Affairs, Defence and Trade. The hearing has been arranged as part of the inquiry process into an Australian government loan of \$133.2 million to the government of Papua New Guinea. There is a statutory requirement for this committee to inquire into and report on this loan to the parliament within a two-month period. The national interest statement was tabled on 28 August and we are therefore to report on 30 October. This statement is a public document and copies are available from the secretariat at the table. This loan was executed with the government of PNG on 21 June 2000 as a result of its agreement with the International Monetary Fund and the World Bank on the details of the reform agenda. We here in Australia have followed the work done by the Morauta government over the last 14 months with considerable interest and admiration. We look forward to learning more about them and the terms and conditions of the loan here this morning. It was unfortunate we did not receive more responses to our attempts to get submissions on this loan. It was particularly unfortunate that other claims on its resources prevented ACFOA from appearing here today, as they wanted.

On behalf of the subcommittee, I welcome representatives from Treasury and the Department of Foreign Affairs and Trade. The subcommittee prefers to hear all evidence in public but should you at any stage wish to give evidence in private you may do so and consideration will be given to your request. Although the subcommittee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the houses themselves. Would you like to make a short opening statement before we proceed to questions from the subcommittee?

Mr Sewell—The national interest statement on the PNG loan which was tabled on 28 August provided reasons for the loan being in Australia's national interest, with particular regard to our foreign policy, trade and economic interests. It also provided details of the nature and terms of the loan agreement. As requested by the subcommittee, this opening statement provides information on the use of the International Monetary Agreements Act 1947, known as IMAA, to provide loans to other countries, the role of the IMF in providing assistance to countries undertaking economic adjustment programs, the nature of the IMF's assistance and

that of the World Bank to Papua New Guinea, and the uses to which the Australian loan would be put by Papua New Guinea.

The IMA act was amended in 1998 to establish a framework for the provision of financial assistance by Australia to countries undertaking economic adjustment programs with the support of the IMF. Prior to the amendment of the act, there was no legislative basis for dealing with requests for assistance in support of IMF programs, and these had been dealt with in an ad hoc manner. For example, in 1995 the government to government loan to Papua New Guinea was put in place using funds obtained initially from the Minister for Finance's advance. Support for Thailand in 1997 was arranged by way of a currency swap between the Reserve Bank of Australia and the Bank of Thailand. The parliament agreed that it was inappropriate to draw on the balance sheet of the Reserve Bank of Australia for such arrangements, which are properly matters for government and should be reflected in the government's accounts. The IMA act was amended to provide such a framework. A transaction under IMAA provides temporary assistance to the recipient country. It offers balance of payment support to boost market confidence, helps stabilise financial flows across the country's exchange markets, and reduces volatility in its exchange rate.

Full details of the reasons for the loan to Papua New Guinea are set out in the national interest statement which has been tabled. In summary, the PNG loan has been provided because PNG is a strategically important neighbour with which Australia has major trade and investment interests. Australian assistance will help advance our longer term interests by contributing to macroeconomic stability and underpinning sustainable growth and needed structural reform.

The second aspect covers IMF processes for supporting economic adjustment programs. The IMF is a cooperative institution in which member governments provide temporary financial assistance to any member country experiencing difficulties in paying for imports of goods and services and/or servicing its foreign debt. As a condition of such support the country agrees to undertake policy reforms to correct the problems that underlie its balance of payments difficulties. Temporary financial assistance from the fund provides members with the opportunity to correct maladjustments in their balance of payments without resorting to measures which may be destructive of national or international prosperity. Before the IMF releases any money the member must demonstrate how it intends to solve its payments problem so that it can repay the loan within its normal repayment period of three to five years. As the IMF has an obligation to the whole membership to preserve the financial integrity of its transactions, it lends only on condition that the member uses the borrowed money effectively. The borrowing country therefore undertakes to initiate a series of reforms that will eradicate the source of the payments difficulty and prepare the ground for high quality economic growth.

Along with its request for a loan, the potential borrower negotiates a plan of reform with the IMF based on its own particular economic circumstances. In developing plans of reform important considerations are that countries have good quality government spending, including attention to spending on health and education, and good governance with a proper focus on avoiding corruption and with openness in fiscal policy and policy making. The specifics of each IMF supported adjustment program are selected by the member and hence the program of reform is the member's, not the IMF's. The IMF's main concern is that the

policy changes are sufficient for the member to overcome its payments problem and that they do not cause harm to other members. Depending on the seriousness of the payments problem and the amount the member wishes to borrow, the executive directors of the IMF, representing the entire membership, judge whether the reform measures will be sufficient and whether the IMF can reasonably expect repayment. If the IMF's board of directors is satisfied that the reforms will solve the problem, the loan is disbursed in instalments, tied to the member's progress in putting into effect the reforms designed to strengthen its economy.

Details of the PNG reform program are discussed below. Processes for securing IMF agreement to support an economic reform program can be protracted, involving detailed negotiations between the IMF and the authorities of the country concerned. In the case of PNG the IMF commenced consultations soon after the Morauta government came to office in July 1999. Prior to final agreement on its financial support in March 2000, the major milestone was the agreement in December 1999 between the IMF and PNG on the PNG authority's draft letter of intent which set out the basic direction of the economic reform program. As the potential major bilateral donor in support of the IMF's assistance and, in particular, in view of the government's obligations under IMAA, Australia was kept fully informed of the general progress of these consultations. Since PNG's re-engagement with the international financial institutions, bilateral loan assistance has also been provided by Japan—a loan of \$US50 million—whose support is formally linked to the World Bank program. The Peoples Republic of China, with \$US10 million, and the European Union have also provided financial support in the form of grants since the Morauta government came to office.

The third area is the detail of the PNG agreements with the IMF and the World Bank. As indicated in the national interest statement, Australia's support for PNG has been carefully calibrated in line with progress in re-establishing relations with the international financial institutions. In relation to the IMF, on 29 March 2000 the IMF approved a \$US150 million 14-month Stand-By Arrangement in support of the PNG government's economic adjustment program for 2000-01. The Stand-By Arrangement recognised the substantial progress made by the Morauta government since it took office in mid-1999 in reorganising PNG's finances and restructuring its economy. The first disbursement of \$13.4 million was made with the Stand-By Arrangement was approved, to be followed by three disbursements linked to IMF program reviews. Disbursements are conditional on further PNG progress against its program of policy adjustments.

The PNG government's economic reform program, which is published on the IMF's web site—that is the letter of intent of 20 March 2000—aims to establish sustainable growth by reducing inflation and the budget deficit, underpinned by far reaching structural reforms, to improve public sector governance, to promote private sector development and to strengthen the financial system. A key feature of the wide ranging reform program is that it envisages a return to fiscal stability through an overall fiscal deficit of 1½ per cent of GDP in 2000, with a balanced budget in the coming year and beyond. Other macro-economic targets include a pickup in growth in 2000 to about 4½ per cent, a reduction in inflation to five per cent by the end of the year and an increase in gross official reserves. A key fiscal reform measure is the enhancement of control over government expenditure.

On the monetary side, the large amount of excess liquidity that emerged in 1999 has been mopped up. The new Central Banking Act enhances the powers of independence of the

Central Bank and reduces the government's recourse to Central Bank credit. The Banks and Financial Institutions Act strengthens financial sector supervision and regulation. Key structural reforms include the privatisation of large-scale public enterprises and the replacement of the rural development program with district development program grants, which will be allocated to district and local development projects in a way that enhances transparency, fairness and cost-effectiveness.

On the World Bank side, on 13 June 2000, the World Bank approved a \$US90 million structural adjustment loan in support of the government's program of structural reforms to strengthen economic management and governance in public institutions in the financial sector. The loan supports the PNG government's ongoing efforts to redress past policy and governance shortcomings in a sustainable manner. It includes components to improve fiscal and debt management, governance and civil service effectiveness, delivery of health and educational services, forestry management, the quality and efficiency of financial services and the operating environment for business. The World Bank's loan supports measures to strengthen public sector institutions and the integrity of the civil service. It aims to enhance governance through greater transparency in public sector decisions and programs and to improve public sector management capacity in the provision of core government services to priority areas, such as rural development, health, education and fighting crime. The loan also provides for an improved climate for private sector development and improved natural resource management.

The final area that I will discuss here is the usage to which PNG might put the Australian loan. The Australian Loan Agreement with PNG provides that the funds shall be used, firstly, to repay the outstanding swap with the Reserve Bank of Australia, and, secondly, to supplement PNG's international reserves. The Loan Agreement further provides that PNG is to maintain net international reserves at a level in conformity with the targets specified in the IMF program. As indicated in the national interest statement, the RBA swap was put in place in December 1999 as short-term bridging finance following agreement between the IMF and PNG on the basic direction of the economic reform program. As mentioned in the national interest statement, the Loan Agreement contains standard commercial terms and conditions, including an indemnity clause designed to protect the Commonwealth's interests. The previous Australian government loan to PNG in 1995 was repaid in full and on time.

CHAIR—Mr Oliver, does Foreign Affairs wish to make an opening statement?

Mr Oliver—Yes. I will make a very brief statement, and then I can elaborate further, if you wish. Prime Minister Morauta's first year in office has brought increased stability and improvement to PNG's economic and political situation. Prime Minister Morauta has moved convincingly to stabilise the budget and to re-engage international financial institutions. He has successfully concluded a Stand-By Arrangement with the IMF and a structural adjustment loan with the World Bank—you have heard the details of those initiatives from my Treasury colleague. The accompanying terms and conditions of both arrangements have forced the PNG government to begin to meet much needed political, bureaucratic, domestic and economic reforms.

PNG has also embarked on a program of privatisation and reform to the health, education, forestry and financial sectors. Progress towards a settlement in Bougainville continues, and it

remains somewhat elusive, but negotiations are continuing and the way ahead has begun to be identified. Australia remains committed to helping on Bougainville, but the presence of the Peace Monitoring Group there is not permanent and reductions are being implemented.

I will now turn to the specifics of Morauta's reform program. Since coming to office in July 1999, Prime Minister Morauta has, in our view, made solid progress. He has been able to secure passage for his legislative program through parliament whilst maintaining the momentum of reform. Some recent reforms passed through parliament include: the Central Bank Act, which tightens lending procedures for the PNG Banking Cooperation and reduces the likelihood of appointees being politically nominated; the Banking and Financial Institutions Act, which requires financial institutions to comply with international banking standards; and the Privatisation Amendment Act, which clarifies the roles of the Privatisation Commission, the managing director and the chairman. There have also been Rural Development Fund guidelines passed which require MPs to develop and submit project bids for their district fund allocations, which has generally improved the accountability and transparency of this process. An Organic Law on Political Parties and Candidates was also passed recently through parliament. It will require MPs to vote for their prime ministerial candidate's budget. It severely limits the ability for an MP to swap parties and generally strengthens and regulates political parties in PNG. There will be an election in PNG in around August 2002. Prime Minister Morauta has said publicly that he will not convene the national parliament in the period from mid-January until July 2001. In this period he is open to challenge through non-confidence motions. To date the Prime Minister has yet to table a motion to adjourn parliament but we expect that he will do so.

In terms of PNG's economic and trade relations with Australia, PNG is an important trading and investment partner for us. It is our eighteenth largest trade partner. Two-way trade last year was valued at about \$2.1 billion. That is some one per cent of our total trade. It is our twentieth largest export market. We exported some \$970 million worth of goods to PNG last year. It is our twentieth largest import market. We imported slightly more than we exported—around \$1.13 billion worth of goods and services last year. Of that, two-way services trade is about \$475 million—but here again we are, I suppose, the largest provider. We provided some \$303 million worth of services to PNG. PNG is our eleventh largest investment destination. There is some \$2.3 billion worth of Australian investment in PNG and there is about \$405 million worth of PNG investment in Australia. The principal exports that we have to PNG are refined petroleum, specific machinery, manufactures and general industrial machinery. Our principal imports from PNG are crude petroleum, non-monetary gold, silver and platinum, and agricultural products—basically coffee and coffee substitutes.

I think it is fair to say that the Australian government regards PNG as a close and important neighbour and partner. We are by far and away PNG's largest trading partner, its principal source of investment and aid and we are a major supporter of the PNG Defence Forces. It is very much in Australia's interests that PNG remain a stable, democratic and prosperous neighbour. The government has strongly welcomed the reform programs outlined by Prime Minister Morauta and has firmly committed itself to continuing to support those reform efforts. We are both impressed and encouraged by the progress that has been made so far by the PNG government since coming to office in July last year and we are, I think, confident that under Prime Minister Morauta those reforms will be vigorously pursued. That said, we do not underestimate the difficulties faced by the PNG government. These are very substantial and

will take time to resolve. We need to be realistic, patient and understanding in our support for the PNG government. Efforts to date to turn the economy around, to rebuild confidence in the institutions of the state, to begin to restore international business and donor confidence, and to begin to address some of the key law and order issues have so far been commendable. Generally speaking, I think reform has got off to a very good start and implementation is probably now the key issue that we should be watching. If there are any other matters, we can probably address those during question time.

CHAIR—Thanks very much, Mr Oliver. Perhaps I could begin the questioning with Treasury. Excuse my ignorance, Mr Sewell, but what is the difference between a loan and a swap?

Mr Sewell—With the loan, funds are paid to the government, and there is a repayment schedule. So it is a one-way transaction from us to them and then a repayment. With the swap, there was an arrangement whereby Aussie dollars were swapped or given to PNG, and in return kina were lodged with our central bank, the RBA.

CHAIR—You also made reference to the repayment of the 1995 loan, which you said was paid in full and on time. What is PNG's record in terms of loan repayments in the past? Have they always been spot-on in terms of their repayments?

Mr Sewell—To my knowledge, that is our only loan to them. Their performance fully met the conditions of the loan. I am not familiar with loans they may have had with other countries.

Mr PRICE—Would you take that on notice?

CHAIR—Just for the record, in actual fact this loan ultimately will not cost the taxpayer of Australia anything.

