Papua New Guinea 4

BACKGROUND

Papua New Guinea (PNG) is the largest of the PDMCs, with a rugged landmass of 453,000 square kilometers and a sea area of 3.1 million square kilometers. It is well endowed with minerals (oil, gas, gold, copper, nickel), forests, and marine resources. The population in 2000 was 5.1 million people, approximately 85 percent of whom live in rural communities. There is considerable cultural and linguistic diversity: more than 700 languages are spoken.

Economic growth has not translated into broad-based social development. PNG ranks last amongst PDMCs on the Human Development Index scale. GDP per capita was about US$750 in 2000; its distribution is extremely skewed. Life expectancy at birth is 54 years, the infant mortality rate is 77 per 1,000, and the adult literacy rate is just 52 percent. There is also marked gender inequality: PNG is probably the only country in the world where women have a lower life expectancy than men. Thirty-one percent of the population lived below the US$1 a day poverty line in 1996.

While significant pockets of pure subsistence agriculture continue to exist, the livelihood of the majority of the rural population is supported by semisubsistence agriculture, which comprises traditional subsistence gardens that provide the basic needs for the family and small-scale commercial agriculture that provides the family with cash income. The most important cash crops are coffee, palm oil, cocoa, betel nut, and vegetables. There is a high correlation between poverty and the areas that are highly dependent on agriculture.

PNG achieved independence in 1975. It has a democratic system of Government based on the Westminster system. The Head of State is the British sovereign as represented by PNG's Governor-General. The Head of Government is the Prime Minister who is elected by the 109 members of the National Parliament. National elections are held every five years. In addition to the national Government structure, there are 20 provincial governments, 87 districts, and 284 local-level governments. Following the passage of the Organic Law in 1995, provincial assemblies no longer consist of separately elected members, but comprise elected national members of parliament, heads of local-level governments (also elected), and certain appointed members.

It is estimated that around 97 percent of the land in PNG is under customary ownership, while the remaining 3 percent was alienated by the colonial administration, largely for the purpose of plantation agriculture and urban development. Since independence, land has been mobilized for development through a leasehold system. For example, the palm oil industry is following a lease/lease-back approach where traditional land is leased to the Government (for 99 years) and then subleased to the palm oil interest for a shorter period, such as 20 years. Under this scheme traditional landowners receive a flat-rate payment for the land, royalties from palm oil production, and employment options. Over the years, governments of PNG have acknowledged the need to improve the system of land mobilization. However, doing it has been difficult, and in 1995 the Government was forced to suspend a land mobilization program because of widespread public concern that the program would result in confiscation.

THE MACROECONOMIC ENVIRONMENT

PNG's real GDP grew at an average annual rate of 3.4 percent during the period 1978–1998, or about 1.1 percent in per capita terms. This growth was led by the mining and petroleum sector, which accounts for around one-quarter of GDP.

Per capita GDP in the nonmining economy grew at just 0.2 percent during the same period.

In the late 1990s, growth performance was adversely affected by severe drought, the Asian economic crisis, macroeconomic mismanagement, and a deterioration in the governance environment. Real GDP declined in 1997 and 1998, and grew by 3.2 percent in 1999 only because of a recovery in mining and petroleum output (Table 4.1). In 2000, there was a growth slowdown: real GDP increased by an estimated 0.8 percent, because mining production fell by almost 8 percent, while the primary sector expanded by less than one percent. Formal employment in the nonmining private sector remained stagnant in the 1990s, and there was a diminished resource mobilization effort as the Government budget moved into deficit.

The overall fiscal position deteriorated from a small surplus in 1997 to deficits of 2.1 percent of GDP in 1998 and 2.6 percent in 1999. Large unbudgeted public expenditures in late 1998 and the failure to secure external commercial and concessional loans led to substantial Government borrowing from the central bank. Monetary policy became increasingly subordinated to financing the fiscal deficit, thus jeopardizing the achievement of the policy objectives specified in the 1973 Central Banking Act: to promote monetary stability (defined as exchange rate, interest rate, and price stability, together with international credibility); to promote a sound financial environment; and to support sustainable medium-term growth in the nonmineral private sector. Parliament was adjourned in December 1998 to avoid a no-confidence motion, and public policymaking became less transparent and less predictable. However, a new coalition Government came to power in July 1999, restored fiscal responsibility, and committed itself to a Structural Reform Program (SRP) (see Box 4.1). The budget outcome for 2000 was improved despite the growth slowdown, with an estimated deficit of only 1.8 percent of GDP.

Export revenue was hard hit by cyclones, prolonged drought, and the Asian crisis in 1997–1998, so that the economy suffered from external shocks as well as fiscal mismanagement. As primary product export revenue fell, perceptions of political instability led to private capital outflows, and expected external loans failed to materialize. PNG's currency, the kina (K) came under severe pressure and, despite central bank intervention in the foreign exchange market, depreciated 50 percent against the US dollar in 1998. The kina continued to lose ground in 1999. However, export growth resumed in the latter year because of the growth in mining production, and continued at almost 8 percent in 2000 because of a revival of cocoa production and improved log exports. The current account surplus rose to almost 12 percent of GDP in 2000. The capital account deficit increased to over 6 percent, because the drawdown of the first tranche of a World Bank structural adjustment loan was more than offset by an increase in private capital outflows. However, the overall balance of payments surplus was still almost 6 percent of GDP. Foreign reserves provided close to three months of nonmineral imports cover, compared to one month a year earlier. The kina depreciated by a relatively modest 8 percent in nominal terms during 2000.

The central bank has responded to periods of macroeconomic instability by tightening monetary policy. The yield on 28-day Treasury bills rose from 8.4 percent in 1996 to 19 percent in 1998 and 23 percent in 1999. Even with this rapid increase in yields, commercial banks were reluctant to augment their holdings of bills, demonstrating how strong the perception of country risk had become. As a further means of monetary tightening without adding to the Government's debt servicing costs, commercial banks were required from August 1998 to place 10 percent of deposits in a noninterest-bearing account with the central bank (the Cash Reserve Requirement). The state bank, Papua New Guinea Banking Corporation, which had extended substantial credit on a noncommercial basis, was also directed by the central bank to stop new lending.

During the first half of 1999, the monetary authorities made disconcerting changes to the direct instruments of monetary control. The Cash Reserve Requirement was suspended on 31 December 1998, abolished on 12 January 1999, and reintroduced on 15 January 1999. It was then reduced to 5 percent on 16 March, when the Minimum Liquid Assets Ratio (MLAR) was reintroduced at 15 percent, after being reduced to zero in August 1998. On 10 June, the MLAR was increased to 20 percent and the Cash Reserve Requirement excluded as an allowable element of the MLAR, so that MLAR effectively became 25 percent. A kina deposit facility was also introduced as a means of absorbing liquidity, given the lack of interest in Treasury bills. The new administration that took office in July 1999 made no changes in the monetary policy environment until September, when it formally raised the MLAR to 25 percent and abolished the kina deposit facility. The fiscal situation and the precarious balance of payments position precluded any immediate prospect of easing monetary policy. Indeed, in January 2000, the central bank sold Treasury bills in order to reduce reserve money.

During 1998 and 1999, the broad money supply increased by 1.8 percent and 8.8 percent, respectively. In 1998, net foreign assets fell 36 percent, while domestic credit increased by 20 percent, because credit to both the Government and the private sector grew substantially. In 1999, net foreign assets grew by 46.0 percent, while domestic credit increased by 4.0 percent. Growth in credit to the private sector was more subdued at 10.6 percent, and that to the whole of Government was 11.1 percent. In 2000, the broad money supply increased by just 1.6 percent (September quarter), reflecting the growth slowdown and the further tightening of monetary policy, through the open market operations mentioned above and the maintenance of the Cash Reserve Requirement at 5 percent. Net foreign assets increased by 71 percent, but domestic credit contracted by 9.4 percent: net credit to Government fell, and credit to the private sector increased by just 5.4 percent. Treasury bill rates dropped during the year from 21.9 percent in January to 15.3 percent in September, despite the monetary tightening. This reflected a downward revision of inflationary expectations, due to appreciation of the kina in the first half of the year, and an increase in liquidity in the banking system.

PNG's inflation rate has been double-digit in the 1990s, except for 1997; and has accelerated since then because of drought-induced local price increases and because of the depreciated kina (Table 4.1). Consumption has a high import content, and inflation tends to track the kina-US dollar exchange rate. Introduction of a value-added tax and the flow-on effects of civil service wage rises in 1999 also contributed to the 2000 inflation rate of 17.9 percent.

