John Millett

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Committee Secretariat

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PO Box 6100

Parliament House

Canberra ACT 2600

Economic and security challenges facing Papua New Guinea and the island states of the southwest Pacific

Introduction

I am pleased to present my views and analysis of the economic and security challenges facing PNG, far the largest by area and population of the Pacific Island countries, the closest to Australia geographically and historically and the principal recipient of Australian aid over a long period.

The views have been distilled from living and working there for some 30 years from the early 60s, as a civil engineer during the colonial period of infrastructure development, through the pre- and post-Independence period as managing director of a new statutory financial institution, to the late 90s as director of the Institute of National Affairs, then a privately funded "think tank". Since leaving that post and the country in 1997 I have maintained interest as a correspondent for the *Economist Intelligence Unit* and as an occasional contributor to *Pacific Economic Bulletin*.

I hope to demonstrate that, with little to show for 33 years of conventional policy advice and a lot of donor aid and soft institutional loans, policy makers, advisers and donors need the courage to think and act outside the square if PNG is to become as good a development partner as it can be. I hope to show that policy designed in advanced economies hasn't always traveled well to PNG. In particular, I will argue that whatever benefits may flow from the proposed guest worker scheme - for Australian horticulturalists and political relations between the two countries - they will not include positive impact on the country's most intractable problem, high and rising unemployment and associated crime and social unrest. I will also argue that as well as this endemic internal macro-economic imbalance, an external imbalance is currently masked by the beneficent terms of trade courtesy of China's stellar growth. These macro imbalances constitute binding constraints on PNG's development. I will address them first as, in my opinion, their elimination is a precondition for achieving a secure and prosperous future for both PNG and for the bilateral relationship. In the second part of the submission I will address the specific issues of interest to the committee.

Binding constraints: macro-economic imbalances

The ubiquitous question "What went wrong?" reflects the stark contrast between PNG's promise and performance. Whereas many analysts, led by the World Bank, answer "poor governance" I contend, on the evidence, the correct answer is "poor policy". Poor governance didn't exclude 7 of every 10 new workers from the monetised economy year after year since 1980. Nor did it cause the three-fold increase in the cost of living and the loss of practically all the gain since independence in per capita income during the period 1994 - 2002 . Only poor policy, which determines the allocation of resources in the economy, could wreak such damage. Good governance could not have overcome bad policy.

Despite its quite recent emergence in the development literature's serial list of explanations for why orthodox growth policies fail and poverty persists, critics already see governance as being too abstract to get a handle on. They are more comfortable with the return, in the growth-diagnostic, binding-constraint framework, to basic foundations of sustained growth—capital accumulation and entrepreneurship.— and with its intuitive economic logic and ability to rank reforms according to impact on growth. The approach helps differentiate reforms essential for growth from those that deliver desirable efficiency gains. More disciplined art than science and requiring in-depth knowledge of the economy under examination, it challenges conventional wisdom.

The binding constraint concept has come front and centre of development thinking in the continuing search for understanding why poverty prevails in much of the world despite more than a half century of policy advice and financial assistance from international development institutions. Peruvian economist Hernando de Soto in his book "The Mystery of Capital: Why capitalism triumphs in the West and fails everywhere else" contrasts the residual pockets of poverty in the numerically puny West with the pockets of emergent privilege amidst the rest of the world's pervasive poverty. He writes: "Marxist thinking, in whatever form it reappears - and it will - supplies a much mightier array of concepts for grappling with the political problems of capitalism outside the West than capitalist thinking does" (page 214). United States economist William Easterly in his book "The Elusive Quest for Growth" gives an insider's account of policy evolution in the World Bank characterising it in the sub-title: *"economists' adventures and misadventures in the tropics"*. In Barcelona in September 2004 a gathering of international economists declared the passing of the "Washington Consensus" on policy advice promulgated by the international institutions in the 80s and 90s - noting that the best performing parts of the developing world had had least to do with it - and the birth of the "Barcelona Consensus". Amongst other things, this consensus argues for experimenting with policies that address the most binding, country-specific constraints to growth along with encouragement in that endeavour from international lending institutions and aid agencies. It considers mechanical copying by developing countries of rich country institutions risky. The consensus has little to say about governance other than warning that giving your mates a leg up is not a legitimate form of policy freedom. One contribution to the Barcelona gathering was a decision tree aid to "getting the diagnosis right", that is, identifying the one or two constraints the alleviation of which would be most welfare-enhancing and cost-effective.