Mr Sewell—That is right. The interest rate on the loan is the Commonwealth's cost of funds plus a margin to earn a return above the Commonwealth's cost of funds.

CHAIR—I noticed in the papers that part of this legislation also covers the Indonesian and Korean situation. Are these similar loans in their context?

Mr Sewell—Yes. As it transpired, the Indonesian and Korean loans were not proceeded with, but the legislation, which was amended two years ago, provides a framework for loans in support of IMF programs. That is the instance we have here. The IMF did have a program in Korea, and Indonesia does have a program.

CHAIR—Just the other day, there were reports in the papers regarding some of the prudential difficulties that had occurred with the PNG Banking Corporation—in fact, the government sacked all the directors. I suppose it is evidence of some of the reforms the present PNG government is undertaking, but would that relationship between the PNG Banking Corporation and the New Guinea government have any bearing on this particular loan? Is there enough stability in the system to keep you satisfied?

Mr Sewell—Yes, there is. We would see the activities with the PNG Banking Corporation as being part of the reform program. It is the entity which, under the program, was slated for privatisation first up. We see this as a step in that direction—to appoint a new board and to ready the entity for privatisation.

CHAIR—So the sacking of the board did not present any ringing bells for you?

Mr Sewell—No, we saw it as a positive step in the privatisation process, which is an important part of the reforms.

Senator BOURNE—Do you know what is being privatised? The bank or what?

Mr Sewell—I think there are five major entities: the PNG Banking Corporation, Air Niugini, Elkom, Telikom and the Harbours Board. They are the five major ones. Then there are a number of other smaller entities.

Senator BOURNE—Is there a view as to whether the private interests that will finally take over these entities will be from within PNG or Australia or America or the world? Is there a view of where that will happen from?

Mr Sewell—I think it is probably expected that there will be a combination of outside interests as well as those internal to PNG. As part of the privatisation program, the government has set aside a certain percentage of the equity to be available for members of the corporations, or citizens of Papua New Guinea, to purchase shares. So there is a proportion set aside which would have to be taken up by PNG nationals.

Senator BOURNE—So there would be a minimum ownership within PNG on all of those?

Mr Sewell—Yes.

Senator BOURNE—We have got a big aid program. Do the measures that have been agreed with the IMF clash in any way with the aid program, or do they have anything at all to do with the aid program?

Mr Dillon—Only in so far as our activities interact with the PNG reform process and so do the conditions, so clearly we have to ensure that we are talking to the bank and the fund in particular sectors. But to my knowledge PNG, the fund, the bank and Australia, and in particular our aid program, are basically working on the same path and where issues arise they are worked out. The aid program provides a whole series of technical advisers who are working in PNG institutions basically on the reform process identified by the bank and the fund.

Senator BOURNE—So as part of our aid program we have the technical advisers in there doing that.

Mr Dillon—We have a whole series of technical advisers, yes.

Senator BOURNE—And that is part of our aid program too?

Mr Dillon—Yes.

Senator BOURNE—I have one last question. Mr Oliver, how realistic do you think it is that this will actually work, that the reform program will actually work? Do you think it is realistic? Do you have a time frame?

Mr Oliver—I think it would be wrong for me to try and speculate. I suppose the main thing to say is that under the Prime Minister Morauta we do have a considerable measure of confidence that as prime minister, more so than, if you like, many of his predecessors, he has a real understanding of the reforms that are required. I think we and the international financial institutions have been quite impressed by the speed with which he has begun to introduce reforms and the commitment he appears to have to them. I think it would be wrong of me to say that all the reforms that the Morauta government wishes to achieve will be achieved. It is a simply enormous task and I think it will take a very long time to resolve all the difficulties that face PNG. But, as governments go in PNG, this one has demonstrated a very high degree of commitment to the reform process and I think Australian government ministers who have visited PNG and have talked to ministers there and have met with Prime Minister Morauta feel that this is the best shot that PNG has had in a very long while at really getting reforms to work.

Mr Chairman, just coming back to your comments earlier about the loan repayments. To the extent that repayments will be made, as part of the program of reform the IMF and World Bank have insisted on a whole range of reform measures being an integral part of the various assistance that they have provided. I think they will underpin a commitment on the part of the PNG government to ensure that repayments are made, and that disbursements of financial assistance from the World Bank and from the IMF are conditional on certain reforms being implemented, undertaken or achieved. So there are various benchmarks along the way and we will just have to see how far towards those progress is made before additional assistance is passed out. But the signs are encouraging. We will just have to wait and see what happens.

Mr NUGENT—On the privatisation issue, you mentioned that there were several possible privatisations. How realistic are some of those privatisations? For example, I understand that Air Niugini is one of those operations that is to be privatised. If you believe anything you read in the media—of course, on this side of the table we do not always believe too much we read in the media—they are obviously having difficulty finding buyers, and the more that prospective buyers have a look at potentially buying Air Niugini the more they are finding financial problems within the structure of the corporation. I do not know whether that applies to other areas of privatisation. How much work have we done, in looking at giving this loan, to how realistic some of those reform measures are or the privatisation measures are in terms of actually coming to fruition, as opposed to being good intentions?

Mr Sewell—I suppose you could say that the history of attempted privatisations in Papua New Guinea, say in the last 10 years, has not been good, and I think your question reflects some of the difficulties that they have experienced. We would have to acknowledge that the program is certainly ambitious in both the breadth and the timing that is intended and that has been factored into the programs of the international financial institutions. Certainly it will be

difficult to meet those objectives in that time and to find willing buyers, amongst other things. Progress to date has been quite encouraging and I think we would be in a position to give some sort of a considered judgment perhaps six or 12 months down the track as to what sort of success they have had. It is possibly a little early at this stage to comment on individual privatisations.

Mr NUGENT—Given, as I understand it from your introductory comments, that part of this loan is being used effectively to retire other debt or to repay other commitments, could you give us a feel for how much of this loan would be used, if you like, on what is almost a swap basis of debt for debt if you are retiring other commitments? How much will be used for that and how much will be used for other purposes?

Mr Sewell—Essentially as part of the Australian government policy to encourage PNG to re-engage with the IMF and World Bank, the processes were set in train pretty soon after the Morauta government came to office. A key target there was the draft letter of intent, which was signed between the IMF and PNG back in December last year. Under the IMAA Act, Australia could not enter into a government to government loan until certain conditions had been met. Included in that was the agreement on an IMF program and a request from the IMF for our support. The agreement on the IMF program did not come until March this year, when the Stand-By Arrangement was agreed to. Essentially the swap was seen as short-term bridging finance until we had the conditions under which IMAA could come into operation and a loan could be provided under that. The loan effectively is for the same amount as the swap and, when it matured after the one rollover on 21 June, our loan was used to replace that swap. So the Reserve Bank reversed the swap.

Mr NUGENT—So it is not new money?

Mr Sewell—No.

Mr NUGENT—Mr Oliver, I have a couple of questions for you. I think you talked about PNG's stability. I accept that there are a number of good things that have been done in recent times—some of the political reforms and so on—but what is the assessment of the government in terms of PNG's stability? It seems to me that issues like Bougainville have a real potential for causing significant instability. All of the information that is coming to this parliament from Bougainville indicates that there is increasing frustration with the fact that the PNG government is not, if you like, doing the things it needs to do to cement that situation and that the Bougainvilleans are getting increasingly upset, frustrated and impatient and so it is likely to blow up again in the near future.

Mr Oliver—That is a very broad question. Generally speaking, it is fair to say that PNG is under a number of pressures in terms of its stability. It finds itself next to Irian Jaya and West Papua, and developments there are unstable. It obviously has law and order difficulties which are very severe in the Central Highlands and in a number of provinces. Certainly developments in Bougainville, which have been going on for a while, while broadly encouraging do nonetheless open up prospects for things going wrong, not least because of developments in the neighbouring Solomons. There are certain attractions between parts of Bougainville and the West Solomons. In terms of stability it is also worth saying that the PNG government itself is particularly concerned about law and order issues and the general stability

of Papua New Guinea. Certainly the sentiments for autonomy which exist in a number of provinces are a source of concern to the government there.

In Bougainville itself, things sort of go in cycles: sometimes you are quite encouraged by what happens and sometimes we all get rather depressed. But I think we are now moving out of a period where we have been concerned by the very sorts of frustrations and concerns that you expressed a moment ago. During the course of this year, political negotiations have resulted in a number of steps forward—the Loloata understanding, which was achieved back in March, the Gateway communique, which came out in May, and most recently discussions in Rabaul have all moved the peace process on Bougainville forward. These developments seem to be interspersed by ‘low’ periods when people get frustrated that not enough is happening, tensions rise on Bougainville, and eventually somebody pulls a rabbit out of the hat and the process goes on. We feel that during the course of the last six months there has been steady progress. It has its highs and lows, but the key thing is to ensure that the process does continue. At the moment we feel reasonably confident that discussions last week did result in yet another step being reached and we would like to think that negotiations will continue to go forward. This is not to say that at any time things cannot go backwards, but I think we see a steady progress up ahead of us and because of that we are beginning to be reasonably positive about reducing the size of the Peace Monitoring Group in Bougainville, which we think is consistent with developments in the peace process.

Mr NUGENT—You mention that in making this loan there were a number of objectives and targets that we were looking to see occur in PNG, but those objectives and targets were stated in fairly broad terms. What sort of particular actions are we expecting to see from the PNG government to achieve those targets and objectives?

Mr Sewell—The PNG government’s reform program was agreed with the IMF on 20 March and that is published on the IMF’s web site.

Mr NUGENT—I do not have that in front of me.

Mr Sewell—I can give you a copy. It covers a broad range of objectives. The IMF, over the period of the Stand-By Arrangement, which goes for 14 months, will assess PNG’s progress against those broad targets, and further disbursements of their Stand-By Arrangement are linked to progress against those targets. We have committed to a further \$30 million worth of support, which will be in three separate tranches linked into the IMF reviews. There are really two elements to the question of progress. Firstly, there are various monetary targets which are embedded in the program which the IMF is primarily interested in and against which they have sought our support and the support of other bilateral donors. Aside from that, there is a raft of economic and governance reforms which relate to improving fiscal performance, improving performance of the monetary system, structural reforms which include the privatisation process and also the changes to the Rural Development Fund. They are some of the key reforms which will be looked into by the review teams over the period of the Stand-By Arrangement.

Mr NUGENT—I have not had the benefit of reading them, but for argument’s sake, does it say that the PNG government must run a budget surplus? Is it that precise? Does it say that it cannot spend more than an X percentage on defence, for argument’s sake?

Mr Sewell—I would think they would tend to be a little broader than that. The IMF has tried to get away from having a prescriptive approach to reform programs. These essentially are seen as nationally owned by the government concerned. I think in recent years they have felt that there is more chance of success if the government sets those targets and attempts to meet them and the IMF is not trying to be too prescriptive about this or that percentage here and there.

Mr NUGENT—It just seems to me that there has been a long history of lots of money going to PNG, with lots of good intentions with new prime ministers. I am not having a go at the current regime per se, but there is a long history of new regimes, us having confidence, there being some promising signs, us handing over some more money, and so on. But, at the end of the day a long time since independence, PNG unfortunately is an economic difficult case. What would give us confidence that it is going to work this time?

Mr Sewell—I think that, as the representative from Foreign Affairs has mentioned, we do have significantly greater confidence in the Morauta government compared with predecessors. We do have confidence that the reform program on which he has embarked is very broad ranging and covers not just economic targets but improved governance and changes in the electoral system which should hopefully have broad effects across PNG overall. Having said that, we do acknowledge that progress will probably be slow and it is tremendously difficult.

Senator HUTCHINS—Mr Sewell or Mr Oliver, or both, may have mentioned this: you were talking about privatisation and I think you mentioned health, education, forestry and the finance sectors. I think both of you have mentioned the reform of the central bank and other initiatives in that area. What did you mean when you said ‘health, education and forestry’? Could you elaborate on what you meant by that.

Mr Oliver—I mentioned the health and education sectors as being ones which were in particular need of long-term development. The PNG government is acutely aware that both these sectors will need considerable infusions of both human and financial resources. That is something which will take a particularly long time, but PNG’s economic future depends very much on the welfare and wellbeing of its citizens and also on their general level of education. While off the top of my head I could not give you details of the reform programs, I mention them simply to underline the key importance of those two sectors. In terms of our aid program, they are sectors which have been specifically targeted as priority ones. Michael Dillon may wish to add a little bit to that.

The forestry sector I mentioned largely as one which is obviously a major resource for PNG. It is a major source of long-term revenue. It is also a resource which is particularly vulnerable to overexploitation. The reform of that sector largely revolves around getting sustainable development under way and making sure the contracts for logging and so forth are brought under control. I think that has been one of the focuses of the present government and it is certainly one of the issues which is of particular concern to the IMF and to the World Bank.

Senator HUTCHINS—So were they stipulated in the discussions about these loans? Was it stipulated, say, that in forestry we would not have these difficulties of overexploitation that seem to have been under way up there? Were they mentioned?

Mr Oliver—Both the IMF and the World Bank will want to see progress in reform in the forestry sector as part of the conditions for the continuation of the provision of their assistance.

Senator HUTCHINS—How will you measure that?

Mr Oliver—I do not know, that off the top of my head, I can give you an answer to that, but I could certainly try to find out for you whether there are any particular benchmarks or guidelines laid down by the World Bank in its structural adjustment—

Senator HUTCHINS—What I am getting at is whether there is anything that says that this many hectares cannot be ripped up this year or this type of tree cannot be forested. Could you find out for me?

Mr Oliver—We can certainly do that for you. I think that would be available.

Senator HUTCHINS—Mr Oliver, I think it was you who mentioned that rural grants were being replaced by district grants. I think they were the terms you used. If I am wrong, I apologise. I am just trying to find out the definition of rural to district it. As some point I think you were suggesting that the opportunity for the misuse of these grants by local MPs is lessened by going from rural to district. I am just wondering what you meant by that.