Under the SRP, the Government has committed itself to maintaining macroeconomic stability, improving the governance

Table 4.1
Macroeconomic Indicators for Papua New Guinea, 1994–1999

	1994	1995	1996	1997	1998	1999
Output and inflation			(percent change)			
Real GDP growth	5.2	-3.3	7.7	-3.9	-3.8	3.2
Mineral	-2.7	-10.4	0.3	-26.0	16.8	12.3
Nonmineral	9.8	-1.3	10.1	2.5	-8.1	2.1
Change in CPI (end period)	2.8	17.2	11.9	3.9	13.5	14.9
Gross Investment (% of GDP)	15.2	19.4	27.9	27.1	30.3	
Money and Credit			(annual percent change)			
Net foreign assets	-38.4	166.5	190.1	-7.6	-35.8	46.0
Net domestic assets	7.4	-0.3	2.3	14.6	18.0	1.0
Total domestic credit	7.1	1.5	6.5	22.7	20.1	4.0
Private sector credit	11.9	-4.8	0.4	22.7	18.0	10.6
Broad money growth	2.4	10.7	32.0	6.9	1.8	8.8
Central Government			(percent of GDP)			
Revenue and Grants	26.1	27.3	27.5	32.3	29.8	29.8
o/w Grants	2.9	3.8	2.5	4.6	6.1	5.8
Total Expenditure	28.4	27.8	26.9	32.1	32.2	31.7
Recurrent expenditure	26.2	24.1	23.3	26.7	25.0	23.3
Wages and salaries	7.9	6.5	8.7	9.6	9.0	9.2
Interest payments	3.3	4.3	3.7	4.4	4.3	4.4
Development expenditure	2.2	3.8	3.7	5.5	7.2	8.4
Current Balance	-0.1	3.2	4.2	5.6	4.8	6.6
Overall Balance	-2.2	-0.5	0.5	0.1	-2.2	-1.8
Foreign Financing	-2.2	-0.7	0.1	-1.1	-1.2	2.2
Domestic Financing	4.4	1.2	-0.7	0.9	3.6	-0.4
Balance of Payments			(US$ m)			
Exports, f.o.b.	2,745	2,831	2,602	2,192	1,843	2,019
Mining	1,856	2,057	1,779	1,327	1,324	1,438
Other	889	775	823	865	520	581
Imports, f.o.b.	-1,323	-1,268	-1,521	-1,484	-1,109	-1,525
Mining	-238	-338	-458	-394	-244	-308
Other	-1,085	-930	-1,063	-1,090	-865	-1,218
Services, net	-863	-733	-880	-900	-787	-615
Private transfers, net	-115	-107	-53	-32	-6	-8
Official transfers	163	185	129	93	75	181
Current Account	606	908	277	-131	17	23
(In percent of GDP)	11.0	18.0	5.4	-2.8	0.4	1.5
Official Capital	-106	-34	6	-62	-54	-10
Private Capital	-599	-716	60	108	-123	-381
Mining Sector	-543	-738	197	95	-102	—
Other (Including Errors and Omissions)	-56	22	-137	12	-21	—
Overall Balance	-98	158	344	-86	-161	42
Gross Official Reserves (End of period)	96	268	549	355	194	204
(in months of nonmineral imports)	0.9	3.0	5.4	3.3	2.2	2.0
External public debt (per cent of GDP)	41.4	41.1	36.3	43.3	51.8	45.3
Exchange Rate (US$/K) end of period	0.8485	0.7490	0.7425	0.5710	0.4770	0.4120

— Not available.
Source: BPNG 1999; IFS.

environment, reforming the public sector, and encouraging private sector investment and growth (Box 4.1). Financial sector reforms are in preparation as part of the reform process.

The *Medium Term Development Strategy 1997–2002* (Ministry for Treasury and Planning 2000) and the SRP spell out the strategies for achieving broad-based, sustainable economic growth and social development. Effective implementation based on good government, and governance, is required. A promising start has been made by a new administration working within an inherently unstable political system to address many interlocking issues. Paramount among these is a law and order problem, which is the biggest obstacle to private sector development, and which must be attacked directly and quickly.

THE STRUCTURE OF THE FINANCIAL SECTOR AND INSTITUTIONS

The financial sector accounted for 6.5 percent of non-mining GDP in 1998. It consists of a central bank—the Bank of Papua New Guinea (BPNG)—six commercial banks, one development bank, twelve insurance companies, two main pension funds and a number of smaller funds, eight finance companies and merchant banks, 126 savings and loan societies (only 21 active), a number of investment funds, and a stock market company and three brokers.

The six commercial banks include ANZ (PNG) Bank, a wholly-owned subsidiary of ANZ Bank (ANZ); Bank of Hawaii (PNG), a wholly-owned subsidiary of the Bank of Hawaii; Bank of South Pacific (BSP), a locally owned bank previously owned by National Bank of Australia and bought by public sector entities when the latter pulled out;[13] Maybank (PNG) Ltd, a wholly-owned subsidiary of Maybank of Malaysia; Westpac (PNG), a

[13] BSP is a private sector bank owned by the Motor Vehicle Insurance (PNG) Trust, the Credit Corporation (PNG) Limited, the Defence Force Retirement Fund of PNG, the Teachers Savings & Loan Society, and the Lutheran Church of PNG.

Box 4.1

Structural Reform Program

PNG's Structural Reform Program (SRP) 2000 was first outlined when the current Government won office on 14 July 1999. Domestically designed, and subsequently endorsed by ADB, the World Bank, and the International Monetary Fund along with other external agencies, the SRP's objectives and associated policy actions were presented in the 2000 budget papers. Their objectives and policy actions:

- **Promoting good governance** through improved policy-making procedures; greater transparency in decision making; strengthened capacity for drafting legislation; presentation of legislation on the Government's web site; review and enforcement of Government procurement procedures; extension and enforcement of requirements for public sector agencies to report to Parliament; strengthening of key governance agencies (Auditor-General, Ombudsman Commission, Parliamentary Accounts Committee); strengthening of the capacity of the National Statistics Office; enforcement of a code of conduct for the public service; and introduction of a moratorium on all new forestry licenses, extensions and conversions.
- **Sustaining macroeconomic stability** through strengthening debt management, enacting legislation

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wholly-owned subsidiary of Westpac Banking Corporation; and Papua New Guinea Banking Corporation (PNGBC), a Government-owned bank, which was established under the Banking Corporation Act and is now part of the Finance Pacific Group (FPG). Westpac and BSP share an ATM network, as do PNGBC and ANZ. The two networks are not mutually accessible.

Box 4.1 (cont.)
Structural Reform Program

ensuring the independence of the central bank to manage monetary policy and the exchange rate, and improving public financial management and expenditure controls.

- **Improving public sector performance** through a public expenditure review, design and gradual implementation of a public service reform program, review and strengthening of provincial and local government roles, increased coordination between government at all levels, narrowed scope for the Rural Development Fund, and linking it to district development plans.
- **Removing barriers to investment and economic development** through continuing tariff reform and trade liberalization; deregulating to stimulate agriculture and informal sector activity; completing a taxation review; simplifying and streamlining business registration and work permit approvals; increasing the scope for competition in coastal shipping and aviation; privatizing public enterprises; and carrying out financial sector reforms, including actuarial reviews of the National Provident Fund and the Public Officers' Superannuation Fund and introduction of legislation to improve regulation and supervision of the banking and insurance industries.

The assets of the six commercial banks accounted for almost 48 percent of the K7 billion total assets of the financial sector at the end of 1998. The largest of the banks is PNGBC, which held 44 percent of the total assets of commercial banks.

Public sector financial institutions dominate the financial sector. In addition to BPNG and PNGBC, the Government owns the Motor Vehicle Insurance Trust, Niugini Insurance Corporation, the Rural Development Bank (RDBPNG), the National Provident Fund (PNGNPF), the Public Officers' Superannuation Fund (POSF), and the Investment Corporation. These institutions have maintained around a two-thirds share of financial sector assets for more than 10 years.

The Investment Corporation, created by Parliament in 1971, is a statutory corporation that has investments of its own, but also runs a separate investment fund established under the 1973 Investment Corporation (Unit Trust) Ordinance. The Corporation's primary objective is to provide for equity holdings by eligible persons in domestic enterprises in cases where the corporation believes that it is in the country's long-term interest, and where significant equity holdings would not otherwise be readily achieved. The Corporation has the power to borrow and lend money; subscribe and dispose of shares and securities; provide guarantees; underwrite share issues; appoint its own board members; form companies and subsidiaries; and establish and manage investment companies, unit trusts, and other mutual funds. It receives no budgetary support. However, because of misappropriation of funds and lack of fresh capital, there has been little new investment in recent years, and no dividends have been paid to the Government. In the late 1990s, a new managing director and board were appointed.

For the vast majority of citizens, access to financial services is poor. The number of bank branches and agencies has fallen from 400 in the 1980s to 139 in 1996, mainly because of law and order problems. There are 32,889 people per bank office in PNG—by far the highest number of persons per bank in any of the PDMCs.

PERFORMANCE OF FINANCIAL INSTITUTIONS[14]

There are major differences in the performance of individual financial institutions. All Government-owned financial institutions failed to achieve positive real rates of return in the

[14] At present, ANZ, Bank of Hawaii, and Westpac do not report their financial results to BPNG in detail, so it is difficult to obtain detailed information on these banks.

1990s, and their capital levels declined. Most Government agricultural lending schemes have failed; in 1996, the Government had to rescue the RDBPNG from insolvency. In 1998, RDBPNG was merged with PNGBC, along with the Motor Vehicle Insurance Trust and Niugini Insurance Corporation. The merger significantly improved the capital structure of the bank and the group.

Papua New Guinea Banking Corporation

The poor performance of PNGBC over the 1990s was related to the high level of nonperforming loans. This in turn reflected a number of bad loans made as a result of political pressure and Government direction, a high cost structure related to high personnel costs, and the high costs of premises. Substantial write-offs were made in 1992–93 and in 1998. There was some recovery in profitability in the late 1990s, because of interest earned on PNGBC's large holdings of Government securities, but concerns remained over the quality of its loan portfolio and its subjection to continued political intervention. These issues will need to be addressed before the Government can go ahead with privatization. In all Government-owned or -controlled financial institutions, governance is the most important issue.

Bank of South Pacific

Shareholder funds in BSP had risen from K8.3 million to K56 million by the end of 1999. BSP's interest margins are around 6 percent and it has a general provision of 2.5 percent (K7 million), which is quite conservative. In 1991, its market share was 5 percent; it is now over 18 percent. This growth has been achieved by putting emphasis on service and by having continuity of management, through which the bank has gained experience of their customers and in their business. Overseas banks, with constant changes in management, lose local knowledge and experience. However, BSP needs additional capital, around K15 million, and would welcome an owner that could give it access to sources of foreign exchange.

