PRIVATE SECTOR ASSESSMENT (SUMMARY)[1]

A. Key Characteristics and Challenges

1. The Papua New Guinea (PNG) economy consists of a large subsistence sector which provides a livelihood for roughly 85% of the population, a capital-intensive resources sector, and a relatively small formal sector of service and manufacturing industries. The resources sector focuses mainly upon exploiting the country's rich natural resources, notably minerals, hydrocarbons, fisheries, and timber.

2. Despite recent strong economic growth, conditions for private sector development have not improved. PNG's overall ranking on the World Bank's Ease of Doing Business Index[2] has continued to fall over recent years, reaching 113th out of 185 in 2014. As other countries have reformed and moved up the ratings, PNG has slipped. As has been demonstrated by many weakly performing or conflict-prone, resource-rich developing countries, natural resource abundance does not necessarily lead to—and can actually undermine–broad-based development. PNG faces two fundamental economic development challenges: (i) to increase natural-resource-based production and convert revenues into sustainable development outcomes, and (ii) to broaden the base of the economy and the basis for economic growth and job creation. Private sector development is, therefore, at the core of PNG's future economic growth prospects, yet surveys and assessments point to chronic constraints, notably poor infrastructure and utility services, a high crime rate, weak property rights, lack of competition and market access, and the inability of the finance sector to finance investment opportunities.

3. To broaden the base of the economy, the enabling environment for business must be improved and transaction costs reduced. The rural economy, which employs the vast majority of Papua New Guineans, is to a large extent remote and poorly served by infrastructure and other services. The transition from subsistence to a market economy is severely hampered by the difficulty of getting market information and transporting goods to formal markets or to ports for export, and the lack of financial services to finance micro-entrepreneurs, including women.

4. A survey of the business environment, conducted in 2012 to support a private sector assessment, highlighted financial markets, competition policy, and state-owned enterprises (SOEs) as areas of particular weakness and of operational relevance to the Asian Development Bank (ADB).[3]

5. Financial markets remain sound but risk management needs to be strengthened. The high degree of liquidity in the financial system is indicative of profitable lending opportunities foregone. But there are other factors that impact on risk. The absence of a secondary market in government debt (which is partly a reflection of the fact that banks tend to hold such debt to maturity) means that government securities cannot be easily liquidated, especially at times of stress. The deposit concentration is also significant, as deposits are mainly sourced from companies and government trust accounts which could flee or be converted to foreign currency. Retail deposits are low, at only about 20% of total deposits. These factors suggest that it may

---

[1] This Private Sector Assessment (Summary) is based on Asian Development Bank (ADB). 2014. *Private Sector Assessment of Papua New Guinea*. Manila. Extensive fieldwork, carried out in early 2014, accompanied this study and focuses on current policies that affect private sector activities and analyzes policy adaptations advisable to place the economy on sustained, high rates of growth.

[2] World Bank. 2014. *Ease of Doing Business*. Washington DC.

[3] Institute of National Affairs. 2012.*The Challenges of Doing Business in PNG*. Port Moresby.

be prudent for banks to hold capital ratios well in excess of regulatory requirements; indeed, the regulatory requirement could be raised in the light of such findings.

6. Reforming the government debt market will also be an important next step for finance sector development. A more developed government debt market will increase the supply of investible resources to the PNG economy, as foreign capital will be attracted. The first reforms should center on the primary market, where the number of dealers is too small and the conditions for entry, such as the minimum bid size, too restrictive. An early step could be a reduction in the size of the minimum bid, followed by further development of the central bank bill tap facility. Lengthening the duration of issues would also be helpful. The second set of reforms concerns the secondary market, where liquidity and trading are low, largely for reasons of lack of competition, the concentrated nature of the financial system, and bank behavior. The strengthening of repo facilities[4] is essential for secondary market development, as it would broaden the demand for securities and increase trading liquidity.