Mr Oliver—I think the main concern which we and the international financial institutions had about the Rural Development Fund was the fact that very large amounts of funds were provided by government to members of parliament for a variety of uses, and they were large and not very transparent and the accountability of those funds was lacking. As to the details of the requirements of the IMF and the World Bank to bring the Rural Development Funds under closer scrutiny, I think we can get you the details of what is required, the way in which those funds are going to be better used and the reforms which the Prime Minister of PNG has introduced that have, if you like, satisfied the IMF and the World Bank that those new procedures will meet those requirements.

Senator HUTCHINS—Maybe I am wrong, but I thought you were suggesting that the MPs do not now have that largesse to distribute, that it is a decision made by the central government. Is that the situation now?

Mr Oliver—I think it is fair to say that the disbursement of the money is going to have to be accounted for by the individual MP who is in receipt of it.

Senator HUTCHINS—So the individual MP will still have X amount of dollars to distribute as he or she sees fit?

Mr Oliver—I think they would have to produce a program which they will ask to be funded under the Rural Development Fund, and the program that the MP submits will be subject to some form of scrutiny. If the program looks credible, then the funds will be disbursed. I do not think the funds are provided up-front—that is, someone says, ‘Here’s a million kina; we’d like you to account for that at the end of the year.’ I think the process has been designed so that

each MP has to make very clear what the funds are going to be used for and to satisfy the government in some way that there is a real program out there and a real purpose for these funds to be put to.

Senator HUTCHINS—Would I be right in assuming that these would be applications for things like hospitals, schools and roads?

Mr Oliver—Yes—a whole range of things, from community projects to small infrastructure projects. The range is very broad indeed. I think the funds were originally introduced to try to ensure that money did reach lower levels of the community. The accountability provisions have been very considerably tightened up at the insistence of the IMF and the World Bank. As to the details, I am sure we can get those for you.

Senator HUTCHINS—You were speaking earlier about the need for reforms in health and education. I know you said that those areas are now to have more scrutiny, but are you concerned that, say, something like health or education may not be adequately addressed on some sort of national basis because there still is this ability to individualise districts?

Mr Oliver—Michael Dillon might want to elaborate on both those programs. Over the years, the health services in PNG have received very large amounts of government money, sometimes with effect, sometimes with less effect, the same too with the education system. A point has now been reached where the integrity of the development of both those sectors needs to be looked at. Prime Minister Morauta's government is concerned that on both counts in the past both those sectors have not performed as well as they should have and very radical restructuring and refunding is very necessary indeed. Again, the reasons for the decline in education and health services in PNG are something that we could go into more deeply but I am not sure that I am a great expert on them. They are elements which, from an Australian government point of view, we are very concerned to support through the aid program because they are fundamentally essential to PNG's economic and long-term recovery. Michael, would there be some point in elaborating on what we do in both those sectors?

Mr Dillon—Once I start, I might not finish. It might be best if we just continue on.

Mr PRICE—Can I take up where Senator Hutchins left off. As I understand it, what you are saying to the committee is that the same level of corruption is going to occur but it is going to be more transparent. In other words, the discrimination that occurs within electorates will continue but we will just be able to see it more openly. Am I understanding you correctly?

Mr Oliver—I would have to say that it was your choice of words rather than mine.

Mr PRICE—You choose your words; that is fair enough.

Mr Oliver—It would be difficult for me to elaborate in great detail as to why we think the sectors have been under performing.

Mr PRICE—No, I am not talking about sectors. We have all seen the documentary recently by Sean Dorney which showed that one side of the river gets nothing and the other side does,

all because of the basis of support. What is to stop an MP developing a plan for his electorate which mirrors the existing prejudices?

Mr Oliver—What is to stop it? Probably PNG's political culture is one which will take a very long time to change and I would not want to say that these reforms will bring about an immediate shift in culture in the next two to five years. I suppose a start has to be made somewhere and a process of greater accountability has to be introduced. We would like to think that the reform programs which Morauta has put in place will see a greater measure of accountability and transparency gradually introduced. I do not want to suggest that the kinds of concerns which you have expressed will vanish overnight. I do not suppose that they will. Overall, I would hope to see a gradual improvement which will bring about a fairer and more broad ranging distribution of resources to communities that need them, but there will be occasions where resources are not allocated in the optimum way. I am sure that will continue.

CHAIR—As I understand it, you would really have to put a submission to the government that you wanted to build a school, a bridge or whatever it might be in an area. The days of 50 dozen cartons of SP lager would be gone, would they not?

Mr Oliver—I would hope so.

CHAIR—In that respect, if you have to get a clearance from the government, at least that would be transparent. There would not be too many activities hidden under the table.

Mr Oliver—One would hope so.

Mr Dillon—Mr Chairman, I think you are right: there are tighter guidelines now, and they are a direct result of the bank coming along and raising this as an issue. But, to take John's guarded optimism a bit further, I think there are some developments happening now that will affect the way MPs do operate within the system. So you have the tighter guidelines for the rural development funds that are already in place. You have the political integrity bill just gone through the parliament that will, in a sense, stop MPs changing parties as often as they did. That will start to bring more of a long-term vision. Then there is planned legislation to move away from first past the post electoral systems to some sort of preferential system. When you take all things together, you will see that the incentives that operate on MPs will begin to change and that it will not be possible just, in a sense, to divert your rural development funds to a small proportion of wantoks and get elected. MPs are going to have to do a much better job in representing their electorates if they want to be re-elected.

Mr PRICE—The integrity bill still requires another passage through parliament, does it not? It is not completed. Where are the changes to the voting act?

Mr Dillon—My understanding is that the legislation is under development. It has not been introduced.

Mr Hunt—Yes.

Mr PRICE—I do not want to denigrate in any way the reform proposals of the government. How do you see the ordinary citizens of Papua New Guinea being affected by these changes?

Mr Oliver—I guess the short answer is that we will see at the next election. I suppose as a general observation the reforms that have so far been introduced have been introduced specifically to meet the requirements of our own government maybe and also those of the IMF and the World Bank. It is probably fair to say that those reforms have not yet directly impacted on the average PNG citizen.

Mr PRICE—When do you see there will be an impact?

Mr Oliver—I think one of the difficulties which the present government faces is that your initial efforts to reform are based on correcting difficulties that you have inherited, and that necessarily takes quite a long while. I think the average citizen of PNG would hope to see the benefits of reform coming through in terms of a more stable economy, a more prosperous economy, also the efforts made by the PNG government to ensure that services provided by government do get out and meet the needs of local communities, improvements in law and order—

Mr PRICE—Okay, you have identified yourself as an optimist, which is fair enough. I am a bit of an optimist. In what time period do you see those sorts of benefits being demonstrable to ordinary citizens of the country?

Mr Oliver—I think Prime Minister Morauta would hope that some of those benefits would be evident to the electorate by the time he gets to the next election.

Mr PRICE—Before the next election, I know, but that may be too short a time period.

Mr Oliver—Yes, I suppose all time frames are too short. But I think that, as the IMF and World Bank programs are introduced and if the reform program remains on track, further disbursements of their assistance will be delivered. That in itself will be evidence of reform. To what extent there is a reform benefit directly to the average citizen is much harder to tell. I do not think the way of life for 80 per cent of the population is going to change dramatically in the next two to three years.

Mr PRICE—If I could just return to the peace process that you touched on. Am I still correct in saying that not one extra aid dollar has been spent on Bougainville but reallocated out of what would have otherwise gone to all 19 provinces?

Mr Oliver—Again, I will ask Mike to say a few words in a moment. But, in answer to Mr Nugent's earlier question, I suppose I did omit to say that part of the encouraging developments that we see in Bougainville relate to the fact that most people really do not want to go back to war. They do want to see their lives returned to normal and do want to see economic activity in the province built up. Part of what we try to do there is to allocate a substantial volume of development assistance into Bougainville precisely to build up the economy—

Mr PRICE—I note the cost of the other provinces. There is actually no new aid money going to a peace process per se; it has all been reallocated out of the existing aid budget.

Mr Oliver—It comes from the existing aid program but it is, if you like, not at the expense of other provinces, because we have been providing assistance to Bougainville for a number of years. A couple of years ago the minister committed Australia to provide \$100 million to Bougainville over five years.

Mr PRICE—Yes, but that was within the country aid budget; that is my point. Would you agree with that?

Mr Oliver—Yes.

Mr Dillon—Mr Price, I seem to recall you have raised this issue before, and you will get the same answer.

Mr PRICE—I have a flat forehead, I apologise.

Mr Dillon—You will get the same answer that I provided before: Bougainville is part of PNG. We have a Development Cooperation Treaty with PNG, and the aid to Bougainville comes from within the allocation made under that Development Cooperation Treaty. I would make a couple of points though: the aid program to Bougainville is much more flexible than in other provinces. We have taken account and cognisance of the fact that there has been conflict for a long time and that the infrastructure in Bougainville has virtually disappeared. We do things under the aid program in Bougainville that we would not do anywhere else in PNG or anywhere else in the world. In particular, we have very flexible arrangements on supporting the peace process.

Mr PRICE—Good, thanks. On the peace process, you mentioned that you felt that there had been one step forward in the recent negotiations, yet I note a deadline of 15 September has been established. You also mentioned that the Bougainville commitment of the Peace Monitoring Group is coming down. Do we actually have an exit strategy there or could they be there for the next five years?

Mr Oliver—Let me deal with the last part first, if I may. The Peace Monitoring Group used to be a force of around 300, made up of largely Australians and then New Zealanders, Fijians and Vanuatians. It was reduced earlier this year by 50 down to about 250. Currently, it is being reduced down to about 200 and, over the next few months, we would hope to see it reduced further—maybe to around 150, 160 or 170. In doing so, we are very concerned not to allow the reductions in the Peace Monitoring Group to impact negatively on the peace process. Our impressions to date is that they do not and that reductions have so far not impacted in any adverse way that we can see on the peace process. But, equally, we appreciate that when you take such a large force and reduce it, it probably has some psychological impact on the local population. We would want to avoid that. So I guess you can say that we will reduce the PMG as circumstances and the peace process allow and do what we can to make sure that it does not get upset.

In terms of a deadline, I think the discussions in Rabaul last week have just about ensured that that deadline is now, to all intents and purposes, no longer a deadline in the sense that something has to happen before then. I think the meetings last week have enabled all the parties to accept that further work is to be done, and they will get on and do that. So I do not think we are expecting anything untoward on the 15th. I might ask my colleague Bruce Hunt if he wants to elaborate a bit on that. I was away from Australia last week and I am not sure that I have the details of what happened in Rabaul.

Mr Hunt—I would simply echo Mr Oliver's comments. I think they went into the Rabaul meeting and in the weeks beforehand aware there had been a deadline of 15 September hanging over them, and that was present during their talks in Rabaul. I think the results from Rabaul have somewhat moved that deadline off the agenda. Even before then there were indications coming out of Bougainville about the deadline. They were saying, 'What does it mean? Do we actually want a signed document that is part of a legislative package? What was the proposal that there be a deadline of 15 September? What was it anticipating?' I think the Rabaul talks and the conclusions at Rabaul have met their need for progress to continue to be made in the negotiations and discussions. The sense we have is that the Bougainvilleans are satisfied that sufficient progress has been made to remove whatever sword or threat hung over the prospects of negotiations by a date of 15 September.

Mr PRICE—Mr Sewell, could I ask whether this loan has its origins in statements by Treasurer Costello that he would help the government provide assistance to the government—

Mr Sewell—And also the Prime Minister visited Papua New Guinea in early October last year and prior to that in September had met with Prime Minister Morauta in Sydney. So the process of negotiations was quite protracted between in particular the IMF and World Bank and the PNG authorities.

Mr PRICE—And the swap facility, even though it is at our RBA borrowing weight plus a margin, would be cheaper than Papua New Guinea could otherwise negotiate on its own?

Mr Sewell—Yes, it would be.

Mr PRICE—A number of the questions touched on privatisation. I note that one of the banks is to be sold and that NAB has left the country. Is Treasury or Foreign Affairs doing anything amongst Australian potential investors to acquaint them with the opportunities, bearing in mind it will be a commercial decision by any individual organisation?

Mr Sewell—From our perspective in Treasury, we understand that the World Bank is active in that sort of process in searching out possible borrowers.

Mr PRICE—To be borrowers?

Mr Sewell—Sorry, not borrowers, purchasers. Further to that, I would add that there are two processes whereby the privatisation commission is being assisted, with which there is an involvement from Australia. The first of those is the Office of Asset Sales—

Mr PRICE—No, I understand all that. What I am asking though is: if it is not Treasury, which department in Australia, given our close links and history with PNG, is talking to potential Australian companies about the opportunity? I mean, presumably Telstra might be a bidder. Most of the banks are already there, so perhaps we are not likely to get one of the Australian banks interested.

Mr Oliver—I think the short answer may well be that the process of privatisation is a matter really for the PNG government, and the way in which it makes known to potential purchasers the existence of assets which it wishes to sell is something which will be conducted and undertaken by the PNG government with assistance from various areas of government. But I do not think we as a government are intending to, if you like—

Mr PRICE—Bring it to the attention of anyone.

Mr Oliver—I do not think so. I am not aware of that. I could be wrong, but that is my understanding.

CHAIR—I know we are running over time, but one of the aspects of this particular inquiry we have to address is whether or not this loan is in the Australian public interest. In fact, that is stated in the national interest statement on page one. Could we just establish by what means and including what factors is the definition of ‘national interest’ arrived at? How is our national interest served with this particular loan? If the loan had not come about, would our national interest have been affected? Are there any other ways Australia’s national interest as it involves PNG could be served? If you like to take it on notice.

Mr Oliver—I may have to take some parts of it on notice. I think Australia’s national interest first and foremost in PNG would be to have a stable, prosperous and democratic PNG. It is a near neighbour; it is a very important trading partner; and its stability and long-term prosperity is very much in Australia’s interests. This particular loan I guess served the Australian national interest in trying to underpin the financial stability of Papua New Guinea at a time when its own financial situation was in particular difficulty. Those difficulties were recognised by the International Monetary Fund and the World Bank, and their support for a program of recovery—prepared by the PNG government—was given. I think we found the support of the international financial institutions to be very reassuring and very encouraging.