Bizarre policy outcomes

The "twin peaks" of poor policy outcomes in PNG can be revealed through the lens of the current China-induced terms of trade windfall that PNG shares with Australia. The PNG government became a net foreign investor midway through 2006. Government debt has fallen by a quarter in the period 2002-07. It now represents about one third of GDP. Reserves have been rising even faster than debt has been falling, more than doubling since 2003 and now providing comfortably more than a year's non-mineral import cover. This bizarre external condition has its equally bizarre domestic counterpart - a monetised economy which absorbs only 3 in 10 people becoming of working age, after allowing for subsistence labour demand, while 90% of land remains undeveloped.

Investing the increased national income derived from the commodity price boom in expansion of agricultural export production would be the most promising use of the windfall. The return on investment would be measured directly in expanded GDP, employment, foreign exchange earnings and tax revenue; and indirectly in reduced lawlessness and cost of doing business. The return would far exceed the interest savings from paying off debt or interest earnings from holding foreign securities.

Why hasn't this happened? I suspect the answer is along orthodox lines: there is no need for government to intervene directly in production; fixing infrastructure is sufficient, private investment will do the rest. However, it has taken more than broken roads to exclude 7 out of 10 new workers from the economy year after year since 1980. The golden age of rural expansion occurred before the Highlands Highway was built and transport costs were higher than now. The main barrier to markets lifting the labour force participation rate is absence of credible property rights in rural land available as loan collateral. This situation won't change any time soon. Only the public sector is able to carry the financial risk in developing customary land. Public sector intervention in the face of market failure has a place even in market-oriented economic theory. Proof of this can be seen, in the context of current global financial mayhem, in nationalisation of a British bank and in the substantial inventory of residential property the US administration will soon be carrying on its balance sheet.

Deficient policy design

Four main principles, derived from policy in advanced economies, underpin policy in PNG. First, the public sector's influence on economic performance is determined by the budget balance, not the level of spending. Second, spending on economic infrastructure and social services is unambiguously good for the economy. Third, producing market goods and services and generating household incomes thereby is solely the private sector's role. Fourth, converting group property rights in land supported by customary law to State-sponsored individual property rights is a pre-condition for development.

Adhering to the latter two principles has produced the bizarre condition in which idle land and labour co-exist in a rising sea of poverty and lawlessness. Thankfully, the World Bank having lately recognised the error of its 1970s ways, the fourth principle has already been jettisoned. It is time for the third one to meet the same fate.

Adhering to the former two principles resulted in the erosion of foreign reserves from the mid-80s and much currency depreciation from 1994, when the currency was floated, with attendant rapid increase in the cost of living. Why? Because the level of government spending ultimately generated demand for foreign exchange faster than the private sector could supply it. Moreover, the currency re-alignment did not, as economic theory says it would, induce increased rural exports. Why? Because farmers see the higher prices of their imported consumption as well as higher grower prices flowing from the weaker currency.

A tale of two booms

Between 1994 and 2002 PNG lost almost all the gain since Independence in real per capita GDP. The kina's trade weighted index fell 12% annually for a total 70% loss in international purchasing power; the consumer price index increased at the same rate for a total 3.5-fold increase in the cost of living; and interest rates trended sharply upwards peaking in 1998 at 21%.
The period was bounded by mineral and oil export booms. The former was an investment boom continuing till 1996. The latter is a price boom and still in play. Over the period 1993-96 primary budget expenditure grew half as fast as the value of mineral and oil exports; and the proportion of primary expenditure funded by taxes and dividends from that sector declined at the trend rate of 13% per year. This decline was accompanied by currency (trade-weighted index) depreciation at the same rate and 11% inflation. By contrast, over the period 2003-06 primary expenditure grew slightly faster than mineral and oil export value. Moreover, the proportion of primary expenditure funded by revenue from the sector increased at twice the earlier period's rate of decline. This increase was accompanied by 2% currency depreciation and inflation.

The difference between the two periods in the proportion of expenditure funded by revenue from the mineral and oil sector could explain the different exchange rate experiences. In turn, recent research by the central bank establishes the causal link from exchange rate changes to inflation. As well, during the first export boom international reserves were exhausted (and the kina floated) while under the current boom they have risen to record levels - prompting the IMF to recommend the kina be allowed to appreciate.