ANZ and Westpac

ANZ and Westpac are well managed and deal with the corporate end of the market. This gives them significant access to foreign exchange. In 1999, ANZ made K20 million profit from foreign exchange transactions (compared with BSP which made only K6.5 million). Westpac repatriates profits, but avoids the 25-percent restriction on shareholder funds by having a parent guarantee.

Costs for all banks have increased substantially as a result of the law and order situation. Air Nuigini has refused to carry cash because it is worried about theft and hi-jacking. This has meant that banks have to hold increased cash levels at each branch and use charter flights to adjust liquidity. Freight costs are likely to increase further. Banks also have had to fit bullet-proof glass at all branches, or restrict access through the "air lock" approach.[15]

FINANCIAL DEEPENING AND INTERMEDIATION

There was little financial deepening in the 1990s. The ratio of broad money to GDP was 30.0 percent of GDP in 1994 and rose to 31.1 percent of GDP in 1999 (Table 4.2). During the same period, the ratio of quasi money to broad money fell from 65.7 percent to 57.2 percent, with savings deposits virtually stagnating and term deposits rising only because of proceeds from the public float of a mining company. Narrow money rose as a percentage of broad money from 34.3 to 42.8, with a slight shift from demand deposits to currency.

Total domestic credit accounted for just over 80 percent of the total money supply in 1999. Of this amount, approximately 54 percent was credit to the private sector, which represents a relatively modest use of loanable funds for the private sector. After growing at around 10 percent a year in the 1980s, the

[15] The 'air lock' is a small glass entrance lobby. The door into the bank will not open until the door from the street has closed, and similarly upon exit.

average annual growth in commercial bank credit to the private sector (including State-owned enterprises) in 1992–1999 fell to just over 6 percent in nominal terms (BPNG 2000). Since the average annual inflation rate was 10 percent per year during this period, that represented a decline in real terms. This slowdown reflected a loss of business confidence and crowding out by the public sector, as well as the closing of bank branches.

Lending in PNG remains focused on urban areas, particularly to foreign businesses. Lending to the agriculture sector has declined substantially in recent years, reflecting the large-scale default on agricultural debt in the early 1990s, coupled with mounting costs of maintaining rural branches (because of law and order problems), and of realizing collateral (particularly in land). At the end of 1999, the commercial banks' outstanding advances comprised 7.8 percent for agriculture, forestry and fishing; 3.9 percent for manufacturing; 3.9 percent for finance; 20.5 percent for commerce; 11.0 percent for transport and communication; 3.4 percent for building and construction; 36.8 percent for other businesses (including service businesses and utilities); and 11.1 percent for personal loans. Total advances to Government were under 2 percent.

There is a lack of savings instruments: retail savers and investors are generally limited to deposit accounts with commercial banks at negative real interest rates.

Since 1994, there has been a serious distortion in the interest rate structure, reflecting growing country risk and increasing unwillingness to hold Government debt, as noted above. In 1995, 1997, 1998, and 1999, Treasury bill rates have been as much as 5 percent above commercial lending rates, and also above the commercial banks' first mortgage lending rates. In 1999, banks were paying around 8 percent on deposits and receiving 26 percent on Treasury bills. Since early 2000, however, BPNG has been reducing interest rates, and the level of bank deposits has fallen. Distorted incentives have also been created by the different tax rates on financial instruments, for example between Government securities, bank interest, pension fund earnings, and capital gains.

Table 4.2

Financial Intermediation Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
	(in millions of kina)					
Money Supply (M2) [a]	1664.7	1842.2	2431.6	2598.2	2645.8	2,880.0
Narrow Money (M1)	571.3	645.9	864.9	919.5	1021.3	1233.7
Currency outside banks	166.2	180.5	208.1	225.0	276.9	342.5
Demand Deposits	405.1	465.3	656.8	694.5	744.4	891.2
Quasi Money	1093.4	1196.4	1566.7	1678.7	1624.5	1646.3
Savings Deposits	269.8	272.7	312.0	329.8	333.9	305.6
Time Deposits	823.6	923.7	1254.7	1348.9	1290.6	1340.7
	(in percent)					
Growth of Demand Deposits	—	14.9	41.2	5.7	7.2	19.7
Growth of Time Deposits	—	12.2	35.8	7.5	-4.3	3.9
Growth in Private Sector Credit	5.7	-1.0	-7.8	36.3	29.0	10.6
	(in percent of GDP)					
Currency in percent of GDP	3.0	2.9	3.0	3.3	3.6	3.7
Narrow Money in percent of GDP	10.3	10.2	12.5	13.5	13.2	13.3
Broad Money in percent of GDP	30.0	29.2	35.2	38.1	34.3	31.1
	(in percent)					
Private Sector Credit (percent of GDP)	15.4	13.4	11.3	15.6	17.8	16.4
Private Sector Credit (percent of total credit)	48.8	47.7	41.3	45.9	50.5	53.7
Currency (per cent of broad money)	10.0	9.8	8.6	8.7	10.5	11.9
Narrow Money (percent of broad money)	34.3	35.1	35.6	35.4	38.6	42.8
Quasi Money (percent of broad money)	65.7	64.9	64.4	64.6	61.4	57.2
Demand Deposits (% of narrow money)	70.9	72.1	75.9	75.5	72.9	72.2
Total Domestic Credit/ Banking Assets	82.9	78.1	68.8	75.7	80.7	—
Currency in circulation per capita	39.6	42.0	47.3	50.0	60.1	67.1

— Not available.
a. Exclusive of other items (net).
Source: BPNG 1999.

Interest rates on both deposits and lending increased between 1994 and 1999. Weighted average rates on deposits rose from 4.5 percent to 8.5 percent, while the weighted average lending rate increased from 10.0 percent to 18.2 percent (Table 4.3). Lending rates have generally been positive in real terms, but deposit rates have been negative. The nominal interest rate spread rose from 7.7 percent in 1994 to 9.7 percent in 1999. In real terms, the spread rose from 5.5 percent to 9.7 percent. Net interest margins (net interest income as a percentage of average earning assets) for the commercial banks increased from around 6 percent in 1994 to 11.5 percent in 1998 and 10.3 percent by mid-1999.

COMPETITION

Imperfect competition in the banking sector is the inevitable outcome of the small size of the domestic market and the consequent diseconomies of scale. Savers are therefore faced with a limited range of savings instruments, and have been discouraged by negative real deposit rates. The foreign commercial banks have focused their lending on large corporations with foreign links, while the Government-owned PNGBC has focused on serving the resident market, accounting for 50 percent of the loans and deposits of the banking sector.

PNGBC has relatively low profitability because of a high level of nonperforming loans and a high cost structure (personnel costs are one-and-a-half times as high as the other banks'). Substantial write-offs were made in 1992–93 and 1998. Much of PNGBC's lending is noncommercial and is politically motivated. In addition, it receives income from BPNG in a nontransparent manner.

The prospects of increasing competition are dimmed by the slow growth in the real economy, the high intermediation cost structure caused by the lack of security and poor infrastructure, high sovereign risk, and the risks of lending to new borrowers in rural areas. The deterioration in rural financial infrastructure is related to increasing law and order problems and land tenure problems. Most banks are considering further reducing the number of branches and agencies in rural areas.

Table 4.3

Savings and Lending Rates, 1993–1999
(percent)

	Weighted Average Deposit Rates	Weighted Average Lending Rates	Treasury Bill Rate (182 days) Rates	Inflation Rate	Real Deposit Rates	Real Lending Spread	Nominal Interest
1994	4.50	10.00	10.75	2.8	1.7	7.2	5.5
1995	9.40	15.40	21.48	17.2	-7.8	-1.8	6.0
1996	4.00	10.20	9.19	11.9	-7.9	-1.7	6.2
1997	5.10	10.60	14.50	3.9	1.2	6.7	5.5
1998	8.70	20.20	23.94	13.5	-4.8	6.7	11.5
1999	8.50	18.20	20.44	14.9	-6.4	3.3	9.7

Source: BPNG 2000.

Neither money markets nor securities markets are well developed. Although some long-term Government bonds may be available for the public, there are almost no long-term instruments.[16] Most of the short-term Treasury bills are available only to commercial banks. There is no yield curve. Corporate capital market institutions have not developed because of the lack of a developed capital market. With the failure of small, poorly regulated financial institutions, such as savings and loan societies, and the perception of high risk, there are now few savings opportunities to citizens who live outside the urban areas.

The lack of efficient and competitive nonbank financial institutions (NBFIs) has also inhibited competition. While some new NBFIs have entered the financial sector in recent years, and while local ownership of finance companies is strong, market share for NBFIs fell from 12 percent of financial sector assets in 1990 to 7.6 percent in 1998. Mismanagement of RDBPNG and the poor performance of savings and loan societies are partly responsible for the decline, and prudential supervision of NBFIs needs to be improved. The decline in NBFIs' market share is

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[16] The volatile interest rates and exchange rates that have been the experience of the 1990s have tended to shorten the maturity of securities held and have constrained the development of longer-term debt instruments.

matched by the gain in market share of the commercial banks; this has been partly due to the expansion of PNGSB, but also to the expansion of the Treasury bill market.

NONBANK FINANCIAL INSTITUTIONS

National Provident Funds

There are not one but three national provident funds: PNGNPF covers all private sector employees and POSF covers all public servants. Their boards include the Secretary to the Treasury and representatives of both employers and employees. There is also a Defence Force Retirement Fund of PNG.

Papua New Guinea National Provident Fund. PNGNPF was established in 1991 by an Act of Parliament. It makes pension provisions for private sector workers. The act was revised in the mid-1990s to permit employers to opt out; some companies now run their own funds. There are also some independent pension providers. Unless they have opted out, companies are required to contribute to NPF if they have more than 20 employees. Some companies that are smaller than this contribute on a voluntary basis. However, many smaller companies that are required to pay are not now making their contributions.