If the loan had not been provided, I think the PNG government would have faced very serious difficulties in meeting a whole range of financial commitments and a whole range of difficulties in stabilising its economy. I think we felt that Australia has a particular responsibility to do whatever we can to make sure that this important near neighbour is given every assistance in pushing through very much needed and very much welcomed reforms. If what we are doing does contribute to that process, and we believe it will, both PNG and ourselves will be much better off. What happens at the end of the day, I guess we will have to see. The conditionality provisions that were applied to IMF and World Bank assistance will be monitored very closely, and we will see how we go. It was very much in our interest to respond very promptly to the appeals of Prime Minister Morauta for assistance, and I believe that the speed with which we moved to support his reforms was appreciated and, indeed, was in many ways instrumental in encouraging others to do the same. But as to the actual detail of your question, Mr Chairman, maybe I should take some of that on notice.

CHAIR—If you would, thanks very much indeed. Just before I close this section, I understand Treasury has a copy of the submission from Buoyant Economies who are appearing a bit later today. Could the committee be provided with comments in writing on the various matters raised in their submission? In line with the tight time frame that we have, there is some urgency in it, unfortunately.

Mr Sewell—Certainly.

CHAIR—Thank you very much indeed. Thank you all for your attendance here today. Before you leave, if you could give *Hansard* the opportunity to check any matters with you. The transcript of your evidence will be sent to you, and you will be able to correct errors of grammar or fact. If you have been asked or have undertaken to provide that additional material, we would really stress that it needs to be received as soon as possible. Thank you.

[11.18 a.m.]

LOHIA, His Excellency Mr Renagi R., High Commissioner, Government of Papua New Guinea

CHAIR—On behalf of the subcommittee, I welcome His Excellency the High Commissioner for Papua New Guinea. Your Excellency, for your information; the subcommittee prefers that all evidence be given in public, but should you at any stage wish to give evidence in private, you may do so and consideration will be given to your request. Although the subcommittee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the House themselves. Would you like to make a short opening statement before we proceed to questions from the subcommittee members.

Mr Lohia—Mr Chairman and members of the committee, firstly let me thank you for giving me this opportunity to appear before this important committee and to address the Foreign Affairs Subcommittee this morning. I understand that the subcommittee is specifically inquiring into the recent Australian government loan to Papua New Guinea as required under the International Monetary Agreements Act. However, it may be useful if I take a couple of minutes, with your permission, Mr Chairman, to brief the subcommittee on the circumstances leading to the loan agreement and on the current political and economic landscape in Papua New Guinea.

The current government of Prime Minister Sir Mekere Morauta came to power in July last year. Sir Mekere's government inherited an economy that was experiencing severe difficulties. It was an economy that had been exposed to the full brunt of the Asian crisis; it was an economy that had experienced a number of natural disasters; and it was an economy that had suffered from poor governance. The new government set itself a number of objectives aimed at addressing the economic slide with which it was faced. Those objectives were: first, to stabilise the exchange rate and the financial system; second, to restore fiscal responsibility; third, to rebuild the integrity of state institutions and to ensure more orderly government processes and decision making; fourth, to re-establish sensible and productive relations with the rest of the world; and, finally, to pursue a lasting solution to the conflict on Bougainville.

The government has made great steps in the last year to address all of these issues: the budget has been turned around from a position of massive deficit; the exchange rate has stabilised; the Central Bank's independence has been legislated and its hand has been strengthened with respect to financial sector regulation; government spending has been targeted at priority areas and institutional strengthening measures are continuing; and the government has made a significant commitment to resolving the Bougainville issue. However, we have not accomplished all this alone. As you would know, Mr Chairman, the government took immediate steps last year to re-engage the International Monetary Fund and the World Bank. This culminated in the provision of a \$US115 million standby arrangement from the IMF and a \$US90 million structural adjustment loan from the World Bank. The Japanese Bank for International Cooperation also provided a \$US50 million loan in support of the World Bank structural adjustment program.

And, of course, the Australian government lent \$US80 million in support of the IMF program. The money from the Australian loan was used to retire domestic debt held by Papua New Guinea's Central Bank. This is in accordance with the government's aim of reducing debt held by the Central Bank. It also provides considerable debt servicing relief for the government as domestic interest rates in Papua New Guinea have only just begun falling from levels of around 20 per cent. All in all, the effect of the Australian government loan is to significantly strengthen the government's financing position, which will boost market confidence, help stabilise foreign exchange markets and yield benefits for the efficient conduct of monetary and fiscal policies.

In terms of Australia's foreign policy, trade and economic interests, the government of Papua New Guinea concurs with the sentiments expressed by the Treasurer in the national interest statement. Papua New Guinea is Australia's nearest neighbour geographically, our two countries are very close friends politically, and we both benefit from significant trade flows. Many Papua New Guineans live, work and study in Australia, just as many Australians do in Papua New Guinea. The benefits of Australia's assistance and that of our other development partners are already beginning to show some significant signs. Inflation is being brought under control, interest rates are beginning to ease and fiscal policy control is being re-exerted. Business conditions are improving, the financial sector is strengthening, and confidence is returning. The government has undertaken a huge program of structural reforms in consultation with the World Bank to ensure that this recovery is successful and sustained.

Mr Chairman, on the eve of my country's 25th anniversary of independence, we are making solid progress on the road to recovery. Papua New Guinea is the largest country in the South Pacific after Australia. It is important that Papua New Guinea continue to set an example as a stable and well functioning democracy, especially given recent events in Fiji and the Solomon Islands. With the help of Australia and our other development partners, I believe that this goal is firmly within our grasp. Mr Chairman, I am happy to take any questions that you or the subcommittee members may have although, if they are technical in nature, I may have to take them on notice and my colleagues in Port Moresby will be able to help me answer those queries. I have a copy of the statement that I would like to submit to the committee. Thank you very much.

CHAIR—Your Excellency, thank you very much for a most comprehensive statement. May I ask you an unfair question: does the government of Papua New Guinea have a crystal ball in which they can make any estimates as to when full economic health may be achieved? Is there a timeline that has been set whereby you can say, 'Under all these programs and initiatives we have got, by year such and year we should be in pretty good shape'?

Mr Lohia—Taking into account that the life of this government is for two years, I have a lot of confidence that the goals set by this government will be met. The country is hopeful that the current government or the mentality of doing things is returned to the next parliament, and I believe the programs set now will continue for another five to 10 years to establish the process of growing from now on.

Senator BOURNE—I have just one question. Your Excellency, does the PNG government have a view of whether they consider the structural adjustment program to be a fair and reasonable one? I understand that you have picked bits and pieces from what the IMF has

suggested. Do you have a view about whether you think it is achievable and whether you think it is fair to ask PNG to achieve what it is being asked to achieve in the time that it has been given?

Mr Lohia—Papua New Guinea, like Australia, is an independent country: it has its own assessment of the health of the nation and the people. This government's responsible thinking is that what they have agreed with the World Bank and IMF is achievable within the time given, another two years. Beyond that, if Morauta and his partners are retained, we have a lot of confidence that the goals they have set for themselves will be achievable. Of course, that is within a framework of support and confidence from the friends of Papua New Guinea, including Australia, New Zealand and the international community. There is no island in this world; we are all interdependent. Much of our confidence will depend on how the world evaluates our health from time to time.

Mr NUGENT—I think you were present during part of the evidence being given by the previous witnesses. Clearly the view of the government of this country is that it is encouraged by some of the reforms and actions that are currently being put in place by your government. In other words, the official view from Australia is that your government is doing all the right sorts of things, and clearly a lot of the credit for that can be given to the leadership of your current prime minister. Given the political history of instability and the constant turnover of members of parliament in your parliament at each election—you have a very high percentage of what we call here 'oncers', in other words, people who are elected for one term only—what is your assessment of how your new package is being received by the people of PNG and the likely return of the current government at the next election? In other words, is the program embarked on by the current government likely to be continued beyond the next couple of years? You said yourself, 'if they return'; what is your assessment of that situation?

Mr Lohia—I believe that the people of Papua New Guinea learn fast and we have learnt our lessons. I believe that whatever government comes in, if it has elements of the present government we should be able to continue the program for recovery, especially for the people of Papua New Guinea.

Mr NUGENT—Given that that part of the program quite clearly envisages reductions in expenditure in a number of areas of government expenditure, it is going to be very politically difficult, isn't it—given the history of largess that has largely been undertaken?

Mr Lohia—Going back to the first part of your question about instability: any democracy starts up with a lot of instability because there are a lot of different interests and they are expressed freely. That is what Papua New Guinea is: we have a village which allows people, clans and parties to express themselves, showing on the outside a kind of instability, but within there is a degree of stability and responsibility. I am pleased that, over the whole 25 years, governments have changed, as governments have changed here and everywhere. I am pleased and that is something we will be celebrating in our independence because we have achieved those changes on the floor of parliament, respectful of law and in the interests of Papua New Guineans.

Mr NUGENT—Thank you.

Mr PRICE—Thank you, Your Excellency, for appearing before the committee this morning. Could I ask you about your own views on the peace process in Bougainville? I guess from an Australian perspective, we are always impatient to have the situation resolved. But what is your view on getting a final peace deal stitched together in Bougainville?

Mr Lohia—I believe that for 10 years we have had difficulties and now, towards the end of that 10-year period, the government is beginning to see the light at the end of the tunnel. Hopefully, the problem will be managed in such a way that we can achieve permanent peace within five years.

CHAIR—Your Excellency, thank you very much for your attendance today. I am sure that I speak on behalf of all the committee in wishing you and the folk of Papua New Guinea great celebrations on the occasion of their 25th anniversary. The transcript of your evidence will be sent to you, and you will be able to correct errors of grammar or fact. If you have been asked or have undertaken to provide any additional material, the secretary would be grateful to receive it as soon as we could because we are on a time limit.

[11.37 a.m.]

MACKAY, Mr Christopher Ian, Executive Director, Australia-Papua New Guinea Business Council

CHAIR—On behalf of the subcommittee I welcome Mr Chris Mackay, the Executive Director of the Australia-Papua New Guinea Business Council. The subcommittee prefers that all evidence be given in public, but should you at any stage wish to give evidence in private you may request to do so and consideration would certainly be given to your request. Although the subcommittee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and, therefore, have the same standing as proceedings of the houses of parliament themselves. Mr Mackay, would you like to make a short opening statement before we proceed to questions from the subcommittee?

Mr Mackay—I would just like to begin by saying that I have learnt more from being here than I have from the national interest statement which was circulated. The Australian business community has an interest in the Australia-Papua New Guinea relationship for a number of specific reasons. We welcome the opportunity to be here today to comment and to add to the building of a stronger relationship for the future—hence the interest in the statement concerning Australia's national interest on the occasion of the recent loan to Papua New Guinea. The specific reasons Australian companies are interested in the relationship are commercial and social in nature. Commercially, if there is a good relationship at the government level, companies believe there is less risk in making an investment in Papua New Guinea than elsewhere. There is also a belief that the Australian government will be more active in making representations to the government of Papua New Guinea during difficult times. Examples of this aspect would include non-payment of government debts and market access considerations for instance.

Socially, companies are very alert to the wellbeing of all employees. At the present moment they are especially concerned about Australian citizens employed in Papua New Guinea, because of the current level of law and order. There is a belief that the Australian government will seek to assist in this respect as and when necessary. In most respect the experience of Australian business has been that the Australian government has acted in accordance with the above when dealing with the relationship between Australia and PNG. If there were to be criticism it would be in the detail not the substance. With respect to the statement, Australian business looked to the statement for a clarity of definition which encapsulated the above sentiments so as to reinforce its beliefs. Just as a little digression from what I have prepared, business investment is both a matter of hard-headed figure crunching and also a question of confidence. So when it comes to Australia's national interest, as our government members previously implied, there are broad statements rather than specific detail, and that is what builds confidence and trust.

More clarity would assist greatly in informing Australian boards of directors how they might expect the Australian government to act in a number of different circumstances. In turn, this would lead to decisions, broad though they may be, formulated in the knowledge that should a particular event occur then it could be predicted that the Australian government would act in a particular manner. This does not imply that Australian business expected there to be an exhaustive set of prescriptions. Rather it expected broad guidelines that were

clear signals pointing towards a range of action points that may be expected to occur. With regret, and whilst there are a number of very positive statements made in the statement, it is unclear to the business community as to what the Australian national interest in its relationship with Papua New Guinea actually is. As I said at the outset, there were more statements which would help clarify that and I look forward to the report which I will be able to circulate.

On a positive note, the statement does make it very plain as to why the loan was entered into on prudential grounds and these reasons are fully supported by the Australia Papua New Guinea Business Council. They include the attitude of the Australian government towards a government in PNG it respects and knows is working with the international institutions, the World Bank, IMF and ADB, to create an economy that is transparent and progressive. When such statements are made in parliament, the inclusion of wide and more inclusive undertakings that clearly state the national interest would assist the business community further.

For instance, there is a need for a statement that addresses long-term issues and is not specific to one Papua New Guinea government or another. The present statement raises a myriad of questions such as: what will the attitude of the Australian government be when a different government is present in Papua New Guinea? I will just remind the subcommittee that a great deal of the statement was basically a letter in support of the Morauta government. Well, business goes over many governments, not just one. The benefit to the business community would be a better understanding of long-term intentions and approach to relations, through a perception of vision of the underlying philosophy guarding Australia's national interest. The benefit would be reflected by more stable policies concerning Australian company investment intentions in PNG. If it is in Australia's national interest for there to be a stable and progressive economy in our immediate region, it is probable that the Australian private sector will play an important part in the continuing development of the economy in Papua New Guinea. It follows that Australian boards of directors need to know, unambiguously, what the Australian government's intentions are over a long term.