Summary

Two binding constraints have been diagnosed: structurally unbalanced budget funding leading to heightened exchange rate risk and price instability and low appropriability by foreign investors producing for the domestic market; and access to finance for development of the predominant informal sector. To date no policies have been forthcoming to deal with the first one. Attempts since Independence to deal with the second one have mainly aimed at changing customary attitudes to land. These have met with mixed success but failed overall to achieve growth adequate to absorb a fast growing labour force. A single policy, aimed at changing attitudes to financing rather than to land - a return to the pre-independence direct budgetary participation - could deal simultaneously with all three constraints. Currently the budget imbalance is masked by abundant foreign-exchange receipts flowing from the export price boom, though export volumes are in decline. It is possible that new projects will reverse the volume trend before the terms of trade revert to normal. However, government has virtually no control over the rate of development of these projects which depends on decisions made in headquarter offices overseas. A more certain way of expanding the export base would be in agriculture through the budget. This would also, and primarily, overcome the second constraint - access to development finance. The call on the budget would be bigger than in the 60s and 70s when foreign-owned plantations paid wages for development of alienated, government leasehold land.

Micro-economic issues

Employment opportunities, labour mobility, education and skilling

Employment opportunities: Latent opportunities abound as self-employed, land-owning farmers. Pacific island leaders should look overseas less and at home more for agricultural work to absorb labour. Whether the primary focus should be on agricultural productivity, as orthodoxy would dictate, or on “productiveness” is an open question. The difference between these similar terms - productiveness and productivity - is the difference between using available resources and using availed resources well. The market-based version of economic theory has little to say about productiveness because it assumes full resource utilisation. In PNG, however, over the period 1980 to 2006 some 13 million person-years of labour resource - almost two-thirds of the available increase - was not availed for development, despite land abundance. This is an unproductive economy - it doesn’t use all available resources. What resources it does use, it may do so more or less productively. Capital deepening or new technology may well raise productivity, that is, increase output per unit input; but it wouldn’t necessarily increase inputs, that is, absorb labour on the scale required to eliminate the overhang. What is beyond question, however, is that this level of economic exclusion renders reliance on enforcement means alone to deal with crime futile. The law and order problem, the biggest one facing investors according to surveys, is really an economic one, specifically grossly inadequate labour force participation in the monetised economy.

Labour mobility: Workers move freely within PNG. Professional Papua New Guineans are internationally mobile - airline pilots, resource company executives and medical doctors have served in the Middle East and Africa as well as in Australia. The value of Australia’s proposed unskilled guest worker programme must be assessed against the scale of PNG’s unemployment as well as of Australian farmers’ labour shortage. It will do nothing to absorb the estimated 1.25-1.5 million unemployed Papua New Guineans nor the 7 out of 10 new entrants to the work force excluded from the monetised economy.

Education and skilling: Whereas geography determines countries’ natural physical endowments, their stocks of human and social capital are products of their histories. PNG’s relatively short modern history makes comparisons of human capital stocks across countries less useful than comparisons over time within the country. The well-remarked low ranking on the UN’s human development index is neither surprising nor particularly relevant, though movements in ranking do say something useful. The more telling and encouraging facts are that Papua New Guineans today are better educated than ever before. It is, however, appropriate to ask whether more progress could have been made and, if so, why it wasn’t. For example, would universal primary education be a distant dream still for too many of the two million children under 15 years of age, if the tertiary sector didn’t absorb more than half the education budget? Six of ten children entering grade 1 drop out by grade 6. Universities graduate 1200 professionals annually, not all of them easily finding jobs.

Barriers to trade, foreign investment, economic infrastructure, land ownership and private sector development

Barriers to trade: PNG has recently partially reversed a tariff reduction programme it had completed under obligations within APEC membership and a World Bank structural adjustment programme. This is aimed at survival of existing industries, not establishing new protected ones. Given the grave scale of unemployment this is appropriate. Expanding rural production and incomes would increase demand for urban-based production and employment and reduce the need for protective tariffs. Quarantine regulations appear to be the main barriers to trade from PNG’s perspective.