Both employers and employees are required to contribute 5 percent of employees' income to the fund. The employee may contribute an additional 5 percent of income, but this is not matched by the employer. Members can withdraw all their contributions and up to one third of the employer's contributions to buy or renovate a house, and they may withdraw any additional funds they have contributed to pay school fees. If a member has been unemployed for six months, he or she is permitted to withdraw all employee contributions and some employer's contributions, according to a sliding scale, with the maximum payable only if the employee has been employed for 15 years or more. If the maximum is not paid out, the balance is forfeited to the fund. New rules are being proposed which would allow the balance to remain in the member's account.

PNGNPF produced investment guidelines in 1993, but did not adhere to them. Despite not having the authority to borrow or to pledge members' assets, management borrowed to invest in Australia and in local mining companies and, under Government directives, to lend money to the Government. However, the investments were not profitable and the borrowing was costly because of high interest charges and adverse changes in the kina exchange rate. By 1999, PNGNPF had accumulated substantial losses. Under a new general manager, it began selling nonperforming assets to repay loans, but soon reached the point where it had to contemplate selling some performing assets. In 1998 and 1999, there were losses equivalent to 60 percent of members' balances.

In 2000, PNGNPF's financial difficulties became public knowledge. The PNGNPF board was replaced and a commission appointed to review management and governance practices. A proposal to write down members' accounts by 50 percent to bring them into line with the actual value of fund assets was subject to legal challenge. The new management proposed some new guidelines to the board, which involved concentrating on blue chip investments, where they would not hold a stake of more than 10 percent. This would be a significant change with the past. At present, the 1991 act stipulates that the Government appoint the chairman and two other board members; in addition, there are two representatives of employers and employees. Management recommended that this be changed so that the Government appoints only one member, the number of employee and employer members increase by one each, and the Government -appointed member is not the chairman.

Public Officers' Superannuation Fund. POSF was established in 1991. Its board consists of the managing director, who is appointed by the Government, three Government representatives, and three employee representatives. POSF requires 6 percent contributions from members. The Government contribution is deferred until benefits become payable and is then 1.4 times the employee's accumulated contribution inclusive of interest. Members may borrow on their accounts only for housing. Like PNGNPF members, they are not required to repay the sums if they sell (which is a rare event). POSF also provides life insurance for its members. When they retire, members may take a lump sum or a pension, or a combination of the two. The majority take the lump sum, despite advice from POSF management to take the pension. One problem is that most people when they retire return to their villages, where remoteness makes the process of collecting the pension difficult. It is also expensive for POSF in terms of payments.

POSF's performance during the 1990s was poor. It earned less than the interest rate on savings accounts, which meant a negative real rate of return. This poor outcome was attributable to Government-designed investment guidelines that emphasized social policy goals, and failures of corporate governance and auditing. The Fund was placed under new management in 1999.

POSF and PNGNPF have been, and remain, major means of mobilizing savings, facilitating private sector investment, and providing a social safety net. However, they have underperformed because of poor governance and political influence on decision making. The funds were reviewed in 2000 with a view to producing plans for improvement, and in December a National Provident Fund (Financial Reconstruction) Bill was enacted. This became effective in January 2001 and provided for a 15-percent write-down of members' balances as at the end of December 1999; a quarterly Government grant of one million kina for 15 years (indexed to the CPI); and an additional employer levy of 2 percent for the period 1 January 2001 to 31 December 2003. PNGNPF's insolvency problem was thus solved, but returns on assets needed to improve.

Rural Development Bank of PNG

A rural development bank was established in 1965 as a statutory corporation called Papua New Guinea Development Bank. In 1984, the name was changed to the Agricultural Bank of Papua New Guinea to emphasize the importance of agriculture in the country's development. In 1994, the name was changed again to Rural Development Bank of Papua New Guinea (RDBPNG). A further change was made in 1998, when RDBPNG became the development-banking arm of FPG, with the objective of improving RDBPNG's performance, which has been very poor in recent years (Table 4.4). The poor performance and continual changes in name and reporting have had an unsettling effect on management and staff.

Table 4.4

Operating Performance of RDBPNG, 1995–1999

	1995	1996	1997	1998	1999 (forecast)
			(thousands of kina)		
Total Income	11,064	12,965	12,232	15,084	5,392
Total Expenses	10,288	9,120	7,926	9,167	5,997
Net Profit/(Loss) before tax	-3,753	-1,165	-929	-20,866	605
Total Assets	77,931	92,722	97,626	87,493	45,694
Share Capital	32,618	76,974	76,975	76,975	10,183
Shareholder Funds	-14,663	57,734	57,624	44,052	13,862
Provisions for Loan Losses	-45,868	-46,860	-78,407	-102,151	-10,405
			(percent)		
Interest Spread	7.08	6.54		5.37	1.95
Earnings Spread	2.72	1.39	2.07	0.80	0.22
Loans related Expenses to Total Expenses	48	51	60	72	48
Staff Expenses to Total Expenses	26	23	20	14	28
Administration Expenses to Total Expenses	27	26	21	14	24
Profit/Loss to Average Shareholders' Funds		-7.4	-1.6	-31.3	5.0

Source: RDBPNG 1998.

The main reason for the declining performance has been the substantial increases in provisions for bad and doubtful loans, from K45 million in 1995 to K102 million in 1999. Against this, the ratio of expenses to income has been improving.

RDBPNG operates with a regional distribution structure, with each region set up as a profit center. At the present time there are four regions controlling 12 branches, with a further two branches located in Port Moresby. In addition, there are eight representative points located throughout the regions. The Highlands region is the largest in terms of activity as measured by loan approvals. RDBPNG's organizational structure consists of three departments and nine divisions. This level of infrastructure is high relative to the size of RDBPNG, and is expected to be rationalized following the integration with FPG.

RDBPNG currently retains a separate board, despite being integrated with FPG. The board consists of 10 members, including the Managing Director of RDBPNG, the Managing Director of PNGBC, and the Managing Director of the Motor Vehicle Insurance Trust. An alternate director comes from the Department of Treasury and Planning, while the chairman comes from the private sector. The board is appointed by the Government.

RDBPNG's annual reports, while giving comprehensive information on lending activity in terms of loan approvals by district and industry sector, lack information on expense breakdowns, as well as information on directors. The Reports for 1997 and 1998 were qualified by the Auditor General because of the lack of information on the adequacy of provisioning. The lack of formal reporting to the central bank also indicated a need for improved disclosure of the financial status of RDBPNG. The stance of the Auditor General appears to have been justified: general provisions had to be increased by some K28 million following a review of the loan portfolio. There are also major delays in the release of information: financial information and reports are often more than 12 months old by the time they are published. This makes it difficult for the stakeholders to obtain a current view of performance.

Part of the funding for the RDBPNG comes from the issuing of Agricultural Bank bonds. However, most funding comes from the Government, which also on-lends funds from donor agencies.

LEGAL AND REGULATORY FRAMEWORK, SUPERVISION, AND CENTRAL BANK AUTONOMY

A new Central Bank Act was passed in April 2000 that increases the independence of the BPNG, which had been previously subject to Government intervention. The Banks and Financial Institutions Act was also revised in order to strengthen BPNG's powers of supervision, regulation, and licensing of bank and nonbank financial intermediaries. Pyramid schemes that had developed in early 1999 with the approval of the Government are no longer condoned by the new administration, which has initiated action leading to the liquidation of the two largest schemes, and which has outlawed them under the revised Banks and Financial Institutions Act. In addition, regulation and supervision of the pension and insurance industries will be strengthened through a new Insurance and Superannuation Act.

BPNG has adopted a capital adequacy ratio for commercial banks in accordance with the Basle core principles. At present, the ratio is 8 percent of risk-weighted assets, of which at least 4 percent must be core capital. BPNG is seeking to increase the ratio to 10 percent for international banks and 12 percent for local banks (because they do not have the asset backing from the overseas parent). In addition, liquid assets (including Government securities) with less than three years to maturity must be maintained at or above a predetermined percentage of deposits and prescribed liabilities. Banks must also at all times maintain shareholders' funds that exceed the sum of fixed assets plus investments in nongovernment securities and loans to subsidiary companies.

All banks are locally incorporated, which is a regulatory requirement; but only two of them are locally owned. BPNG receives many applications to start banks, but these do not meet the criteria for granting banking licenses. The criteria include

(i) local incorporation;
(ii) minimum capitalization levels;
(iii) good, experienced management;
(iv) good structure and corporate governance arrangements;
(v) provision of alternative product lines to the existing banks; and
(vi) "fit and proper" owners.

A lack of skilled human resources is a major constraint on effective supervision: although BPNG has restructured its supervision department, vacancies were and are hard to fill. In addition, BPNG needs to develop procedures manuals and to have greater power to demand accurate and timely reporting from banks.

The Securities Act of 1997 establishes the Securities Commission of Papua New Guinea (SCPNG), with responsibility for licensing stockbrokers and stock exchanges, regulating the public issue of securities, and regulating takeovers and mergers. Under the act, the chairman of the SCPNG board reports to the Minister of Commerce and Industry. However, the commission at present forms part of the Investment Promotion Authority: it does not have an independent source of funding or an independent board. In addition, the staff of the commission have departmental responsibilities within the authority. This is not in accordance with sound practice, and the SCPNG should be established with an independent board, independent budget, and full-time staff.

Under the same legislation, the Port Moresby Stock Exchange (POMSoX) is established as a self-regulatory body. The SCPNG has the power to instruct it to make or change rules, but rule changes do not generally require prior approval. SCPNG has the responsibility for registering the prospectus when a company wants to make a public offer. Registration involves listing on the exchange. The relationship between regulators and self-regulatory bodies is complex and needs well-trained and experienced people on both sides.