There is a need for clear understanding of the Australian government's intention from the perspective of protecting Australian citizens. Some members of the Australian business community are not of sufficient size to act independently in the case of an emergency. They are active in Papua New Guinea, either on an investment on the ground basis or through sending managers and technical or sales support service to Papua New Guinea on a regular basis. They can be in the country at any time. For instance, a major volcanic eruption would tax the capacity of many small enterprises. A major social disruption most certainly would. It would assist the business sector decision making process should there be a better understanding about such matters.

There is a need to understand Australian government intentions should regional stability be threatened because of economic management problems in Papua New Guinea. Australian business is the biggest employer of Papua New Guineans outside of the PNG government, and this complements the Australian government effort in the education sector. It is through this combination that PNG will build an economic capacity that translates into stability in our region. Therefore, from our perspective it is of strong benefit to continue with a close relationship. Australian business is conscious of the role Australia has played over the past 25 years in the continuing economic stability of Papua New Guinea. The national interest statement implies that Australia will assist when the Papua New Guinea government is

conforming to an unstated set of rules. Australian business needs to understand the full implications inherent in the statement. Australian companies are very alert to the conduct of public affairs in Papua New Guinea over recent years for a number of reasons, including the fact that existing investments have a historical perspective to them. They have continued to be supportive. It is true, however, that business conditions are such that it is unlikely that any new major investment will occur outside of the minerals and petroleum sectors. This implies that no major Australian company is likely to invest in, for instance, a manufacturing plant in Papua New Guinea in the short term because of existing conditions. It also implies that except for certain consumer items there will be a continuation of Australian companies exiting Papua New Guinea investments but continuing to service the market from a trading position.

CHAIR—Thank you very much indeed, Mr Mackay. I am not quite sure whether we are overly enthusiastic or whether we should be quite pessimistic about it. Loosely translated, what you are saying is that there is not much interest by the majority of Australian companies in going in for any sort of investment in Papua New Guinea at the moment.

Mr Mackay—Not at the present time. There are certainly a great number of resources—physical, renewable and sustainable. There is a wealth of talent in Papua New Guinea amongst Papua New Guineans. A relationship of a commercial nature between Australian companies and Papua New Guineans would be highly profitable and I am sure that, in future years, this will occur.

CHAIR—How good is the Australian government information that you get as Australian businesses? Do Austrade keep you informed of what is likely to be there? Do you rely on any government intelligence for the economic conditions? Or are you relying principally on your own resources?

Mr Mackay—It is a mixture of Papua New Guinean government sources and Australian government sources. Because of the nature of present circumstances, the Australian business community is highly active in terms of contact in all of those places. We make regular visits to Papua New Guinea as a council and we are involved in constant dialogue. We attend the Ministerial Forum, for instance, and in response to some concerns that were raised in that forum last March and along with my colleague Mr Lohia, the High Commissioner, the council, has taken a lead. We thought up a working group which is very actively engaged on furthering prospects of increased economic activity between us.

Mr NUGENT—As I understand it what your statement effectively said was that Australian business was happy to go to Papua New Guinea if the government gave it a pretty guaranteed set of very specific insurance undertakings about what it would do if certain things eventuated. I would have thought that would be very difficult for any government to do—not just this government but Australian governments on an ongoing basis—given the wide range of things that might happen. You quoted, for example, natural disasters. When the famine was on in PNG a couple of years ago I was up there at the time and I very much remember the Australian helicopters that were active, amongst other things. For example, recently in the Solomons, during the difficulty there, the Australian government acted very much to pull out Australian citizens and so on. Clearly I would have thought that Australian governments—and I make the point that that is governments of all persuasions—have been very supportive of

Australian businesses overseas in emergency situations. In terms of commercial factors, surely you do not expect the government to underwrite commercial activity?

Mr Mackay—I will take the last first because that is easiest. The answer is: not at all.

Mr PRICE—Stop beating your wife.

Mr Mackay—We stop short of wanting to know the name of the ship. With regard to the support that the Australian government has provided over the years, it certainly has been evident. However, the reality is that there have been some difficult circumstances in PNG over the time and, if we were to sit down together, there would be a number of questions such as: why didn't one act to restrain excesses, especially when we have such a high input into the PNG economy through aid and through Australian business presence?

Mr NUGENT—What sorts of excesses are you talking about, bearing in mind that PNG is an independent country?

Mr Mackay—Absolutely, and nobody would dispute that. The sort of thing that has occurred over a number of years has been, for instance, that the tenders board has not operated efficiently, including when there has been Australian aid money involved.

Mr NUGENT—And what would you expect the Australian government to do to fix that?

Mr Mackay—I would expect the Australian government to require that transparent processes were in place.

Mr NUGENT—Isn't that what the government's part of our AusAID program is all about?

Mr Mackay—It is.

Mr NUGENT—So how else would you expect the Australian government to require of the PNG government to make that process more transparent and fairer?

Mr Mackay—That self-answers, because since 1999 that matter has been taken care of.

CHAIR—I have got a bit of vested interest in this because I have a company in my electorate which has been attempting to get payment for a government contract in New Guinea for about eight or nine years. Is that a common occurrence, from your experience?

Mr Mackay—Not eight or nine years. If the PNG government is under stress like it is right at this minute, payment terms do go out as far as 120 days, possibly longer.

Mr NUGENT—Eight or nine years is a bit more than 120 days.

Mr Mackay—That is right. There must be something very specific relating to the case. Other than what I just said, I cannot help you.

Mr PRICE—It is a significant reform process that the PNG government has embarked on. Being optimistic that things go well, would you be able to provide the committee with an estimate, given favourable conditions, about what might be the likely increase in direct investment in PNG from Australian companies?

Mr Mackay—It is very hard to quantify. The statement that has been made to you is there is approximately \$2.3 billion of investment in Papua New Guinea, and it has been linked, as a majority, to mining interests. We talk about \$5 billion, because we count a little differently to ABS. That is an estimate. There is no doubt that there are significant opportunities in Papua New Guinea at the present time for investment. In mining there is Ramu Nickel, to be followed by Frieda River, and there are some other smaller mines. From that perspective, the figures could be significant. If we are talking about the number of opportunities at the present time, we would be talking about very few in number. I could answer it that way. You could come up with a figure of a billion quite easily, but it might be related to \$US800 million in Ramu Nickel, which is the price tag on that particular one. From my experience, there is a great deal of interest in investing in Papua New Guinea and investment will take place. It is a close neighbour, we have a great deal of familiarity with the country and there are opportunities there. However, in terms of total numbers of companies, I could pluck a figure like 100 from the air, and I would not be that far wrong, that would invest if there were an investment environment which was more than fifty-fifty in terms of positives.

Mr NUGENT—How critical is the law and order problem in terms of businesses going into PNG? What is your view or experience, or the view of your members? How many members do you have, by the way?

Mr Mackay—At the present moment we have 63 members. Largely we represent larger corporations which do have some capacity to spend some corporate time. The smaller companies tend to fill a container and make sure that the payments are secure. So they tend not to want or need to join councils of this nature which work in the business environment.

To answer the question, the attitude is that law and order largely can be regarded as a management problem until it impacts on either loss of goods or loss of life. The banks have been experiencing loss of goods, as in money, for some time. It was getting to a point of there being one a week. There has been some loss of life, but not significantly so, and cases of women being abused in some instances. It can happen around the world in any other location, but there is a sense that it is of the highest priority to maintain civil order.

Mr NUGENT—In terms of things that need to be fixed in PNG to get the economy really humming, where would you place that? Is it the most important thing to be fixed? Or is it much lower down the scale?

Mr Mackay—No, it is at a very different point of an economy. I place that imperative at the point where ownership and reliance upon domestic productive effort occurs. There are signs appearing at all levels about production. This translates into a contribution to consolidated revenue. If you do an analysis of the consolidated revenue source in PNG, very little comes from personal domestic productivity. That implies there is a lack of ownership in the consolidated revenue process, which also implies that, without an ownership aspect, there is no factor that puts pressure upon parliamentarians to spend it in specific directions. I often talk

about investment. By that, I mean investment inside Papua New Guinea and related to people taking charge of their own lives, making a contribution to consolidated revenue and then owning their own government.

CHAIR—Thank you very much indeed for being with us today.

[11.59 a.m.]

HARKNESS, Mr Leigh Christopher, Director, Buoyant Economies Pty Ltd

CHAIR—Welcome. For your information, the subcommittee prefers that all evidence be given in public, but should you at any stage wish to give evidence in private you may do so and consideration will be given to your request. Although the subcommittee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the chambers themselves. Would you like to make a short opening statement before we proceed to questions?

Mr Harkness—You received my submission, and in that I stated that the loan was not really in the public interest because really it was a reward to the Reserve Bank—to let the Reserve Bank off the swap that it had got into. The program will not solve PNG's problems. It really will not be able to fund the repayment of that loan unless they fund it out of the aid that we give them. The whole program will damage the fragile economy that Papua New Guinea has and cause misery and despair to the people.

I am not an expert on PNG. What I want to talk about is the current account deficit problem. To understand that, I will give a little bit of my background. In 1980, I went as the economist to the Ministry of Finance in the Kingdom of Tonga. They had a small balance of payments problem and I had to try and solve that problem. Normally, you have an economist in the Treasury who says, 'Oh, it monetary. It is the Reserve Bank's problem,' and the people in the Reserve Bank say, 'Oh, it is caused by the fiscal policy.' But I was responsible for both and I had to sort out what was going on. Eventually, I traced it down to a growth in bank credit. Essentially, a new bank manager had come in and decided to lend a lot of money, and that had run down foreign reserves. So we sent the bank a note telling them: if there is more than six months imports in foreign reserves, you can lend as much as you like, but if it gets below that, start restricting your lending; if you get to three months, hold the lending at that level; if you get to two months, stop lending. The way you test these policies is you put in a shock. We had a shock three months later when Hurricane Isaac hit the kingdom and destroyed all the export industries of the country. The Australian government came to us and said, 'Of course, you will be wanting balance of payment support?' but we were able to say, 'No, we've got things in order,' and we did not have any problems. In fact, the IMF later commended the government for the policy that it had put in. The World Bank even found that, while those policies were in, the kingdom was the fastest growing South Pacific island country. So it did not hinder the growth of the country. It enabled its balance of payments to be stable.

I then joined the Australian Treasury and it occurred to me that maybe there was some relationship between what I found in Tonga and what was happening in Australia.

Overhead transparencies were then shown—

Mr Harkness—Looking at Australia's case, what we found there was that, yes, the current account deficit was exactly equal to the growth of credit and growth of currency. About 94 per cent is bank credit and about six per cent notes and coins. Despite all the wages policy,

privatisation and all the types of economic policies that we have gone through—the type of thing that the IMF says you should do—this relationship has been solid.

Mr PRICE—When is the start and the finish of your cycle?

Mr Harkness—It shows from 1980 to the latest number—the June 2000 number. All the data is from the *Reserve Bank Bulletin* and I am quite happy to leave a copy of that data.

The whole point is that these sorts of problems are not caused by your efficiency or productivity—all the types of policies that the IMF gets people to do in their structural reform programs. It is a monetary problem. It is to do with the way the banking system is run and managed—not any amount of structural adjustment, as we have done. As you can see, we have been through this whole thing and it has had no effect—and it will have no effect in PNG.

By way of comparison, here is one overhead for the Philippines with a similar relationship—the growth of bank credit is the dark line and the current account deficit is the other line. So this is the type of relationship that exists between these variables. The IMF and the World Bank would say that the current account deficit is related to the fiscal deficit. As you can see, we have had current account deficits and the line going down means that we have had current account surpluses. It has had no impact at all on the current account deficit. They are not directly related.

Mr PRICE—Is there an economic theory?

Mr Harkness—Yes. I now want to explain why this is—that is the important part. It is a little technical because it is to do with what happens between the balance sheets of the banking system and how that interacts with the economy. Remember, the IMF do not even recognise that these relationships exist. They will deny that there is any relationship. In fact, they will tell you that those lines are equal. Anyway, all the data is there. I want to explain how this thing works.

Essentially, if you look at the balance sheet of the banking system, not just one bank or the Reserve Bank; let us put these all together and treat them as one unit. On the liability side, you have what we normally know as our deposits. That is a debt of the bank, but it is our asset. There is the foreign debt and equity in the bank. On the other side, there are the foreign reserves, loans and government securities. If there is an increase in exports, you have an increase in foreign reserves. Say there is a \$50 million increase in exports, then your foreign reserves go up and your deposits go up. This is in a situation of fixed exchange rates. I want to start with what happens in the fixed exchange rates so that we understand what happens later on. You can see that that is quite a simple system. If the banks lend money, say, loans of \$100 million, you add loans to one side of \$100 million, and deposits to the other side. And that is how new money is created in the system.

If there is a loan repayment, what happens is that when people repay their loan to the bank, their deposits go down and the loans go down. I have shown here a \$50 million reduction in deposits and lending because loans have been repaid. If lending equals repayments, there is no problem—there is no growth in deposits and there is no growth in loans. If the \$50 million

generated from exports goes into the economy and is spent, eventually it is going to go out in imports. When this money goes out, it causes no problems. The \$50 million came into foreign reserves when it was created and it is there to meet imports when it goes out. We still have \$600 million in foreign reserves there. We have had \$50 million extra spending in the economy from that. When that goes out and comes in on imports, it reduces your foreign reserves. So there is the technical problem that you go through.

It is this growth in credit that causes the current account deficit in Australia and the Philippines, and is also the problem in PNG. There was a time when PNG did have a sound currency—in fact the value of the kina used to be greater than the Australian dollar. If you remember, in the eighties, the IMF told us that we should deregulate our financial systems. They said that we cannot have those quantitative controls any more and that we should liberalise the whole financial system. That allowed the banks to increase their lending without any regard to foreign reserves, and that generated current account deficit problems. They did the same thing in Asia and it created balance of payment problems.

