

REGIONAL COOPERATION AND INTEGRATION ASSESSMENT (SUMMARY)

A. Characteristics and recent trends

1. The economy of Papua New Guinea (PNG) depends heavily on trade. In 2013, exports accounted for about 65% of gross domestic product. Minerals, including gold, copper, and oil, accounted for about 75% of the total value of PNG's exports in 2013, and are expected to increase further during the Country Partnership Strategy, 2016-2020 period following the commencement of liquefied natural gas (LNG) exports in 2014. Major agricultural products, which accounted for 25% of total exports in 2013, include palm oil, coffee, cocoa, copra, copra oil, vanilla, tea, and rubber. Forest product exports account for about 5% of the total, while marine resource exports account for about 2%. PNG's largest trading partners include Australia, Japan, the People's Republic of China, and the United States.

2. PNG's economic structure remains narrowly based and highly dualistic, with the formal sector dominated by retail trade, construction, business services and mining services, which employees roughly 10-15% of the population. Around 85% of the population remains in isolated rural areas, is engaged in subsistence agriculture, and has poor access to economic opportunities and social services. For example, it has been estimated that the welfare effect to the PNG economy is typically only one-third of export values from the mining sector, after discounting the returns that accrue to foreign capital and the purchase of intermediate imported inputs. In the addition, despite a significant rise in government spending in recent years, funded largely by windfall gains during the commodity price boom, the majority of the population lacks access to quality basic services such as health and education.

3. PNG is the largest trading economy within the Pacific region, with links to Pacific island neighbors as well as with Australia and Asia's dynamically developing economies. It has fertile land and rich resources to support expanded export growth, particularly in agricultural products. However, basic infrastructure and an environment conducive to doing business—including efficient and effective policy and administrative practices, law and order, and a low-cost skilled labor force—are lacking. Expansion of PNG's export sector remains constrained by poor infrastructure, particularly the country's transport systems, which have been deteriorating badly in recent decades. This has prevented the effective distribution and marketing of agricultural produce. Agricultural producers also face constraints such as lack of access to credit and agricultural extension support. Inadequate border infrastructure impedes the movement of goods and people between the West Sepik and Western provinces of PNG with the West Papua province of Indonesia. PNG's Liner Shipping Index, which indicates a country's integration level into global liner shipping networks was 6.61 (out of 100) in 2013, placing PNG in the bottom 10% of countries worldwide.

4. The high costs of doing business in PNG also limit trade and investment. PNG ranked 113 of 183 countries in the 2013 World Bank Doing Business Survey.¹ Factors that raise business costs in PNG include poor law and order, corruption, and government regulations and policies. An Investment Promotion Authority exists, the investment approval process has been simplified, and most sectors now are open to overseas investment. However, foreign investment is deterred by inefficient approval processes for investment licenses, visas, and work permits. In addition, input costs, such as electricity and labor, are high and quality is low compared with other countries in Asia and the Pacific. The national minimum wage for unskilled labor increased by 50% in 2014, which raised the costs of employing unskilled workers. As a result, foreign

¹ World Bank, 2013. *Doing Business 2013 Papua New Guinea*. Washington, DC.

direct investment in PNG has been limited and remains concentrated in the high-risk, capital-intensive minerals sector, which has few links with the rest of the economy.

5. Another main challenge for the trade sector is the impact of ‘Dutch disease,’ with rising extractive industry exports leading to a real exchange rate appreciation and causing a fall in the price of agricultural exports through a decline in relative returns to export crops. Another risk to improved trade performance is that investment in upgrading infrastructure, removing agricultural supply constraints, and improving the business environment will not be sufficient to support increased flows of trade and investment.

6. Currently, the Government of Australia provides the majority of capacity building support to PNG in the area of trade facilitation, particularly through support for customs and quarantine management by providing advisers from the Australian Customs and Border Protection Services and the Quarantine and Inspection Service under programs including the Strongim Gavman Program (SGP) and the PNG–Australia Customs Twinning Program. The European Union (EU), under the Trade-Related Assistance Program, is also providing support to PNG through capacity building in trade policy development, quality certification support, and private support for export promotion.

B. Government policies and strategy

7. The PNG Government’s Vision 2050 strategy, under the pillar of “Security and International Relations” sets an objective to “develop robust regional and global cooperation and trade relations measured by increased foreign investment, trade and tourism flows”. As part of this strategy PNG aims to continue to strengthen its ties with traditional partner countries such as Australia, Japan and Pacific Island countries such as Fiji, Vanuatu, Tonga, Samoa and Solomon Islands while taking advantage of its geographic location to engage with new partners within the wider Asia-Pacific region. Over recent years this has included a growing dialogue with the Asia Pacific Economic Cooperation (APEC) Forum, the Association of South-East Asian Nations (ASEAN) Forum, and greater bilateral relationships with countries that offer the greatest potential markets for Papua New Guinea’s trade and commercial interests, such as Thailand, Indonesia, Malaysia, Singapore and the People’s Republic of China.