DEVELOPMENT OF MONEY AND BOND MARKETS

Monetary policy in PNG is conducted through the issue of Treasury Bills once a year. Until November 1999, the Government borrowed throughout the year from BPNG, then made an issue of bills to BPNG at the end of the year to cover the balance. BPNG either held the bills or auctioned them to the commercial banks. Under the old Banking Act, the BPNG could fund the Government up to 20 percent of ordinary revenue over the year, and up to 25 percent with ministerial approval. The new Banking Act, which was passed in November 1999, limits the amount that BPNG can lend to the Government to K100 million, and specifies that this must be charged at market rates and repaid within six months. The Government issues Treasury bills with maturities of 28, 63, 91, and 182 days. BPNG does not issue its own bills.

Since 1995, BPNG has also auctioned Kina auction notes with a maturity of seven days. The weekly kina auctions allowed BPNG to sell and buy money as a means of managing short-term liquidity and influencing interest rates, thus performing a similar function to that of short-term central bank bills. Initially, BPNG set both the interest rate and the quantity of kina bought and sold; but in March 1998, BPNG changed its auction and now announces the auction amount, leaving the interest rate to be determined by the market. However, the usefulness of the kina auctions was reduced in September 1999, when the auction amount was capped at 10 million kina. The auctions had encouraged the banks to move out of Treasury bills and into the notes.

The other main instrument used for monetary policy is the Minimum Liquid Asset Ratio (MLAR), which, as noted above, has been altered frequently since its introduction in early 1999 in order to enable the Government to fund the budget deficit. At present, the MLAR requires all banks to hold 25 percent of total deposits with BPNG. The banks provide daily liquidity reports, and no interest is paid by BPNG on balances.

In August 1998, BPNG also introduced the Cash Reserve Requirement, which required all commercial banks to maintain 10 percent of deposits (including foreign currency deposits) at BPNG at no interest. In March 1999, this was reduced to 5 percent and is seen as an implicit tax on banks to reduce the profitability of holding Treasury bills.

BPNG has tried to separate the Government's financing needs from the liquidity management process. BPNG uses a portion of its Treasury bills for liquidity management; it now auctions such bills on a weekly basis. In some cases, it specifies the series that are available; in others, it allows the banks to nominate both the series and the rate. The bills are largely bought by the commercial banks, but occasionally the POSF or the insurance companies will bid. PNGNPF used to bid when it had sufficient funds. Although BPNG ceased to offer a rediscount facility in 1995, in order to encourage trading in the secondary market, there is not an active secondary market in Treasury bills. However, overdrawn accounts at BPNG are very common. The commercial banks also borrow on the interbank market.

In an effort to encourage competition in the money market, a tap issue facility was introduced in August 1998 to permit NBFIs and the public to purchase Treasury bills. The Government has issued K160 million through this mechanism; the yields on the tap facility are determined by the previous weekly auction. BPNG uses the tap for liquidity management.

The Government has some inscribed bonds on issue (of various maturities longer than three years), but no new bonds have been issued since 1993–1994. The bonds were low-yielding and BPNG holds over 50 percent of the outstanding balance of K246 million. The remaining balance is held by the insurance companies and pension funds. About 20 series are outstanding; about K40 million mature each year, and the last issue will mature in 2006.

A few years ago, BPNG restructured around K40 million of Government bonds by increasing the interest rate and reducing the number of series, and offered the BPNG holding to the private sector. However, the offer was not fully subscribed and there is practically no market for long-term Government bonds; the combination of short-term outlook on the part of investors and the relatively low yield offered is not attractive to investors. For these reasons there is no secondary market for Government bonds.

DEVELOPMENT OF DEBT AND CAPITAL MARKETS

Under the Companies Act, all companies are required to file annual returns and annual accounts with the Registrar of Companies, which is part of the Investment Promotion Authority. The systems for company registration are in place and the registrar is starting to chase outstanding returns. There is an Association of Accountants in PNG.

Port Moresby Stock Exchange

The Securities Act of 1997 and SCPNG were discussed above; also described was the legal framework within which POMSoX operates. POMSoX is owned by two stockbrokers (Kina Securities and Capital Stockbrokers) and by BPNG. The initial capital was K200,000 from each owner. In addition to representatives of the owners, POMSoX's board has an independent chairman, a representative of the listed companies, and an independent person.

There is a lack of clarity in the legislation about the role of owners and members. Originally most stock exchanges were clubs, and owners and members (those with access to the facilities offered by the exchange) were one and the same. Today, however, many exchanges, such as the Australian Stock Exchange (ASX), have "demutualized," so that ownership of the exchange is a commercial decision separate from access to trading and settlement facilities. POMSoX would like to extend access to its facilities to brokers located in Australia and New Zealand and potentially to other developed stock markets. At present, however, SCPNG views owners and members as synonymous; it had not considered that outside entities would want to become owners. This issue will need to be resolved for the benefit of POMSoX before a regional stock exchange facility can be considered.

The listing rules for POMSoX are based on, and are very similar to, the listing rules of the ASX. The major difference is that smaller companies are able to list on POMSoX. There are nine listed companies, eight of which are "exempt foreign companies," meaning that they are incorporated in Australia and have a primary listing on ASX. The ninth company is incorporated in Canada and is involved in a project to build a gas pipeline from PNG to Brisbane. The target companies for listing are the mining exploration companies, regardless of whether they are incorporated in PNG or elsewhere.

POMSoX needs to increase trading levels to 20,000 trades per month to break even. As yet, trading levels have not reached three figures, and a number of measures are being considered to try to increase trading. These include instituting a market-making system to provide additional liquidity, providing 24-hour trading so that overseas investors can trade around the clock, and approaching foreign brokers to trade on POMSoX by direct remote access.

At present, POMSoX does not consider listing existing domestic industrial and commercial companies that do not have a primary listing elsewhere. It could list some real estate assets, possibly through a property trust. The Government has provided incentives for investors by exempting stock exchange transactions from capital gains tax and stamp duty. However, as other countries have discovered, it is not the lack of potential investors but the lack of product that holds back exchange development. U-Vistract (a collapsing pyramid selling scheme) managed to attract K502 million in 12 months. This demonstrates that funds are available for investment if the product and the price are right.

Box 4.2

Foreign Investment Regulation

Overseas investors have many interests in PNG, particularly in mining and extraction. Companies that are more than 50-percent foreign-owned need approval from the Investment Promotion Authority to invest. Certain activities are reserved for citizens and only limited foreign investment—or none at all—is permitted. For example, foreigners may not invest in service stations and fast-food outlets at all, and they are limited to a 49-percent holding in companies operating supermarkets.

The Companies Act discriminates against foreign investment with regard to fees. A company with solely domestic investors pays K115. A company with a single foreign shareholder pays K515. Any transfer to a foreigner must be advised to the Registrar, and once the first transfer is made, the additional K400 is payable. This structure will work against the listing of domestic companies on a regional stock exchange.

POMSoX has an automated off-floor trading system that operates on the basis of order matching. At present, settlement is physical: there are neither depository facilities nor any trust law. The development of a central depository to permit settlement by book entry transfer is part of Phase II of the exchange's implementation plans. However, no work will be undertaken in this area until a review of international developments has been undertaken. POMSoX wishes to be a major shareholder in any depository company, to ensure control and integrity of the systems and procedures. The development of a book entry transfer system is seen as a priority in order to ensure smooth settlement and the integrity of the settlement system when volumes increase.

There is a considerable need for increased professionalism in all parts of the capital market. Brokers' staff members need training; company secretaries and directors need training in their existing Companies Act responsibilities, and, when appropriate, with their responsibilities as listed companies.

The Kula Fund

The Kula Fund, a regional venture capital fund operated by Commonwealth Development Corporation (CDC) and funded by it and ADB, IFC, EIB and other aid agencies and regional governments, has an agent in PNG who manages investments on its behalf and on behalf of CDC. At present, the funds are used for loans (70 percent) and equity investment (30 percent). A reversal of these percentages is sought. The Kula Fund currently has three investments in PNG. It is difficult for its managers to find projects with the size and potential return required. In 1999, there were 106 inquiries, of which 13 proved to be casual and 69 were rejected outright. During the year, two project approvals were completed and funds paid out, while two others were approved but funds were not drawn.

CDC once established a venture capital fund in PNG. It performed very badly because investment was in too many "start-ups" and the average investment size was too small. Also, monitoring and control of many small investments was difficult. Returns were not commensurate with the risk. The only exit strategy available was sale to the sponsor, so that a few years before the exit was due the business was wound down, at a sale price well below what was warranted by the ongoing potential profitability of the venture.

MICROFINANCE

Poverty in PNG has an important regional dimension: the vast majority of the poor (93.5 percent) live in rural areas. The Momase/North Coast region exhibits the highest incidence of poverty, with 45.8 percent of the population living below the poverty line. Poverty rates in the regions of Papua/South Coast, the Highlands, and the New Guinea Islands are 33.2 percent, 35.8 percent, and 33.6 percent, respectively. The urbanized

National Capital District has a poverty rate of 25.8 percent, and accounts for just 3.8 percent of the poor.

In addition to the fact that most poor households are located in relatively inaccessible rural areas, they exhibit some notable characteristics that suggest areas of potential poverty-alleviating interventions. There has been little, if any, human capital investment in three quarters of the poor households. The incidence of poverty is also linked to the ability to earn cash income to pay for nonfood items, to vary and improve diets, and to permit savings for times of economic difficulty (e.g., drought). Almost 17 percent of the poor live in households whose heads earn no cash income, relying entirely on subsistence production (and perhaps gifts of cash). The poverty rate for these households is 47 percent. Poverty rates are also above the national average for households that earn cash from hunting, gathering, and fishing, tree crops, and commercial agriculture.