The next thing the IMF said was that, if you have balance of payment problems, you should float the exchange rate. When you float the exchange rate, it means that international receipts and payments have to be equal all the time. So you no longer have this good source of money from growth in foreign reserves. Payments and receipts have to be equal; you cannot increase foreign reserves. So the only source of money you have is from the growth in bank credit. This growth in bank credit needs goods to buy. The way the monetary system works is that, when you earn, you produce something, and it goes into the economy. The money you receive enables you to buy an equivalent amount to what you produced. So while you are buying only what you are earning, you are consuming only what you are producing. If someone is out there printing money, creating cash, they create a capacity in the economy to buy more than is being produced. As Keating used to tell us, ‘We are buying more than we have produced’, and that causes current account deficits.

Mr NUGENT—So you are saying that, if you go back to a fixed exchange rate, you artificially restrict credit?

Mr Harkness—No. Let us understand the problems before we jump to conclusions about the solutions. If we do not understand what is going on, we cannot solve these problems. On the graph here, we saw two sources of money. When you create money from foreign reserves and that sort of thing, you create a current supply of goods. The money that you are creating on this side is giving entitlements to the economy to buy goods and, at the same time, the growth in foreign reserves is really an obligation to supply by the foreigners for that money. When the banks lend money, they are lending you current entitlements now, but the obligation to supply is some time in the future—it is not now. So you have a current account deficit. Do you know what I mean? There is a shortage now.

If we look at the IMF type program—I will put my notes up so you can see—really the IMF are implementing inappropriate policies. They may be good policies, but they are inappropriate and interfere with the economy. They talk about a balanced budget, but we see that that is not really the problem. Privatisation—what has that got to do with this? Forestry, the civil service, the financial sector—are they deregulating? They are not really addressing the problem. Governance, health and education—these are all important issues that are the

responsibility of government, not of the IMF. The PNG government is looking to the IMF for assistance to help with its balance of payment problems, but they are not providing it. In fact, they are giving the wrong advice. They are now interfering with everything that it does, as they come and do to us. They tell us that we should be cutting our health and education expenses and that sort of stuff.

Mr PRICE—Social security.

Mr Harkness—Yes, social security and all those things.

Mr NUGENT—Mr Chairman, I complain about Mr Price leading the witness.

Mr Harkness—Interfering in things that is none of its business. It does not really know what it is doing. The IMF was actually established to bring stability. It was built around a system of fixed exchange rates and the world prospered under that system. Now it is preaching the gospel of economic liberalisation—liberalise everything, make market forces work. Wherever it goes it creates disasters. We have seen what this liberalisation did to America first of all, with the rust belts and all that sort of thing. We have seen what it has done to our own economy; we have destroyed our manufacturing and primary industries. In Europe they have followed their policies. Asia was running along finely until the IMF came along and told them to deregulate and float the exchange rates—and we had a disaster. We do not really want PNG to follow the same sorts of policies.

If we go in and support this sort of program, we are not giving them any sort of help. The policies that bring stability are those, for example, that would link, say, the growth of bank credit to foreign reserves. We used to do things like that in the 1960s—Menzies had a credit squeeze in 1962 because our balance of payments went down. It was a rather ad hoc sort of thing, but other countries like Hong Kong have had a more structured sort of approach to making sure these sorts of things do not happen.

To explain how you could do it, assume we are going to tell the banking system that they can lend, say, \$10 for every dollar of foreign reserves they have. If their foreign reserves go up they can lend more. Let us assume there is a \$50 million increase in exports, as we had before. That does not mean that the banks can lend \$500 million because as soon as that money comes in some starts going out on imports and that will run down foreign reserves. If the banks start lending a bit that will run down foreign reserves, too. As those foreign reserves come down they will automatically choke off the credit. Credit can grow only so long as foreign reserves grow, so you do not have a problem. As I have shown on this slide, you could envisage a system where we had \$550 million and an increase of \$5 million in foreign reserves. Bank lending has increased \$50 million and deposits have gone up \$55 million.

What we are really doing when we go to Papua New Guinea with this loan is described on this slide. We have \$1,600 million in assets and liabilities and what we are doing is adding, say, \$200 million, or kina, or whatever, to their foreign reserves and their foreign debt. This enables their banks to continue to lend and create deposits and run down those foreign reserves. That is all we are doing. We are not solving the problem; all we are doing is allowing the problem to continue. Consequently we have to ask ourselves: what sort of assistance can we provide? This loan just raised foreign debt. PNG will be unable to repay the loan unless we

give it the money from our aid system. The IMF will be there telling them to cut spending, health, education—creating pain for no gain. In fact, when they find out what a terrible mess we have created, will they come back to us, as the Aborigines have done, and say, ‘We want to be compensated for the disaster that you have been a part of in implementing these policies’?

What sort of assistance can we provide? We maybe need to advise them how to manage their financial systems to avoid balance of payments difficulties. This will reduce the debt and stimulate the economy because, if you do this, you will be able to increase your exports that come into the economy and create a self-reliant country. As Mr Nugent said earlier, you will not then be continually having to fork out money to prop them up. This whole system is at fault. It is this sort of policy that is in the national interest of Australia.

Mr PRICE—You are saying that you have to link credit to your level of foreign reserves. How do you do that though? Let us say that Peter Costello was listening to your policies and said, ‘You beauty,’ and wants to implement it tomorrow. What is the mechanics of it? I do not understand how—

Mr Harkness—What you do is that you tell the banks, ‘You are entitled now to hold foreign reserves. What we are going to do is that we will say for every additional US dollar you hold, we will allow you to lend \$10.’

Mr PRICE—So you have just wiped out \$1 billion worth of profit or \$2 billion from the Reserve Bank.

Mr Harkness—Sorry?

Mr PRICE—Well, the Reserve Bank makes between \$1 billion to \$2 billion a year on profit on its currency dealings, does it not? They are not going to like you.

Mr Harkness—It is a funny thing to have the Reserve Bank call it a profit but it is just an accounting thing in the Reserve Bank. What it does—

Mr PRICE—But the key is: will the individual banks be allowed to hold reserves and then their lending policy is dependent on the amount of foreign exchange that they hold?

Mr Harkness—Yes, when their foreign reserves go up, they can increase their lending. Think of it first of all in a fixed exchange rate mechanism. For Australia—

Mr PRICE—I can remember that.

Mr Harkness—In a fixed exchange rate mechanism. If the foreign reserves go up, banks increase their lending. If they lend too much they will run down their foreign reserves and that will stop them lending. So they can never lend you into a balance of payments problem. At the same time that does not really guarantee that you solve all your problems. You would still have balance of payments problems if you had unemployment, or whatever. If you had a high exchange rate which made you uncompetitive in the world market, you could create

unemployment. If unemployment was greater than full employment levels—say, you said full employment was two per cent and unemployment was six per cent—you would also say to the banks, ‘We won’t let you lend \$10 for every \$US1 you hold if there is six per cent unemployment. We have to take one dollar off for every one per cent of unemployment.’ What that does is encourage the banks to drive the exchange rate to a level that will create full employment. So you have the banks driving the exchange rates to a level that creates full employment and at the same time they cannot lend the country into balance of payments problems because they to have foreign reserves before they can lend. They cannot lend you into debt. That is just an example of the type of thing you can do. I do not want to be exhaustive about this. But just be aware of the nature of the problem. You have this IMF essentially telling PNG to implement these policies that relate to how the economy runs, the physical operations of the economy, when really it is a monetary problem. They are not really dealing with that. In fact, the policies that they have advocated have actually created the problem for them.

CHAIR—What advice would you give to the Australian government as to the best way in which we could assist PNG now?

Mr Harkness—I think it is to provide advice of how to get out of this problem. They are never going to get out of this problem until they get those links right and use their bank credit. They use interest rates, or they try to squeeze credit in some sort of way. Rather, what we found in the late 1980s was that we raised interest rates to slow down credit, and we actually made it worse because the growth in credit is the new loans minus the loan repayments. When we raised interest rates, new lending did go down but what happened was that loan repayments went down even further. So the gap actually increased. The money supply increased and created worse problems, so the Reserve Bank said, ‘We need higher interest rates,’ and it just made the problem worse and worse until the whole thing just collapsed.

These are the sorts of disasters that are going on in economics. Remember, economics is not an exact science at this stage. Sometimes I compare it to where medicine was a couple of hundred years ago. For instance, George Washington had a sore throat and went to his doctors and said, ‘Look, I have this sore throat, what can you do about it?’ They said, ‘What we have to do is bleed you.’ So in the course of 24 hours they bled him of five pints of blood, and he died. That is where economics is. All the IMF doctors come into a country and say, ‘This is what you do,’ and then the economies collapse. In fact, Washington’s doctors said, ‘It is just as well that we bled him. He would have died sooner if we had not done this.’ That is what the IMF said in Asia. They said, ‘It is just as well we implemented these great structural programs otherwise the problem would have been much worse.’ In fact, they created the problem.

Mr NUGENT—Mr Harkness, I appreciate your colourful descriptions. Whilst I do not wish to be offensive, do I understand that you would be one of a minority of economists in this country that would have this view?

Mr Harkness—Yes. I was in the Treasury, I worked there and I was told to get out. In 1989 when the economy was just turning out of this crisis, they said, ‘Our policies are working now. You get out. We don’t need to listen to you any more.’ Of course, their policies did not work. They just created the worst recession since the Great Depression. People do not understand these relationships. When I presented them to the Treasury, they said that it is a coincidence

and tried to discredit it. They could not understand how this fitted in with their theories. And of course it does not. I will give you the data. You can trace it and see that these relationships actually exist. You are looking for evidence here. I mean, people can trot out theories. You mentioned a whole lot of problems before with PNG where you said, 'We gave structural adjustment loans before and we are giving them again.' If they continue with these sorts of policies, they will just have the same problems. This is a monetary problem and not something to do with the physical economy.

Mr NUGENT—I am not an economist and I have often subscribed to the view that, if you ask two economists for a view, you get three opinions—but obviously this committee has to make a recommendation. If we are going to overturn the majority, conventional, official view—and clearly Treasury officials who appeared before us this morning are supportive of what the government is proposing in this case—we need some basis on which to do it. You have produced for us this morning a set of numbers which it would certainly take me a lot longer to go through and try to understand it in great detail. I appreciate we can do that afterwards. But I suppose the proof of the pudding is always in the eating: where have your theories worked elsewhere? I was just looking in your statement, which I only saw this morning for the first time, and I thought you said somewhere—correct me if I am wrong—that you had been involved in solving some problems somewhere else using your approach? Can you give us some details of that?

Mr Harkness—I think you must have missed the beginning of my remarks. I did the conventional economics training. I went to university and I learnt it was always a fiscal problem. But I happened to be economist for the Kingdom of Tonga and responsible for both monetary and fiscal policy. Normally if you are at the Treasury you blame the Reserve Bank and the Reserve Bank blames the Treasury. I had to actually reconcile the problem and find out what caused the problem, and I traced it to the bank credit. The growth of bank credit ran down foreign reserves, so we put in place policies that linked bank credit to foreign reserves. The bank was run by Westpac. We said, 'Okay, if there are more than six months imports in foreign reserves, you can lend as much as you like. If it gets down below that, start restricting your lending. If it gets to three months, hold the lending at that level. If you get to two months, stop lending.' We then put a shock in the system. We got Hurricane Isaac to come right through the country. It destroyed all the export industries, and the economy did not have any balance of payments problems. The IMF actually commended the government for those policies and recognised that it was appropriate. The World Bank later did a study of the Pacific and found that while those policies were in place Tonga was the fastest-growing South Pacific island country.

Mr NUGENT—When was this?

Mr Harkness—From 1980 to 1983 I was in the Treasury.

Mr NUGENT—When did the economy in Tonga fall over? I was there in the early 1990s and it was a basket case.

Mr Harkness—It joined the IMF in 1985, established a central bank and abandoned all those types of policies. They took the more liberal approach and got into difficulties.

CHAIR—Thank you very much indeed, Mr Harkness, for your attendance today. The transcript of your evidence will be sent to you and you will be able to correct errors of grammar or fact. If you have any further information that you wish to provide to the secretary, could he have it as soon as possible, because we have got some pretty severe time constraints.

Mr Harkness—I will give you data that supports the graphs.

CHAIR—Thank you very much.

[12.32 p.m.]

LEVANTIS, Dr Theo, Postdoctoral Fellow, National Centre for Development Studies, Australian National University

NELSON, Professor Hank, Australian National University

STANDISH, Dr William Austin, Lecturer in Political Science, Faculty of Arts, Australian National University

MAY, Dr Ronald James, Senior, Fellow, Research School of Pacific and Asian Studies

CHAIR—Welcome. The subcommittee prefers all evidence to be given in public but should you at any stage wish to give evidence in private you may request to do so and consideration will be given to your request. Although the subcommittee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as the proceedings of the houses themselves. Would you like to make a short opening statement before we proceed to questions?

Dr May—I will make a very brief opening statement, and Dr Standish and Dr Levantis will follow that. All of us can take questions. Professor Nelson is the historian, Dr Standish and I are political scientists. I had an earlier incarnation as an economist. Dr Levantis is an economist. Collectively we have about 100 years experience in Papua New Guinea, which is a daunting thought. Papua New Guinea has gone through a period of economic turbulence over recent years, in part due to poor economic management and in part due to a combination of several years of poor export commodity prices, the closure of the Bougainville mine and the cost of the Bougainville conflict and the declining real value in Australian aid to Papua New Guinea. Papua New Guinea has also suffered from a deterioration in the capacity of the state to deliver services, particularly in rural areas, and to maintain law and order.