Foreign investment: The resources export sector attracts most of foreign investment in minerals, oil, gas, forestry and fisheries, from widely diverse sources, Africa, Canada, China, Malaysia, Japan, Philippines and United States as well as Australia. Formal production for the domestic market also retains a high level of foreign ownership and control. Widespread resentment of foreign investment, mainly Asian, in small retail trade is on-going.

Economic infrastructure: The parlous state of economic infrastructure reflects early policy choice to favour building new assets over maintaining existing ones. The choice was in line with the Eight Point Plan that accompanied Independence and called for equal distribution of benefits. Rehabilitation of economic infrastructure is currently underway with funding from the World Bank, ADB and Australia.

Land ownership: Finance has never been made available for customary land development even by the 40-year old State-owned development bank. Nil access to domestic finance is tantamount to infinitely high cost stemming from nil intermediation. This reflects the constraint on formal banking practice whereby loans must be secured against physical assets represented by an entry in a register administered by the State. Such a register doesn't exist for customary land. This constraint has been dealt with in two ways. First, government went around it and participated directly in low-input, low-output land development through research and development, extension and supply of planting stock. This approach gave rise to the flourishing informal Highlands coffee sector of the 50s-70s which expanded three times as fast as the population until it hit a wall around 1980. Second, government removed the constraint by formalising title to land parcels so that the development bank could lend for agricultural expansion. The State did this by leasing parcels of land from the owners and on-leasing them to registered third parties (which might be a sub-group of the clan, e.g., a family unit) for particular purposes. This is the basis of the out-grower component of the foreign-owned oil palm sector which has expanded at 11% annually since its establishment in the mid-70s. It was also the basis of the failed 20-hectare coffee block initiative of the early 80s to raise village land productivity to plantation levels. Land tenure conversion, therefore, is neither a necessary nor a sufficient condition for growth.

Private sector development: The biggest private sector numerically by far is the informal rural sector. Its long-term sluggish development, the crux of PNG's economic and social problems, is the outcome of policy that opted for formalising before development. Remedial policy should aim for development with existing informal institutions through a public-private partnership which would stimulate desirable institutional evolution over time.

Current regional organisations such as the Pacific Islands Forum and the Secretariat of Pacific Community: I have nothing useful to contribute to this aspect of the enquiry.

Implications for Australia

A continuation of long-term trends in which population growth outstrips growth in rural production and employment can have only negative implications for Australia. Positive implications for Australia can flow only from increasing the labour force participation rate in the rural monetised economy. Achieving that outcome will require public financing of development of rural land held under customary (group) title. In turn this will require re-thinking the roles of the public and private sectors in PNG's still-early stages of economic and social development.

Practical Australian assistance

Australia can assist PNG in this mutually beneficial enterprise in the first instance with manpower in the strategic review of the development process and in establishing the enterprise's public-private partnership structure. Secondly, it can assist with funding the partnership.

Conclusion

Pursuit of economic policies designed for conditions which don't apply in PNG led to two dangerous imbalances which, by early this century, had exposed the fragility of that country's emergence from tribalism to national sovereignty. Over 15 million man-years of labour resource was not availed while 90% of land lay idle and levels of poverty and lawlessness rose. Some 1.25 - 1.5 million Papua New Guineans are unemployed. Seven of 10 new entrants to the labour force fail to be absorbed into the monetised economy. China's relentless growth surge has (temporarily) eliminated the other imbalance - an overweight public sector and concomitant excess demand for foreign exchange. Now, the PNG government is a net foreign investor. This anomaly could most usefully be removed by applying budget surpluses to eliminating the labour overhang by planting up customary land for export production. With encouragement from donors this could be achieved through (formal) public- (informal) private partnerships by 2020.

Terms of reference

(a) The following matter be referred to the Senate Standing Committee on Foreign Affairs, Defence and Trade for inquiry and report to the Senate by 30 May 2009. The major economic and security challenges facing Papua New Guinea and the island states of the southwest Pacific;

(i) the implications for Australia;

(ii) how the Australian Government can, in practical and concrete ways, assist these countries to meet the challenges.

(b) The inquiry to include an examination of the following:

(i) employment opportunities, labour mobility, education and skilling;

(ii) barriers to trade, foreign investment, economic infrastructure, land ownership and private sector development; and

(iii) current regional organisations such as the Pacific Islands Forum and the Secretariat of Pacific Community.