More opportunities for earning secure cash incomes are needed in order to reduce the incidence and severity of poverty. Both the extent of income-earning opportunities and the ability to respond to such opportunities are determined to a significant degree by access to the basic public services of transport, utilities, health care, and education. Access to credit facilities is also important, particularly for people in the informal sector, which must be regarded as poor people's primary source of income-earning opportunities.

Total employment in the formal, nonmining private sector was virtually stagnant between 1989 and 1999. It has been estimated that, assuming continued zero growth in public sector employment, private sector employment would have to expand at the impossible sustained annual rate of about 28 percent in order to absorb all new entrants to the labor force (ADB 1998). Negligible formal sector employment growth has caused a marked increase in unemployment. The urban unemployment rate rose from 9 percent in 1980 to 35 percent in 1990, and has risen further in the 1990s as rural-urban migration has continued. The rural unemployment rate rose from 21 percent in 1980 to 38 percent in 1990 (AusAID 1998). Since only 15 percent of the total labor force was in wage employment in 1990, making inroads on the unemployment problem and creating job opportunities for future new entrants will require development of the informal sector in urban and, particularly, rural areas. The focus must be on semisubsistence agriculture and must encompass access to markets and credit. In 1997, only 30 percent of PNG's population held deposit accounts with commercial banks, and less than 1 percent had loans with commercial banks. The formal financial sector's service to rural areas has declined because of the high costs involved, repayment risk, and law and order concerns.

Informal Sector

At present, the available microfinance institutions (MFIs) fall into three sectors: informal, semiformal and formal. Informal sector MFIs in PNG are not regulated by legislation or recorded in national official statistics, so that there is not much information about them. They include the extended family, self-help groups, and moneylenders. The major sources of informal credit are the extended family or network of friends or neighbors called *wantok*. The *wantok* system has the capacity to mobilize large sums of money, especially to assist a relative wanting to start a business.

Self-help groups include *wok meri* (women's groups), which have been operating in the Eastern Highlands for more than three decades. Members of the group pool their savings and make them available for lending, with or without interest, and mostly for village-based businesses. Members usually have traditional links based on intermarriage to men of the same lineage and tend to include older and less educated women. The main benefit of belonging to *wok meri* is that the women were able to take on the prestigious role of ceremonial transactor, from which they had traditionally been excluded. In Sande, a small group of three or four individuals, usually women in wage employment, meet every payday and contribute equal amounts of money, which they give to one member. This is done on a rotational basis until all members have had their turn.

Moneylenders operate in PNG, especially in the highland and urban areas, and the number is increasing. Anecdotal evidence shows that they charge very high interest rates for short-term loans. Moneylending is not governed by specific legislation, such as the Moneylending Act in the Fiji Islands, but moneylenders do have to obtain a license to operate as a financial institution pursuant to the Banks and Financial Institutions Act.

Semiformal sector

Semiformal sector MFIs include the savings and loan societies and nongovernment organizations (NGOs).

Savings and Loan Societies. The Reserve Bank of Australia initiated the Savings and Loan Society movement in May 1961 and the Savings and Loans Societies Act was enacted in January 1962. Various societies all over PNG formed themselves into a federation in March 1966. Savings and loan societies are similar to credit unions and are now governed by the Savings and Loan Societies Act of 1980 (amended in 1995). They provide savings and loan services only to their members; minimum membership is 500 persons. To join, a member has to acquire one share. Savings are compulsory and are usually made through payroll deduction, especially for employee-based societies. Members of community-based societies pay their savings personally.

Lending policies of savings and loan societies are made in consultation with the members and vary among societies. Loans are charged interest at 1 percent per month on a reducing balance; usually no other fees are charged. The savings of the members serve as security and, in most cases, no collateral or other security is required to obtain a loan. Interest on deposits is as much as 7 percent per year. From 1962 until 1972, the movement was very active, with 320 societies, more than 17,000 members, and savings of K1.5 million. After 1991, however, the movement shifted its emphasis from providing savings and loans to its members to depending on other investments to cover operating expenses. There were also management problems. Loan delinquency increased and most societies in rural areas became dormant.

Concerned about the deterioration of the movement, BPNG initiated a five-year revitalization program, which is supported by the Credit Union Foundation of Australia and the Ocean Confederation of Credit Union Leagues, through the Hans Seidel Foundation. Revitalization is ongoing. A number of provincial Governments are supporting the revitalization program and are making progress in setting up province-based societies.

As of December 1999, there were 21 active and 76 dormant societies. The Governor of the central bank is now the designated Registrar of Savings and Loan Societies pursuant to the act of 1995.

NGOs. NGOs are required to register in order to operate as a company or business under the Companies Act administered by the Investment Promotion Authority. Strictly speaking, only banks and the savings and loans societies are specifically authorized to accept savings and lend money. In practice, NGOs are allowed to carry out microfinance activities, although most are limited to extending credit only. Once a financial institution starts to accept savings, it must obtain a license to operate as a financial institution under the Banks and Financial Institutions Act. Thus, there is no legal framework for NGOs' involvement in microfinance.

Three NGOs operate microfinance schemes: Liklik Dinau Abitore Trust (LLDAT); Women's Councils, through Mere Dinau Associations; and the Lutheran Development Service. LLDAT was established in 1994 and is the first Grameen Bank replicator in PNG. It operates a small head office in Goroka, Eastern Province, and two branches, targeting exclusively disadvantaged women and solidarity groups, and guaranteeing the loans of the members with compulsory savings by group members. By the end of 1997, LLDAT had 52 centers with 889 members. This falls short of the original plan of establishing a Trust Head Office at Port Moresby and 12 operational branches in different provinces within a three-year period ending in 1997. LLDAT is registered as a trust, is governed by seven trustees, and has relied on expatriate management. There is a need to build local managerial capacity; but the most pressing issue is to obtain formal authority to accept savings. LLDAT has not reached viability or sustainability: it relies on Government and donor funds, and had achieved just 18.2 per cent operational self-sufficiency and 16.9 percent financial self-sufficiency as of 1995, although its loan repayment rate was better than that of other microfinance schemes in PDMCs.

Women's Councils/Mere Dinau Associations were involved in the piloting of a credit scheme exclusively for women in East Sepik and Simbu provinces in 1998, but has yet to be firmly established on a significant scale. The Lutheran Church Development Service has launched the "Putim na Kisim", which is a credit cooperative scheme to revive thrift and credit cooperatives in rural areas. This is being implemented in collaboration with the central bank, the PNG Federation of Savings and Loans Societies, the Hans Seidel Foundation, and the Credit Union Foundation of Australia. The project involves initial training, establishment and consolidation of groups, with internal savings mobilization and lending out of savings. There have been four successful pilots in Morobe, where group savings were used to finance group businesses. Groups managed their own affairs including costs of operation.

Formal Sector

In the formal sector, as noted above, the network of branches and agencies of commercial banks has declined from 305 to 138, while RDBPNG outlets have fallen from 37 to 20. However, the PNGBC has the potential of being a significant provider of rural finance and microfinance in the future, because of its takeover of the RDB, and because of the proposed establishment of a village bank network offering a small number of well-defined products of interest to lower-income households.

In September 2000, the Cabinet approved a Microfinance and Employment Policy whose objective is to provide sustainable microfinance services to viable formal and informal enterprises and savings services and the general population. Achieving this objective will involve capacity building of MFIs through a Microfinance Competence Center; the development, testing and implementation of new savings and loan products and delivery methods; and the provision of a Revolving Finance Facility. This initiative is supported by an ADB loan approved in October 2000.

At present, there is a growing interest in microfinance on the part of the Government, donor agencies, church organizations, NGOs, and civil society. There is also an unmet demand for microfinance, especially by those who have difficulty accessing financial services from banks and other financial institutions, and those who are unable to find paid employment.

LAND OWNERSHIP STRUCTURE

Land ownership in PNG falls into four categories: (i) State land vested in the Government; (ii) freehold land held indefinitely free of restrictions; (iii) converted customary land held indefinitely but subject to some restrictions as to sale, lease and mortgage that may be waived by the Minister; and (iv) customary land held by indigenous Papua New Guineans under principles of customary land tenure.

It is estimated that 97 percent of the land in PNG is under customary ownership, 1.5 percent is freehold land, and 1.5 percent is State and converted customary land. Customary land, which is integral to PNG's culture, is owned by clans. There are varying degrees of "ownership" rights, such as cultivation, hunting, or use of trees. Customary land can be sold only to the Government.

State Land and Freehold Land

Legislation (Land Act 1962 and Land Act 1996) has provided that all land other than customary land is State land subject to any estates, rights, titles, or interests in force under the law. Although State lands include freehold land, the latter is normally treated separately, since it is usually held by private individuals. State land has been acquired from indigenous owners by purchase or lease; the acquisition may be by voluntary agreement or by compulsory acquisition subject to payment of compensation under the Land Act 1996. Claims for compensation are determined by the Land Titles Commission and are subject to appeal. The Minister of Lands may declare land to be State land if he is satisfied that land is not customary land. Disputes are determined by the Land Titles Commission, subject to appeal to the High Court. There are complaints of fraudulent declarations by ministers vesting customary land in the State that really belongs to indigenous people.

The Minister of Lands is authorized to grant leases of State land and to grant leases of customary land that has been leased to the State by custom owners. Leases must be advertised and be considered by a Land Board, which is authorized to make recommendations to the minister. Special agricultural or business leases of customary land may be granted by the minister for up to 99 years, without consideration by the Land Board, to any person, incorporated body, or business group that is approved by the custom owners. These leases are called "lease-back" leases: they enable the custom owners to acquire a leasehold interest themselves, or to allow a land group or business group approved by them to do so. All State leases must be registered in the Register of Titles and in the Register of State Leases.