The effect of these developments has been seen in a number of developments which led to the Sandline affair in 1997, to the formation of the Skate government and a number of the policies that we saw through the Skate government, including dealings with Taiwan shortly before the government changed. These developments brought home to Australians the seriousness of the decline in economic and political performance in Papua New Guinea and the ramifications this had for Australia. The formation of the Morauta government and the policies it has pursued since coming in in July 1999 have gone some way to arresting the downward slide, particularly with respect to economic management. These achievements have recently been endorsed by both the World Bank and the Asian Development Bank. The processes by which Morauta was elected could just as easily see him deposed. Despite attempts at political reform, specifically the Organic Law on the Integrity of Political Parties and Candidates and proposed reforms in the electoral system, there is little evidence of a fundamental change in political behaviour in Papua New Guinea. At best, the Morauta government gives us a breathing space and the possibility of reversing the trend to cronyism and politicisation of the bureaucracy. If the Morauta government is to succeed in its efforts, external assistance is needed to support the process of structural adjustment and political reform. Australia has a significant economic stake in Papua New Guinea in terms of both trade and investment and aid and defence cooperation payments. There is also a sizeable population

of Australian residents in Papua New Guinea. Australia also has an interest in Papua New Guinea maintaining a functioning democratic state capable of managing threats to internal and external security in a region increasingly prone to crisis. A loan which supports Papua New Guinea's efforts to achieve a degree of financial stability and thereby improve its capacity for sound economic, environmental and political management has to be in Australia's interests.

Dr Standish—Mr Oliver spoke of Australia's desire to maintain a stable, democratic and prosperous neighbour, but he gave a number of caveats. In particular, he warned about not underestimating the difficulties of the reform program of the Morauta government or, indeed, any government in Papua New Guinea. He emphasised the need there will be for time to resolve Papua New Guinea's problems and the need for patience and understanding. He particularly emphasised the political culture of Papua New Guinea. What impresses me, as a political scientist who has spent a lot of time living in the rural areas of Papua New Guinea, is this emphasis on political culture. What also impresses me is that economists—especially from the World Bank, from the Australian government and my colleagues at the ANU—all emphasise the political basis of the problems of Papua New Guinea. It could be an extremely prosperous country, but there are fundamental underlying political problems and sets of institutional problems behind the capacities of the Papua New Guinea state to deliver the goods which the Papua New Guinea public expect of any government in Papua New Guinea.

I would argue that the colonial contract with Papua New Guinea was: we can rule you if we provide you with things you need such as public order, public health, education and the chance for economic development. That form of contract has been transferred to the independent government of Papua New Guinea. Any government in Papua New Guinea is constantly on notice to deliver services. These funds will assist Papua New Guinea in its capacity to attempt to continue to provide the services that the public wants, but a large number of constraints are built in within the Papua New Guinea political system and within the institutional structures that they have adopted which have been identified sometimes by economists and sometimes by political scientists. In fact, I mentioned a number of them in a paper which the Parliamentary Library published late last year on the governance of Papua New Guinea.

There are continuing challenges within Papua New Guinea which are political and institutional and relate to the political culture as it has developed with the interaction of democratic institutions and Papua New Guinea society. These ultimately affect international affairs, certainly the economic governance of the country. I would therefore re-emphasise Mr Oliver's caveats about the need not to be over-optimistic but to appreciate that this will assist the government in trying to deliver the services which people so desperately need.

Dr Levantis—I want to focus in my own mind what this argument is all about. I think of two issues that we are trying to cover. The first is, to what extent should the Australian government be supporting Papua New Guinea. I guess that it is more of an issue for you people representing the Australian people to grasp. At the end of the day, the second issue is: is this support that we are proposing, this concessional loan, a beneficial thing for Papua New Guinea? We want to clarify the two issues. On the first issue, as I said, that is your responsibility. However, I might add a couple of things to that. I think Australia was a very poor colonial power, as you mentioned. England was a good colonial power. The English left Fiji in good shape, but Australia left PNG in poor shape. We did not set up a proper road system. We did not even build a road between the two major cities of the country and since

then the people still have not been able to afford to build a road. How can development proceed without a road between the two major centres of the country? In fact, Port Moresby remains isolated from the majority of the population, except by air. That is an example of how Australia was a poor colonial power. In that sense, I believe we have responsibility. That is an issue for you people to grapple.

The thing which I am may qualified to talk about is the second issue: is this a positive thing? There has been a lot of research regarding aid concessional loans. The general consensus is that when you provide aid to a country with a government which manages poorly, it tends to be counterproductive—aid actually makes things worse. On the other side of the story, when the government makes an effort to manage things well, when we have good governance, the reverse is the case—aid acts to multiply the effect of improvements. That brings us to the current situation. As Dr Standish said, what economists like myself are increasingly coming to realise is that the most fundamental thing with regard to economic development is how good the political system is. If you have good governance, you will have a booming economy. That is the general trend world wide. When you have poor governance, it does not matter what economic policies you put in place, things will go backwards. The issue at hand—to ask, ‘Is this a good thing?’—is for me to assess the government, the political situation and whether or not they are doing a good job. At the risk of being offensive, I would like to say that probably 90 per cent of what the previous speaker said was either nonsense or completely misplaced. While I have the opportunity, I want to correct a couple of things.

The first thing is that the IMF has virtually no influence on the current policy framework in Papua New Guinea. Their influence is zero. Policy is heavily influenced by the International Advisory Group, which was set up by the Prime Minister as soon as he took office. The International Advisory Group consists of four eminent professors: one from Australia, Professor Ross Garnaut; a professor from Harvard; a professor from Japan; and a professor from another country. These are world renowned, eminent professors. These people are guiding Prime Minister Morauta. A lot of what comes from Prime Minister Morauta is advice from the IAG. That is the first point. The second point is that there are a lot of good policy people working for the Papua New Guinean government who are perfectly capable of formulating their own good policy without the IMF and World Bank imposing things on them.

What happened with the latest agreement with the IMF and World Bank was that the government came out and formulated a future framework and then went to the IMF and World Bank with this framework and they agreed, more or less. They did not say, ‘You do this or else.’ The government went to them first and said, ‘This is what we have decided we are going to do, regardless of whether we get your help or not. Are you going to help us?’ That is a very important correction to what the previous speaker was saying.

Another point that I must emphasise is that the balance of payment or current account problems of the early 1990s had nothing to do with monetary policy—it was fiscal mismanagement. It was economic mismanagement on the part of the government. What had happened was that we had a mineral boom in the early 1990s and the government was expecting windfall revenues to come in. These windfall revenues were not as high as what they had expected, but they went on a spending spree. There was wasteful expenditure and that ended in a terrible balance of payments crisis in 1994. That is another important thing. Again, it is a governance thing. The standard of governance was the issue here.

To sum up what I wanted to say, this loan—and this is a very important point—should not be thought of as a way to support the balance of payments. That should never be a criterion. The criterion is just like when you go to buy a house or make an investment for yourself. If you have some money that you want to invest, your criterion is: is this going to give me a return? That is exactly the way you should view this. Just keep things very simple. Is this going to reap a positive return for the Papua New Guinean government? The answer to that is: yes, so long as this government stays on track in terms of its governance. In other words, the government will spend it well. If I had been here two years ago and had to answer the same question, I would have said, ‘For God’s sake, no, do not give them the money because the government will spend it badly and in the end they will not be able to afford to pay it back.’ But this government will reap a positive return on the investment.

One final point is what we mentioned here earlier. The next issue is: is there any risk of backsliding? In other words, is there a risk that this government will get thrown out and that we will get another Skate government which will go backwards? That is something we have to think about.

Prof. Nelson—I have one brief comment. I did not realise that Theo was going to bring in historical judgment there about Australia being a poor colonial power. He made the comparison with Fiji. If you make the comparison not with Fiji but with what happened with the British in terms of colonial power in the Solomons and then you look at the infrastructure, which is political, institutional and material in the Solomons, or if you look at West New Guinea and at the same infrastructure there which was produced by the Dutch and the Indonesians, what the Australians did in Papua New Guinea looks pretty well. I would suggest that, if you make those international comparisons, Australia comes out about FAQ. The Fiji comparison is true but the more proximate ones are not.

Mr NUGENT—Professor Levantis, you left us high and dry because you posed a question at the end of your statement. What is the answer to the question?

Dr Levantis—Which question?

Mr NUGENT—You said that it is money well spent if the present government survives; you do not think the present government will backslide while it is there, but the question is, looking at the political factors: will it survive? What is the assessment that it will survive?

Dr Levantis—I think the people next to me are better qualified to answer because it is more of a political question. But I will say this. Firstly, there is a lot of public support for this government because they have done a good job. Secondly, the government is currently putting through parliament, with absolute unanimous approval, political reforms which will dramatically improve things because it will create an environment of a two-party system. PNG will have a political system more like you see in Australia, without people just crossing the floor. I will stop there and I will let these people here take over.

Dr May—Let me just make one point. We saw during 1996-97 the effects of a combination of an economic crisis and poor economic management. We had governments running around and negotiating fairly shonky commercial loans, making approaches to Taiwan and so on. What we need to do is to provide support to a government that has the capacity and the

integrity to pursue a sensible economic policy. There are a number of areas of policy making that need to be addressed. Questions have been raised about some of these already. But I think the purpose of a loan is partly to provide a degree of stability that will at least give further support to a government that most of us believe is more firmly along a path to sensible reforms than we have seen for a while and, perhaps, than we are likely to see further down the track in the future. If it has the breathing space, then its own revenue sources and the AusAID program also will be needed to address a number of deficiencies in administration, in state capacity, in the Papua New Guinea Defence Force and in a number of other things. I do not think any of those are easy but the important thing at the moment is to provide a degree of stability to this government to follow a fairly sensible program of reforms.

CHAIR—Just as a matter of interest—and I am not trying to be half smart—Dr Levantis, when were you working in New Guinea?

Dr Levantis—Sorry, I have misrepresented in what I said. I have worked on Papua New Guinea. I have been there three or four times, but my research is on Papua New Guinea. I was just there last week.

CHAIR—Right. Being there last week, do you get any sense from either government officials or the public in general that much is being achieved by the government?

Dr Levantis—I have spent a lot of time with people from the Ministry of Finance and Treasury. The mood is extremely positive. The bureaucrats are very happy with the way things are working now, where the control is back with the bureaucrats. The control that they should have is back with them, whereas previously there was far too much political manipulation from the top as to the directions the bureaucrats should be taking, from Prime Minister Skate. He had his principal adviser who virtually ran the whole show and wrote the budget in his hotel room one night—which is a true story. So the bureaucracy is working properly now and the mood is extremely positive. That is what I felt when I was there.

CHAIR—You have probably heard this morning the issue of privatisation has been raised. Peter Nugent specifically raised Air Niugini. What sort of feedback did you get up there as to how the privatisation program is going?

Dr Levantis—That is actually why I was there. I am working on the privatisation story.

Mr NUGENT—I bought shares in Telstra, two! You might find someone to buy shares in Air Niugini.

Dr Levantis—I am suffering too; I bought those shares. Privatisation can be done very badly if it is done wrongly. The IAG, the International Advisory Group, are very good people, and they are advising the government properly. The role that I was given was to look community services obligations as a priority, before any privatisation takes place. The government are very wary of community service obligations going forward rather than backwards. They will not be embarking on privatisation unless an achievement from privatisation is improvements in community services. So that is an extremely important issue.

They are not just going out trying to raise funds. That is not the objective of the privatisation program. The objective is to improve things as a matter of reform.

I spoke to the chief executive officer of Air Niugini. In the last six months, Air Niugini have turned around quite substantially. There is a problem there with price regulation. The prices of these state owned enterprises are strictly controlled but, due to depreciation and higher fuel costs, and so on, costs have come up. This is one of the main reasons why a lot of them have become loss making in the last two years. Air Niugini have turned around—they have rationalised, they have improved their efficiency and they have cut down on a couple of routes—but there are a lot of third level airlines, which have taken up the slack. So services have not declined at all as a result of this rationalisation, and Air Niugini are probably going to be the first going for privatisation. I do not see that as a negative thing, because it is being done properly. The government is not going to settle Air Niugini unless it is reassured that the services are provided. So that is likely to happen over the next six months.

CHAIR—Is there any indication of what might be just beyond that? What is the next cab off the rank?

Dr Levantis—Probably PNG Banking Corporation. PNGBC was really the Commonwealth Bank of Australia. That is the next cab off the rank. That will be in the short term, but nothing will happen until this services issue is addressed.

Mr NUGENT—They have just fired all the directors.

Dr Levantis—I do not know whether they have fired them.

Mr NUGENT—They have all gone.

Dr Levantis—The Bank of Papua New Guinea took over the responsibility.

Mr NUGENT—Collectively, you make a very powerful case for the loan to continue in the short term. You are all saying that this particular regime is doing the right thing, that they are getting professional, expert advice and that there is a sense of some confidence within the bureaucracy that they are starting to move in the right direction, and so on. But you also made the point earlier that we are talking about a cultural difference—there compared with here. I find it very difficult sometimes to get my constituents to be supportive of some of the things this government does in the name of good governance and good economic management. I am not an expert on PNG—I have been there twice; once was very brief—but I have been up in the highlands, I have met a few people there and it seems to me that you are talking about a population at large that is not—I think it is fair to say—a particularly sophisticated and highly educated population.

Whilst there may be some enthusiasm for what is going on amongst the educated, the elite or the governing classes, some pain will be associated with the cutting back of government expenditure that is part of the package they have adopted. I worry about the culture that has been there—the cronyism, the populism and all the rest of it. It seems to me that a lot of the political leaders have got there because they have offered nirvana, and then they have not been

able to deliver it, because it was never realistic. If this government reforms, what will happen if somebody comes along with a populist approach? However irrational and unrealistic that approach might be in our eyes, they might be potentially electable. I am not asking an economic question; I am asking much more of a political or historical question.