8. PNG has been a member of the WTO since 1996 and since 1999 has continued to adopt an open trade regime. PNG’s simple average import tariff is currently 5.7% and the trade weighted import tariff is less than 2%, well below the International Monetary Fund’s (IMF’s) threshold of 10% for open economy classification. PNG launched a Tariff Reform Program between 1999 and 2006, which set duty rates for most goods—except those produced or have the potential to be produced in PNG—set to zero. The 2014 budget continued with these efforts, re-committing to a tariff reduction program that will be implemented over a seven year period. Currently, about three-quarters of PNG’s imports enter the market duty-free. Export tariffs are charged only on raw logs and crocodile skins.

9. Within the Pacific, PNG is a member of a number of preferential trade agreements and forums. The Pacific Islands Forum (PIF) is the most important regional cooperation forum, with 16 member states agreeing to conduct regional trade under the auspices of the Pacific Island Countries Trade Agreement (PICTA). PNG also plays a lead role in the Melanesian Spearhead Group (MSG) which acts as a platform for cooperation among Melanesian countries with the aim of promoting mutual trade preferences on certain goods. PNG is a member of the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), a longstanding non reciprocal preferential agreement with Australia and New Zealand. PNG exports enter these

two markets duty free without restriction. However, over the last decade SPARTECA's importance for PNG has declined due mainly to the erosion of tariff preferences, with Australia and New Zealand reducing tariff rates unilaterally, and easing restrictions on rules of origin. All of PNG's exports to European countries are duty-free market access under an Interim Partnership Agreement signed in 2011.

10. To promote trade with all partner countries the government has also introduced reforms to lower trade transaction costs in the country. A customs modernization program was introduced, which has resulted in a steady upgrade in customs systems and procedures that have supported the country's accession to the Revised Kyoto Convention. The development of a comprehensive risk management system based on voluntary compliance measures, including the increased use of post-clearance audits, has allowed customs to clear an increasing proportion of goods immediately upon payment of duties and taxes. However, lack of efficiency and coordination of procedures with other border management agencies such as the National Agriculture and Quarantine Services, which is required to inspect 100% of consignments containing agricultural goods, delays cargo clearance.

C. Asian Development Bank's strategy

11. ADB's Pacific Approach², which serves as the country partnership strategy for 10 Pacific DMCs, embraces regional cooperation and integration as a core agenda item in the Pacific Department's strategy to promote sustained and resilient growth that provides improved standards of living in the region. This Mid-term Review of Strategy 2020³ that highlights regional integration as one of three core development agendas for ADB operations.

12. In 2009, ADB approved the Pilot Border Trade and Development project which aimed to remove infrastructure bottlenecks along the northern transport corridor connecting West Sepik Province (WSP) of Papua New Guinea and Papua Province of Indonesia, and improve the investment environment in WSP to enable WSP to capture trade opportunities for development.⁴ While the infrastructure component of the project was deemed largely successful, ongoing institutional and regulatory barriers regarding cross-border trade have restricted its overall impact on the development of PNG's northern coastal region. The experiences of this project have highlighted the importance of addressing in a cohesive and coordinated manner trade logistic and institutional arrangements as well as infrastructure bottlenecks to fully capture the benefits of PNG's strategic positions within the Asia-Pacific region.

13. Building on lessons learned ADB's support for regional cooperation and integration in PNG during the CPS period will be based on three mutually reinforcing pillars, strengthening transport networks; support for trade facilitation and knowledge solutions.

14. **Strengthening transport networks.** Improved regional connectivity is crucial for unlocking scale economies and increasing competitiveness especially for the landlocked Highlands region. With the advent of supply chains, premium is placed on moving goods rapidly, reliably and cheaply through improvements in logistics performance. ADB support will continue to be focused on construction and improvement of transport corridors, port facilities, sea lane

² ADB, 2009. *ADB's Pacific Approach 2010-2014*, Manila.

³ ADB, 2014. *Mid-term Review of Strategy 2020: Meeting the Challenges of a Changing Asia-Pacific*, Manila.

⁴ ADB, 2010. *Loan Agreement (Special Operations) between the Independent State of PNG and the Asian Development Bank: Pilot Border Trade and Investment Development Project*. Manila (2591-PNG).

navigation, and civil aviation. In particular, PNG's road and bridge projects will aim to improve transport efficiency in the sub-regional road network and expand accessibility of rural areas, enhancing economic opportunities and reducing poverty in the process.

15. **Support for trade facilitation.** Inefficient customs and land border procedures and inefficiencies in port operations and logistics performance are key constraints to expanded trade between PNG and the Asia Pacific region. ADB assistance on trade facilitation will be anchored on the support for strengthening the capacity of agencies responsible for border management, trade, tourism, and infrastructure in PNG. In particular, technical assistance support will aim to promote the development of enhanced cross-border links with neighboring Indonesia to facilitate increased trade and travel between these countries.

16. **Knowledge solutions.** Strategy 2020 notes the acute challenges fragile countries face because of their generally weak policy regimes, small domestic markets, economic vulnerability, and weak institutions. It adds that ADB must align its development assistance with other funding agencies at the strategic and project level and pursue capacity and institutional development with more depth, flexibility, and longer engagement. During the course of the next CPS ADB will continue to place a focus of its knowledge products on analyzing the PNG's evolving trade linkages and the implications that this has for trade policy settings and institutions. This support will respond to the need for better information on these economic links to guide ADB and other development partner assistance, and to help shape the policies and strategies of Pacific DMCs to reflect and respond to changing opportunities from, for example, the development of the internet and the falling cost of transporting goods by sea.