

JCFADT Inquiry: The Role of the Private Sector in Promoting Economic Growth and Reducing Poverty in the Indo-Pacific Region

Opening presentation notes for Mr Paul Flanagan, Visiting Fellow, Development Policy Centre, Crawford School of Public Policy, Australian National University 9 February 2015.

Thankyou for the opportunity to appear today.

The subject matter of the inquiry is an important element of the re-orientation of the policy directions for Australia's overseas assistance. I welcome most of these changes in direction, such as an increased focus on the private sector as well as supporting governance programs. Experience indicates they are the fundamental ways to reduce poverty.

Looking through previous submissions, including the excellent submission by my ANU colleagues Robin Davies and Margaret Callan, there has been considerable focus on several levels of assistance for the private sector. These include: building partnerships between the private sector, the community (such as churches and NGOs) and government; direct forms of assistance to businesses (such as financial inclusion funding and enterprise funds); sectoral based assistance in areas such as agriculture or tourism and broader support for the business enabling environment such as lowering the costs of doing business or improving competition policy.

Tonight, I wish to emphasise the importance of appropriate macro-economic settings to support private sector development. The comments will focus on PNG as a key partner country and one where I have the strongest background experience extending back to 1978 and including over two years as the senior advisor to the PNG Treasury from 2011 to 2013. My opening is in two parts – first, the case for considering macro-economic settings as an essential element for supporting private sector development, and second, the type of policy actions that Australia can take to support this element of building the private sector in our partners.

First, good macro-economic policies are essential to private sector development and poverty reduction, including and arguably especially for women. Although the linkage may seem indirect, these macro-economic settings are arguably the most important element for building a thriving private sector and leveraging entrepreneurial abilities. The macro-economic settings encompass good exchange rate policy, good fiscal policy (including tax policy), good monetary policy, and good wages policy.

A few examples. How does a sound exchange rate policy assist the private sector? PNG moved to a market based exchange rate in the mid-1990s. This was an important element of its recovery from the fiscal crisis at that time, as well as supporting the high growth rates following the Asian financial crisis from the turn of the century. However, **on 4 June 2014, PNG moved away from a market based exchange rate. Indeed, it appreciated its currency by 15% at that time. What have been the consequences of this policy? First, PNG businesses are now finding it very difficult to get the foreign exchange required to pay for imports essential to their businesses. By moving the value of the Kina above the likely market rate, there is a significant exchange rate shortage. PNG businesses now need to tell their overseas suppliers that it may take many months, even more than a year, to pay their bills – not because the business doesn't have enough funds, but because they cannot convert their Kina in other currencies required to pay for their imports. This raises**

business costs. It makes business harder and undermines links to overseas suppliers. It undermines PNG's integration with the wider global economy. Currently, the central bank has to decide which imports to give priority to – is it to Puma to pay for petrol imports, or is it to a retailer seeking to restock their shelves, or is it to an agricultural producer to import fertilizer. **A second impact of such a macro-economic policy is on exporters. The largest component of the private sector in PNG in terms of the number of people affected are the small-holder cash cropping activities of farmers. For example, it is estimated that there are 2.1 million people, over a quarter of PNG's population, that receive 40 to 60 per cent of their incomes from selling coffee. This is an absolutely core element of the private sector in PNG. And with the 15% appreciation of the Kina on 4 June, it means that every one of these farmers now receives 15% less for each kilo of coffee they now sell. This obviously changes incentives. Indeed, it is estimated that the change was enough to force 130,000 of these farmers below the poverty line. Women and children are most likely to have been adversely affected. Macroeconomic policies matter.**

A second example. Fiscal policy in PNG is no longer credible and this will affect the private sector. In the very short term, the major scale up in Government expenditure produces more opportunities for contracts. However, with deficits now approaching double digit levels (estimated to be around 8% this year and over 10% from 2016 onwards on realistic scenarios), and the government effectively printing money to finance those deficits, inflationary pressures are likely. During PNG's last major fiscal crisis flowing from the Asian financial crisis, inflation jumped to nearly 20 per cent as did interest rates. The uncertainty and cost of such an environment is very difficult for the private sector to operate in. Additionally, the private sector is dependent on other key policies such as appropriate levels of funding for key infrastructure roads so goods can get to markets, as well as building the education and health of a workforce. Current funding projections are that areas such as infrastructure, education and health funding will be cut by over 25% in real terms over the next two budgets. In this context of required fiscal constraint, there are serious questions about the judgement calls to prioritise new equity funding in areas such as Oil Search shares – the government can get higher rates of return by investing in areas such as education, law and order and infrastructure.