Dr May—Let me have the first go at that. I think that is a point quite well taken. If there is a basis for hope in the present situation, I think what is needed in the longer term is a large-scale change in the political culture—and that is not achieved anywhere readily. But I think we have seen over recent years not only on the negative side a great deal of cynicism towards politicians but on the positive side a great feeling that a lot of politicians are not performing well, a great demand for greater accountability and a great reaction against what is perceived as corruption. I think a lot of us felt that in 1997 with the election we would see a bunch of reformist politicians coming in and that maybe we would have a watershed. That did not eventuate. But, nonetheless, I think the groundswell of public opinion against corruption and against perks by politicians is there. It is partly being expressed through the growth of new NGOs, some of which have some local clout. I think that is a positive sign. It does not ensure that the basic ingrained habits of political behaviour will change, but one of the bases for being optimistic is that feeling. The question came up earlier this morning: will these reforms simply make corruption more transparent? The answer has to be yes. The hope we have to derive from that is, once corruption is more transparent, more people will get pissed off about it, more people will put pressure on politicians and eventually politicians will be forced to change their behaviour.

Prof. Nelson—One of the constraints on any politician gathering together a populist cause and bringing together several electorates to support that one cause is simply that nearly all electorates vote separately on local issues. It is extremely difficult for a populist leader to arise and therefore swoop an election. A populist leader is more likely to operate at the level of the house not at the level of the electorate in that way. I am not denying that there are national issues but the national issues have been subordinate to local issues.

CHAIR—Even if you can achieve it in a small sense—even if you get half a dozen communities to decide that their number one priority is a school or a hospital—you have come a hell of a long way.

Prof. Nelson—Yes.

Dr Standish—I wish to expand on these issues. I think a healthy dose of cynicism is required. The Integrity of Political Parties and Candidates Bill is intended to lock candidates into particular political parties and particular political programs so that an Independent—and 39 of the 109 members of this current parliament were Independents when they were elected—would not be able to vote in the vote for the Prime Minister, which is the crucial vote for Papua New Guinea. They would not be able to vote for a motion of no confidence, which is the second most crucial vote. The third, which you will understand well, is they cannot vote on the budget. The ultimate power of parliament is to reject the budget.

Mr NUGENT—It should apply to all minority parties.

Senator BOURNE—Thank you very much.

Dr Standish—This provision would involve what Sir Paul Hasluck used to call the ultimate self-denial ordinance on behalf of parliamentarians. So, if the parliament does vote for this constitutional change in the second round of voting in about six weeks or a month or so, they will be denying themselves enormous power. I suggest there has to be a question mark as to whether that vote will go through. Secondly, there is what it would do to political behaviour down the track.

The other part of the political reform package is for a preferential voting system. A couple of case studies are cited on this, going back to when there was an optional preferential system in the colonial period in the houses of assembly—it lasted up until 1972. The aim is that a candidate will not garner votes just within what is called his base vote—that is, village, tribe, clan—but will be required to go beyond that safe area and seek second preferences from somewhere else. Therefore, people are forced to behave in a much more collaborative way, and they would build wider coalitions of support across their whole electorate, and the nature of politics would move away from the winner takes all, desperate, phrenetic campaigning with money—and guns, as has been documented in recent elections. This intense localism in turn leads to the localism of members of parliament trying to go for the main chance for themselves and their electorate in the national parliament, and not thinking about national issues. Ultimately there will be a shift in political thinking and people will think more widely and on a wider scale.

There are enormous problems to do with the capacity of the electoral administrators to run such an election. The maximum number of candidates in any seat has been 61—40 is frequent. I looked at an election in 1972, in which there were about 13 or 14 candidates. It got to 11 counts—eliminating the lowest voted candidate each time. As we moved up the line to the 11th count and came to the last two men standing, there was a change in the leadership. The candidate who had campaigned widely got himself elected. He still got only about 11 per cent of the vote. He did not, in fact, have a wide range of support. I watched his political behaviour over the next five years: he was howled down at public meetings, he was given no respect, he was not treated as a national leader or as a representative of that electorate as a whole. Nor did he necessarily behave in that way, although he did work for the province as a whole and subsequently stood in a wider provincial electorate.

So I am sceptical that this culture change will come with that change. My concern is that the kinds of factors that have led to enormous political instability, which has in turn led to musical chairs in departmental heads, will continue. The World Bank pointed out that 85 per cent of departmental heads had changed in the last couple of years; in fact, I think it is higher than that. This kind of instability that removes the possibility of policy continuity is likely to continue. There is no panacea; there is no quick fix. Papua New Guineans are as keen as people in most countries for a quick fix, and a lot is being staked on these constitutional and electoral changes. I do not think we should expect too much of them too soon.

Senator BOURNE—You mentioned that something like 39 out of 109 would not have a vote in a no-confidence motion if that bill goes through. That is most significant if that is the case. We all live on a timetable of when the next no confidence motion can come up in PNG. If that did go through, what sort of changes would occur?

Dr Standish—The intention is to force people into political parties, but it is to force them into political parties when they are campaigning on the basis of local factors which have nothing to do with political parties. It means that for people to have a vote at all they will be locked into those political parties.

Senator BOURNE—For a period of time, or forever?

Dr Standish—For the entire period of that parliament. At any one time in PNG there are usually 10 functioning political parties; they come and go. During elections you have about 20, many of which are non-viable, and some parties that were previously dominant in the parliament now have only one or two members. There is very little continuity in politics and political leaders swap parties. That culture of opportunism and party swapping, floor crossing—yo-yo politics, it is called in Papua New Guinea—is one where I do not think you can change political behaviour from on top by constitutional fiat. That is why I guess I am sceptical about the ultimate prospects of this legislation, and it may not even get through in the first instance.

Senator BOURNE—It would not necessarily stop, in case it ever happened, a brown paper bag being delivered to get a few votes. Or does it say in this legislation that if you belong to this party you must vote for someone who is associated with that party for Prime Minister? Does it say that in the legislation?

Dr Standish—I have not read the legislation; I have read a newspaper summary. I think you can abstain, and some members of parliament did abstain from this recent vote. In fact, 30 of them abstained one way or another. You would have to have a brown paper bag that was big enough for an entire political party. Another dimension is that national government will be funding political parties' electoral expenses, and this is an important change. That is intended to reduce the levels of potential corruption and business influence. Foreign business influence in particular is ruled out. But members of parliament are entitled to receive donations to a maximum of \$1,000 each up to \$500,000 for their electoral expenses within this legislation. So at some level it is dealing with the culture, but on the other hand in terms of enforcing it it might well be unenforceable.

Senator BOURNE—It does sound very difficult, from what you are saying.

Mr NUGENT—Is this new legislation about political parties is passed, if I was an independent and I had to join one of the parties what is to stop me either abstaining or crossing floor? And, if I can do that, how do you get instability by forcing me to join a party? I am not arguing the point; I am just trying to understand it.

Prof. Nelson—I think there is a penalty for crossing the floor, I do not think there is a penalty for abstaining.

Mr NUGENT—What sort of penalty?

Prof. Nelson—Is it resign and re-stand?

Dr May—Certainly in the draft legislation you can lose your seat.

Senator BOURNE—But you could stand again.

Dr May—You could stand again tomorrow.

Dr Standish—A number of members of parliament have been excluded from parliament on the leadership tribunal findings of corruption, misappropriation and the like. They have contested elections and been re-elected. So there is not that form of sanction you get in the system here where you have a strong political party system and if you leave your party your chances of being re-elected are minimal.

Mr NUGENT—I come back to my original point about the culture of the people out in the sticks, because that is really where you have got to make the change. You are making the point that you cannot impose it by constitutional change; it has really got to be grassroots change, hasn't it? How do you effect that in that environment?

Dr Standish—There is a rapid change in PNG political culture. Australian colonial officials were not beyond playing patronage and teaching their members of parliament how to play pork barrel politics. There were often quite effective alliances between district commissioners and members of parliament to get the roads, bridges, schools and so on. We taught people about pork barrel politics quite well in the colonial period. But one of the problems has been this complex power-sharing between provincial governments and national government, and national governments and national ministers had almost no influence, no discretionary funding, within provincial governments for 20 years, which is why they threw out the old provincial government system and put national parliamentarians in charge.

Because of the weakness in capacity of government to deliver those government services of health, education services, road maintenance, and so on, a lot of the funding has not been getting through to church agencies or others. The reason is that people realise that the baseline, essential government services cannot be delivered by government. Therefore, they must go in for showy political stunts, the edifice syndrome of building something with their name on it, or building a hospital just before an election, even though there are no staff to run it—something of that nature. Lack of administrative capacity to deliver the goods has in fact emphasised the need for this kind of political pork barrelling and this kind of system which ultimately reduces the capacity of government to deliver. As Prime Minister Morauta said before he became Prime Minister, members of parliament are not project managers. There were very few, if any, controls on this funding up until now. The recent changes and guidelines that have come in are about trying to bring some accountability into that with the rural development programs.

I cannot see those pressures on politicians changing until the administrative capacity is also increased. I think it is very interesting that the World Bank and the IMF, rather than necessarily trying to cut Papua New Guinea expenditure for services, has, for at least five or six years, been trying to get Papua New Guinea national governments to spend more on the delivery of these essential services, which is not the reputation that the World Bank has around the world. Structural adjustment programs are usually set to cut services. In Papua New Guinea, they have actually been trying to increase them, but the blockage is at that

discretionary level in provincial governments which essentially have not had the funds to deal with these issues now for many years, partly because of \$100 million or \$150 million going to members of parliament at their own discretion.

CHAIR—Are you trying to keep a watchful eye on their international relationship, in light of the disasters of 1997? You have made particular reference to the arrangement with Taiwan. How much damage did that do to PNG? Has their international image improved as a result of the reforms or are we too close to PNG and most people could not care less?

Dr Standish—Is that question to me?

Prof. Nelson—Bill can think of the correct answer while I give a brief answer. I believe over the last year, since the election of the Morauta government, that the international standing of Papua New Guinea has improved remarkably. As an outsider and an observer of Papua New Guinea, I am surprised at the extent to which the Morauta government has been successful. I thought the impediments to it were such and so strong that there could only possibly be slight improvements. The Morauta government is not really a new government, as you probably realise. Morauta was a minister in the Skate government. Most of the people he is dealing with are out of the Skate government and so are extraordinary impediments for him in his operations, as with the public service he is dealing with. My impression is of greater advances by the Morauta than I had anticipated. Not that I have any illusions of extraordinary successes and individual disasters will continue. There will be great corruption at the Weewak hospital, the public service superannuation funds will be misused and the defence services retirement funds will be misused; there will be a succession of minor disasters and I suspect that they will continue.

Dr Standish—I think Papua New Guinea's international position has improved. I spend most of my time looking at the South Pacific or broader development issues, not a huge amount on foreign policy issues. I think there is a rather nervous crossing of fingers and hoping that there will be no repetition of the Taiwan misadventure. It is very interesting that the Chinese government is taking a big part in the 25th anniversary celebrations at the national stadium, which they built, and that they are funding the building of a new foreign affairs department for Papua New Guinea. There was a sense of moral obligation that appeared in letters to the editor when Papua New Guinea turned its back on Beijing a year ago, just before that change of government, which said, 'These are the people who gave us the stadium. We should not behave like this towards them.'

The bigger concern is that PNG could lose all of its friends in South-East Asia by such a move. I mentioned that in this parliamentary paper. It is not something that was mentioned as publicly or as explicitly as that by Australian government spokesmen, but there has been concern amongst some long-term observers that Papua New Guinea, by stepping right outside the ASEAN consensus to deal with China, would lose friends which it sorely needs in that region, particularly because of the potential for instability on the border of Papua-Indonesia.

Dr May—I would like to add a brief note to that. Probably one flow-on from the Taiwan issue was that China was very cross about that but also became more conscious of Papua New Guinea. The funding of the foreign affairs office may in fact be a flow-on from the aborted recognition of Taiwan. I think there is a lesson in that for Australia. We already have the

elaboration in foreign policy of the 'look north' policy. Within the Defence Force there has been a lot of discontent that the defence cooperation program has not benefited Papua New Guinea in the way that Papua New Guinea sees it should have benefited. There is a memorandum of understanding. There are materials procurement contracts with, I think, Malaysia and Indonesia, as well as with Israel. There was the early purchase of aircraft from Spain. Papua New Guinea's reputation has been fairly stable for a while. I do not think it is going down but I think there are a lot of other countries around the place that will show an increasing interest in Papua New Guinea, for various reasons, if Australia's commitment to things in Papua New Guinea diminishes.

CHAIR—What happens if Bougainville blows?

Prof. Nelson—There are both sides. There is Bougainville on one side and West Papua on the other, and both are extreme hazards. Bougainville has certainly been moving as well as could be expected and perhaps better than could be expected, as previous speakers have mentioned. But two issues remain. The first is that there are too many guns still around on Bougainville—the question of the arms. The other is whether the referendum can go ahead and whether the Papua New Guinean government will say that there can be complete independence—that is, whether the PNG government is committed to the integrity of the Papua New Guinean state as it now is or whether it really will allow separation of Bougainville. Those two issues—that is, the disarmament plus the possibility of complete independence—remain.

Dr Levantis—There is one thing that I would like to elaborate on with regard to Papua New Guinea's international reputation. We should be under no illusion that the way the world looks at PNG is very much the way Australia looks at PNG. The world kind of looks at PNG through Australia's eyes—not totally so but very much so, especially the Americans and the British. The way they perceive PNG is a reflection of the way Australia looks at it. Because Australia and the Australian government have formed close relations with PNG now, and because Australia has been much more positive towards the Morauta government, the world is following. The world's perception of the law and order situation in Papua New Guinea comes via Australia's perception. It is very real, of course. That is very important—Australia's relationship with Papua New Guinea.

CHAIR—I thank you all very much indeed. The fact that we have gone a good half hour over the schedule probably says it all. We really do appreciate your being here today. We will be sending you copies of the transcript of the evidence, and you will be able to correct errors of grammar or fact. If there is any further material that you might want to get to the secretary, if you could get it to him as soon as possible that would be appreciated because we are on a time limit. On behalf of the subcommittee I would like to thank all of the witnesses who appeared here today. Your various contributions will assist us greatly in the preparation of our report. As I mentioned at the start of today's hearing, the committee will report to the parliament on this matter on Monday, 30 October 2000.

Subcommittee adjourned at 1.25 p.m.