The PNG Constitution provides that only citizens and citizen corporations may hold freehold estates in land. Citizen corporations were defined by Parliament to mean the State, provincial Governments, local Government councils and authorities, incorporated land groups and business groups, and other corporations declared by Parliament. Freehold land may be leased, but the leases must be registered under the Land Registration Act, subject to the rights of a tenant. Freehold land and leaseholds of freehold land may be mortgaged, but such mortgage is to take effect as a charge rather than as a transfer of land. A mortgage must be registered in the Register of Titles in order to be effective.

Customary Land

Although nearly all customary land is held jointly by the members of groups of indigenous people, the Commission on Land Matters, established in 1973, reported that the size and basis of the indigenous landowning groups in Papua New Guinea varies greatly. Sometimes they are tribes or clans linked by kinship, sometimes they are smaller groups of families also linked by kinship, and sometimes they are villages or localities. In addition, members of other groups might have subsidiary rights or interests in the land. The Commission on Land Matters has recommended in favor of systematic registration of customary land in selected areas. However, no action has yet been taken.

Customary land can be converted into freehold land under the Land (Tenure Conversion) Act providing, first, that all interested persons agree to apply to the Land Title Commission; second, that adequate provision by way of compensation or otherwise is made to those whose interests will be abolished or reduced; and, third, that adequate land will be left for the support of its owners. The Commission may then make an order releasing the land from custom ownership. Land that is converted in this way ceases to be customary land and becomes a form of limited freehold land. Converted customary land can be transferred by sale or gift, but it cannot be leased for more than 25 years without the consent of the Land Board, unless the Minister of Lands waives this restriction. Converted customary land can also be mortgaged. But if there is default, the mortgagee cannot enter into possession for more than 25 years, or lease the land to another person for more than 25 years. Nor can the mortgagee prevent the mortgagor from redeeming the property, unless the Minister of Lands agrees to waive these restrictions. In practice, it appears that the Minister of Lands is usually prepared to waive these restrictions on the leasing and mortgaging of converted customary land.

The concept of tenure conversion seems to be quite well known, and many applications have been received by the Commission to convert customary land to freehold land. However, because of funding and staffing difficulties, the Land Title Commission is able to deal with only about a quarter of the applications for conversion that it receives. Legislation has also been in force for many years to allow liens or mortgages to be granted on crops and livestock and their products, although this is rarely used by borrowers or lending institutions.

The customs of most landowning groups require that decisions be unanimous and agreed to by all members of the group. This has several problematic aspects. First, the chiefs and elders of the group will often tend to dominate the decision making, and force decisions upon other members of the group that are not in their best interests. Second, chiefs and elders may represent themselves as agents for the group and receive bribes or divert monies intended for all group members. Third, uncooperative members of the group may refuse to agree with the other joint landowners, and either prevent decisions and actions being taken, or hold out until other members of the group are forced to buy their agreement. Fourth, a group of people has no identity or status under the law and cannot make decisions or actions as a group.

The Land Groups Incorporation Act was enacted to overcome these social and legal difficulties. The Act enables a landowning group to apply to be incorporated, thereby acquiring a legal identity and status of its own. A constitution for the corporation is prepared by the members, to allow for decisions to be taken on behalf of the corporation by a board or committee. The act makes provisions for disputes between members to be settled by a dispute settlement authority or by a village or local court. Although this legislation removes the legal impediment that a group has no legal identity, and enables decisions and actions to be taken by the corporation, there are nonetheless disadvantages involving misuse of power by the members of the controlling board or committee.

Disputes

Disputes arise most frequently in relation to State lands, converted customary land, and customary land. The main disputes relating to State lands appear to center around, first, Government declarations that land is vacant or waste land and so can be acquired by the State without payment of compensation; and, second, large claims for compensation by custom owners for State purchase and lease of land, some of which are said to be grossly inflated, if not actually fraudulent. Claims for compensation are normally adjudicated by the Land Titles Commission, but because this body is seriously underfunded and understaffed, there are frequently long delays before compensation payments are made. This is a source of friction and resentment.

The main causes of dispute over converted customary land appear to be inflated claims for compensation by persons who allege that their interests will be adversely affected by the conversion, and delays in decision making by the Land Titles Commission.

The main disputes with regard to customary land at present relate to delays in dealing with competing claims for ownership or subsidiary rights in customary land, and difficulties in enforcement of mortgages of leaseholds of customary land. The Land Disputes Settlement Act has been enacted to deal with customary land disputes. Land dispute committees in each province are to establish mediation areas and appoint village magistrates or other suitably qualified persons to be land mediators. A dispute about customary land is first dealt with by the area land mediator. If no settlement is reached, the matter is referred to the local land court. Local land courts consist of the local magistrate and an even number of land mediators, not exceeding four.

Appeals from local land courts are to be heard by provincial land courts, which comprise three provincial land magistrates appointed from the higher grades of magistrates. Provincial land courts are authorized to grant an appeal if the local land court has exceeded its jurisdiction, if it has refused to exercise its jurisdiction, if it conducted the hearing in a manner contrary to natural justice, or if its decision is such that no court doing justice between the parties would have made it, that is, it is clearly wrong or unreasonable. A provincial land court may substitute its own decision for the decision appealed against, or it may refer the matter back to the local land court to deal with, using the direction or guidance given by the provincial land court. A decision of a provincial land court is supposed to be final, with no appeal to any other court. This does not mean that the National Court cannot exercise its inherent powers of judicial review over subordinate courts, and to intervene if the provincial land court has acted without jurisdiction, has refused to exercise its jurisdiction, has acted contrary to natural justice, or has made an error of law.

The main issue with regard to the operation of the machinery described above for dealing with land disputes is delay. Although land mediators, land courts, and provincial land courts have been established throughout most of the country, existing land mediators and land magistrates are experienced and impartial in dealing with disputes, and the public appears to have confidence in their decision making, there are long delays in dealing with disputes. It seems that the major reasons for this are lack of funding and a shortage of land magistrates. Land magistrates are also ordinary magistrates and have to deal with land matters along with other civil and criminal matters falling within their jurisdiction. Local land courts are required to physically inspect the land in dispute before making a decision, and then return to the land when the decision is made to ensure that the parties and witnesses understand it. Having regard to the existing number of magistrates, and the difficulties both financial and logistical of visiting disputed lands on two occasions, the long delays are not surprising.

Difficulties about enforcement of mortgages of leaseholds of customary land arise because there is not a general awareness and understanding among Papua New Guineans, especially in the rural areas, that if a mortgage over a leasehold interest in land is given by a lessee who wishes to borrow money, and the lessee fails to pay back the money, then the lender is entitled under the mortgage to take possession of the leased land, and, if necessary, to sell the leasehold interest to someone else. Because of this lack of understanding, kinspeople and neighbors frequently attempt to block, if necessary by violence, attempts by a mortgagee to exercise the remedies that the law provides to enforce the mortgage.

KEY CONSTRAINTS ON FINANCIAL SECTOR DEVELOPMENT

A disappointing economic growth performance, in terms of both aggregate slowness and the narrowly based growth pattern, has restricted financial sector development. Translating natural resource richness into broad-based, sustainable economic growth and social development is required, and would stimulate financial sector development.

Geographic and Cultural Fragmentation

There are severe development constraints, including the rugged terrain of PNG's 462,000 square kilometers, the complexity of land tenure systems, the dispersal of 4.5 million people collectively speaking more than 700 languages, limited and deteriorating physical infrastructure, a major law and order problem, and the low level of human resource development. Secondary school enrollment rates are much lower than in most other PDMCs, especially for girls and women, who are precluded from full participation in economic development. There is a contention also that the *wantok* system is a cultural constraint on business development: although it can be used to facilitate establishment of small businesses, it may inhibit larger-scale businesses by acting as a disincentive to save. Finally, the concepts of nationhood and parliamentary democracy are relatively recent introductions, with the first-past-the-post voting system tending to underpin chronic political instability, as a growing number of candidates promise potential voters that they will be rewarded for their support with "development".[17] A number of these constraints can be eased over time through appropriate Government policy action.

The present Government has addressed one major constraint by restoring macroeconomic stability, which is a precondition for financial sector development and private sector-led growth.

A Large, Inefficient Public Sector

A large public sector tends to crowd out the private sector, while itself performing poorly. State-owned enterprises cover most utilities, a large share of the financial sector, an airline, printing offices, postal services, and a telecommunications company. There is a need to corporatize and privatize, where appropriate, in order to improve service delivery. The State-owned enterprises are used by the Government to carry out activities of a noncommercial nature, which has meant that the fiscal responsibilities of Government and the commercial role of State enterprises have become confused. In addition, many activities of the State-owned enterprises are not transparent, and all but the largest State enterprises (which have enabling legislation) are not subject to much accountability. Performance has been difficult to evaluate because of a lack of clearly defined reporting and accountability requirements and of clearly defined capital structures. However, privatization is a sensitive issue that is entangled with domestic concerns over foreign ownership. Implementation of public sector reforms therefore has to be handled with care.

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[17] The number of candidates for 107 seats in the National Parliament rose from 880 in 1977, to 1,645 in 1992, to 2,368 in 1997 (AusAID 2000).

Law and Order Problems

Lawlessness and disorder increased during the 1990s and constitute the biggest single obstacle to private sector development (followed by corruption, poor infrastructure, and policy instability). According to a March 1999 survey, over 90 percent of respondents fully agreed that "theft and crime are serious problems that can substantially increase the costs of doing business", compared to 30 percent responding in a 1989 survey (Manning 1999). These costs include security and insurance, wage premiums required by imported labor, and restrictions on hours of operation and time free for education and training. In rural areas, crops can be destroyed by tribal fighting, or hijacked en route to the market; the range and availability of consumption goods is restricted; and banking facilities have been curtailed (making it difficult to pay public servants engaged in decentralized service delivery). It has been estimated that in 1997, 30 percent of the potential coffee crop remained unmarketed because of the law and order problem (AusAID 2000). The lack of physical security also creates a disincentive for individuals to save and invest, since accumulated assets can so easily be stolen.