So what actions can the Australian government undertake to work to ensure macro-economic settings in partner countries are part of the supportive environment for encouraging private sector growth? This can be a sensitive area as these macro-economic issues go to the core of sovereignty.

At a high level, we should utilise multi-lateral opportunities for peer based reviews of macro-economic policies such as provided by the IMF and their annual Article IV discussions. It is disappointing that with the move away from market based exchange rates and the move towards effectively printing money that the Australian Executive Director at the IMF did not encourage an IMF Board discussion of the PNG annual report late last year.

On a bilateral policy dialogue level, we should ensure that such macro-economic issues feature in high level policy dialogues and relationships, including Ministerial discussions. The most effective of these often occur behind closed doors, so possibly this avenue is already being actively pursued. As part of our regional engagement, the importance of relationships is critical. Our Treasurer and Finance Minister should have good relationships with peers in countries such as PNG.

At a more indirect level, we should strengthen PNG's capacity to analyse its own economic performance, formulate good policies and implement actions. This can occur through initiatives such as the Governance Precinct recently announced by the Minister for Foreign Affairs in seeking to strengthen PNG's pool of public policy skills. This indirect support level should also be reflected in

much more support for government to government institutional linkages programs. This should be a whole of government approach, and individual agencies should be obliged to provide this support with appropriate DFAT funding. Support can also be provided to various key relationships that interact with government in the formulation of policies, such as chambers of commerce, the PNG Australia Business Council and other forms of building civil society.

On occasions, and these would be in more unusual circumstances, the appropriate utilisation of Australian laws could be a useful adjunct to other actions. For example, poor macro-economic policies can also be a reflection of corruption. **We have Australian and international rules such as anti-money laundering rules and proceeds of crime legislation that arguably could be used to reduce the incentives for corruption.** Mr Sam Koim, the Chairman of the now unfunded PNG anti-corruption taskforce, “Taskforce Sweep” has expressed concerns that Australia has not done enough to utilise its laws to provide a deterrent to corrupt practices in PNG (see his 4 October 2012 speech to AUSTRAC as an example).

Another example is the possible use in very selective circumstances of powers under Australia’s foreign investment rules to influence decisions that are not supportive of good macro-economic or good governance policies. For example, there are arguments that the Australian Treasurer should have used or should use the powers under the Foreign Acquisitions and Takeovers Act 1975 to limit the major concerns around a major share purchase by the PNG Government in March 2014. Dealings around the \$US1.3 billion purchase of Oil Search shares and its associated loan agreement from UBS led to the dismissal of the PNG Treasurer. PNG’s Chief Justice, acting on recommendations from the PNG Ombudsman and PNG Public Prosecutor, has called for a leadership tribunal for the Prime Minister O’Neill to face allegations “that the Prime Minister failed to comply with administrative and financial processes including the normal borrowing process”. This proposed share purchase should have been notified to the Australian Government and been approved prior the PNG Government buying the shares (it was notifiable under the act as it represented a foreign government taking a direct investment (10.01% at the time of the transaction) in a company with 100% owned Australian subsidiaries with land interests in Sydney and Brisbane secured by guarantees from the parent company and non-recurrent assets of over \$US44m). It is not clear if the notification was made. However, it was still up to the Australian Government, specifically the Australian Treasurer, to ensure a determination was made under Australian law on whether the transaction was in the national interest. Arguably, the Australian Treasurer, in taking a due diligence approach and a broad interpretation of the national interest, could either refuse approval for the transaction or add conditions to the share purchase (such as having the loan approved by the PNG Parliament before the share purchase was completed). Of course, this would be a very sensitive issue but the circumstances are very unusual and significant. At this stage, the Australian Treasurer is or could be implicated in approving this Oil Search share purchase which has led to the dismissal of the PNG Treasurer and is the subject of a referral of the PNG Prime Minister to a Leadership Tribunal (when this last occurred, the former PNG Prime Minister Somare stood down for the time of the hearings).

By focusing on these macro-economic issues, I wanted to encourage consideration of the importance of good macro-economic policy settings which are fundamental to fostering the role of the private sector in promoting economic growth and reducing poverty.

Thank you for your time this evening.

Some macro-economic snapshots of PNG's emerging fiscal crisis which will hurt the private sector

GoPNG Revenue and Expenditure Shares of GDP