Customary Land Tenure and Leasing Problems

Although there is adequate legal machinery to provide for custom landowners themselves to mortgage customary land, either by mortgaging lease-backs or by converting the land into noncustomary tenure and mortgaging the limited freehold that results, successful land mobilization is usually achieved only at very high cost. These costs normally can be undertaken only by relatively large and profitable enterprises, namely mining and logging firms.

There are two main constraints on the use of customary land as a collateral security for a loan: first, the Land Titles Commission does not have sufficient funds or staff to deal effectively with most of the applications made to it for tenure conversions; and second, mortgage enforcement by entry into possession or sale is very difficult to implement, especially in rural areas, because of hostility by kinspeople and neighbors, so that lending institutions are very reluctant to accept customary land as a security for a loan. In addition, difficulties in establishing ownership titles restrict the ability of those in the informal sector to obtain bank loans for development purposes. Commercial banks are reluctant to lend to projects where there is concern over the security of property rights and the capacity to enforce them. The bodies provided by law for adjudicating disputes over customary land (land mediators, local land courts, and provincial land courts) are also terribly understaffed and underfunded, with the result that there are serious delays in the settlement of land disputes.

Lack of Competition in the Banking Sector

The banking system is dominated by the Government-owned bank and foreign banks, and competition is limited. Lack of competition from NBFIs and restricted market access to long-term, fixed-interest instruments or to consumer finance and personal loans has also prevented competition and the deepening of the financial system.

Government Interference in the Financial Sector

There has been considerable Government intervention in the financial sector in the past, which has constrained its development. The independence of the central bank has been compromised and Government involvement has prevented the development of appropriate prudential supervisory processes. A major concern is that financial institutions other than commercial banks have little supervision other than annual reporting. Government involvement has also had adverse effects on the performance of PNGNPF and RDBPNG. Corporate governance in the Investment Corporation has been weak and political intervention common. The SRP addresses these issues.

Limited Access to, and inadequate Legal Framework for, Microfinance

Extremely limited access to microfinance services acts as a constraint on rural development. Improving access requires, among other things, creating an appropriate legal framework for MFIs. Currently, there is no legislation governing NGOs' advancing credit, while they are required to secure a license as a financial institution in order to accept savings. It is unlikely that NGOs could satisfy present licensing requirements, thus restricting opportunities for savings mobilization.

RECOMMENDATIONS

Encourage Private Sector-led Development of the Real Sector.

The Government must maintain a stable macroeconomic environment that is conducive to the development of the financial sector. This involves fiscal prudence, including greater transparency and accountability in the budgetary process; and sound monetary policy. A professional debt management section should be established in Treasury.

A comprehensive public enterprise reform plan should be formulated and implemented. Commercially skilled and competent boards should be appointed and be permitted to operate free of Government interference. The framework under which any privatizations are carried out should ensure that public monopolies do not become private monopolies. The social obligations that some public enterprises currently meet should be separated from commercial objectives, and preferably funded directly from the budget. The Government made substantial progress in these areas with the planned privatization of FPG in 2001.

Improve the law and order situation.

Addressing the law and order problem requires direct action, since the job creation that is often presented as a solution is in fact difficult to achieve because *of* the problem, and since available evidence suggests that in any case job creation may have little immediate impact on criminal activity (AusAID 2000). The 15 percent of the Port Moresby workforce reportedly engaged in the latter earn more than the unskilled wage rate and show little inclination to seek formal employment. Thus, the effectiveness of policing, prosecution, and detention must improve.

Address Land Tenure Issues.

A number of land tenure issues urgently need addressing. More qualified, professional staff and facilities are needed for the Land Titles Commission, so that can deal expeditiously and comprehensively with all applications made to it. The Magisterial Service similarly requires capacity building assistance.

There is a need to increase public awareness of the scope for using crops and livestock, and leaseholds or conversions of customary land, as security for loans, and also of the necessary consequences if the loans are not repaid. The operation of landowning corporations needs to be assessed and means examined for improving the governance of landowning groups. This should facilitate and also safeguard the management of customary land. Conferences under the general heading "Issues relating to the Development of Customary land in PNG" could offer one mechanism for engaging all stakeholders at the beginning of the process.

Provide an Enabling Environment For the Financial Sector.

In regard to the financial sector itself, the Government should focus on broadening and deepening financial markets in order to increase competitiveness. This means reducing Government ownership and control of financial institutions, privatizing PNGBC, and encouraging the development of financial instruments and financial intermediation.[18]

BPNG should reduce reliance on direct instruments. The market for Government securities should be broadened and deepened through the issue of longer-term bonds and instruments. The introduction of instruments of different maturities available to the public would help to create alternative instruments for savers and provide competition for commercial bank deposits.

Supervision needs to be upgraded under the new legislative framework provided under SRP. Strengthened

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[18] The Government planned to privatize PNGBC in mid-2001.

capacity in BPNG will allow it to monitor and supervise banks and NBFIs more effectively.

Strengthening NBFIs would provide more competition, especially for commercial banks. BPNG should monitor NBFIs more closely and issue prudential standards covering risk management; capital adequacy; and loan classification, provisioning and exposure. This is particularly important, as it is likely that NBFIs will be involved in funding through retail deposits. BPNG should also supervise conglomerates, by requiring a higher capital adequacy ratio, placing higher risk weights on investments, and reducing the large exposure limit to 25 percent.

In order to facilitate capital market development, company registration procedures should be upgraded and updated, and staff should be provided with complementary training. This will allow improved monitoring of company returns, enforcement of Companies Act provisions, and application of penalties. Institutional strengthening and capacity building are also needed in SCPNG.

Any privatization process that results in the offering of shares to the public should be supported by a significant publicity campaign, to encourage the public to buy shares and also to create public awareness of the stock exchange.

Assistance should be provided for determining the specification of a regional clearing and settlement facility, such as "PacifiClear," in terms of

(i) the legal changes necessary to implement a dematerialized system;
(ii) the ownership of such a facility;
(iii) the functionality required of such a facility, bearing in mind both current and future regional and national developments; and
(iv) the potential cost of development and operation.

It is recommended that consideration be given to establishing a distributed, networked regional facility that uses Internet technology to link POMSoX to companies and investors in all PDMCs.

Improve Governance.

Improving the governance environment is a top priority of the SRP (see Box 4.1). Better corporate governance is also needed in the financial sector in respect of Government-owned institutions.

RDBPNG needs more independence from Government and a thorough review. Its current financial status is unclear and the limited disclosure in some areas adds to the uncertainty. As RDBPNG has been merged with FPG, there is now no independent specialized development banking institution in PNG. As the Government is planning to privatize FPG, the future of RDBPNG remains unclear.

At the time of the FPG's establishment, a separate subsidiary company was established to deal with community service obligations and Government schemes, including RDBPNG. When this study was concluded, it was too early to determine how effectively the company is operating. In any case, it is clear that without a major improvement in the overall governance and supervision structure within PNG, there is little likelihood of any substantive improvement in the performance of development finance institutions. Implementation of the financial sector reforms under SRP will go a long way to achieving this improvement.

The board structure of PNGNPF should be changed so that the Government appoints only one member, and the employee and employer numbers are increased by one each. Further, the Government-appointed member should not be the chairman. The development of model investment criteria and members' rules on a regional basis would be helpful.

Strengthen the Environment for Microfinance

Efforts to broaden and deepen the financial and capital markets should also focus on addressing the problems of delivering financial services to nonurban areas.

More support should be provided to small microfinance schemes administered through NGOs. As noted above, this requires the establishment of an appropriate legal framework, which must be designed after reviewing existing policies and regulations affecting MFIs. Such a review must be done in a consultative and participatory manner, involving all stakeholders.

A recommended complementary action is the establishment of a coordination agency responsible for developing supportive policies; undertaking/initiating coordination and advocacy activities; and developing effective and transparent mechanisms for finance wholesaling, resource mobilization, and technical assistance to MFIs and other microfinance providers. This agency should also be responsible for developing performance standards, monitoring and supervision, and provision of necessary support services to MFIs, including social mobilization. These activities could be done initially at the national level, and later at the provincial and district levels, with possible funding from the Government's Social Investment Fund.

The capacity of MFIs needs to be augmented through training, technical assistance, and advisory services in such areas as

(i) organizational development and financial management;
(ii) outreach strategies;
(iii) solidarity group formation and social mobilization;
(iv) development of innovative financial products that are responsive to the needs of the poor;
(v) development of management information systems;
(vi) viability planning and portfolio management; and
(vii) resource mobilization.

The Government's new Microfinance and Employment Policy, adopted in September 2000, addresses these issues.

Poverty mapping can assist in identifying priority areas for microfinance; while the Ministry of Commerce, with other agencies responsible for the promotion and development of businesses, could assist in identification of cash income-generating projects. There is a related need to undertake an awareness and education campaign to inculcate thrift and credit discipline among rural groups. This can be done through the media (especially through radio), community drama, or other community activities using a participatory approach.

The Government should initiate regular annual workshops for microfinance, where MFIs can share their experiences, raise issues, and identify remedial measures; and where bankers will be encouraged to participate and to lend their support in terms of funding or technical assistance. The participation of various stakeholders such as development partners or donor agencies, NGOs, policymakers, and representatives from regulatory bodies should be encouraged to raise awareness of microfinance with the intention of getting support and cooperation from various stakeholders.

MFIs need to establish linkages with various support providers, especially in the area of business/enterprise training, advice, market linkages, project development, and appropriate technology and transfer.

The bottom line in the medium term is that effective delivery of microfinance services in rural areas probably requires explicit subsidization by the Government or donors.