7. PNG also faces a number of barriers in improving access to finance, particularly in rural areas which are typically not serviced by the country's three major commercial banks. Microfinance services in PNG are supplied through 21 savings and loans societies, 5 licensed micro banks, the National Development Bank,[5] and around 70 small community-based nongovernment organizations. Microfinance is also served by the Centre for Excellence in Financial Inclusion, which coordinates the provision of financial literacy training, the improvement of management and technical capacity of microfinance institutions, and the monitoring of industry benchmarks and standards, and works with the Bank of PNG to improve laws and regulations to strengthen the finance sector as a whole. It is also the key body to promote implementation of the national financial inclusion strategy and the meeting of targets agreed through signing of the Maya Declaration by the Central Bank. From small beginnings, microfinance has performed reasonably well over recent years, with an increase of more than 100,000 account holders and steady growth in capitalization of most microfinance institutions. Yet despite some progress in recent years, estimates indicate that still only about 15% of the population has access to formal or informal banking facilities. A number of factors continue to constrain microfinance, including (i) poor financial literacy and business management skills among rural households, (ii) low capacity among microfinance and socioeconomic institutions, and (iii) high business costs associated with the remoteness of many communities and poor law and order.

8. The enforcement of competition and prevention of collusive behavior require a strong competition commission, which is currently lacking. Legislation does not make adequate provision for consumer protection, while competition provisions are expressed in dated and complicated language and the range of remedies in respect to infringements is limited.

9. Some policies to promote competition in the economy have been strengthened over the since 2001, notably the formation of the Independent Competition and Consumer Commission in 2002, regulatory reforms in telecommunications and the entry of private companies in mobile telephony in 2007, and the planned role for public–private partnerships (PPPs). But there are serious deficiencies that hobble competition, such as the high cost of financial services. Poor or corrupt governance practices such as discretion in decision making or in tax administration

[4] The repo (repurchase) facility is a central bank tool for lending to banks using bonds as collateral that are then repurchased by banks at a future date at a fixed pre-agreed price, with the buy–sell price difference being the interest rate charged by the central bank on its loan.

[5] One of the micro banks, People's Microbank, is a wholly owned subsidiary of the National Development Bank.

reduce competition and efficiency. Recent trends towards local content requirements and protection of labor dilute competition and create inefficiencies in resource allocation within the country.

10. SOEs are a major source of inefficiency in the economy. These enterprises use capital wastefully, distort market conditions, discourage private investment, and impose an implicit heavy tax on consumer welfare. They are sheltered by low interest rates provided preferentially; thus, the underlying return on equity is even lower than what is reported. The corporate governance environment under which SOEs operate is highly defective and contributes to poor commercial performance. Noncompliance with key elements of the Independent Public Business Corporation (IPBC) Act has been a problem since 2002, leading to weak governance and accountability. The IPBC has consistently failed to publish annual reports with audited financial statements. Moreover, corporatization has not prevented political interference in SOE operations.

11. There are two major impediments to the efficient operation of SOEs. First, regulatory contracts for monopoly service providers agreed with the Independent Competition and Consumer Commission (ICCC) are structured in a way that militates against realizing productivity gains. The most promising solution lies in greater contestability through increased private sector participation, backed by hardened budget constraints and no bail-outs of SOEs. Second, SOEs have been obliged to shoulder a large community service obligation burden without any compensating fiscal transfers. Allowing private companies to bid for community service obligations should follow up a recent policy change towards greater commercialization of SOEs.

B. Government Private Sector Development Strategy

12. As early as 2007 the Government of PNG declared its intention to make the promotion of private-sector-led growth central to its aims, but the record shows that actual performance has lagged intentions. The regulatory burden continues to be heavy, there is a strong bias towards resource and credit allocation to SOEs, competition is weak, and there has been little improvement in the governance environment. Furthermore, policy options being considered with respect to small and medium enterprises (SMEs) have worrisome components relating to reserved activities.

13. The vision for development promulgated by the Government of PNG is based on the private sector being the engine for accelerated, sustained growth. Translating the vision into policy reforms is proving difficult. The state remains a dominant presence in the economy well beyond its traditional and widely accepted role as a supplier of public goods. There appears to be a tendency towards protection through toughening local content rules and labor restrictions, which damages private investment prospects. In the resources sectors, there appears to be a move towards imposing requirements of “free” or discounted state equity; if pursued, these will further deter investment. There is no overall privatization strategy. Some policy reforms towards greater use of public–private partnerships are at an early stage; however, experience has shown that success can take many years after careful planning.

C. ADB’s Strategy

14. The ADB country partnership strategy for PNG can respond to the development vision of ADB, which places private sector development at the center of growth policies. The midterm review of Strategy 2020 identifies private sector development, use of sophisticated knowledge-based technologies, and innovation as the key agents of development, propelling low-income countries towards middle-income status.[6] At the same time, the government's development strategy of diversified growth relies upon a larger role for the private sector, especially in energy and infrastructure. Thus, there is a clear unity of objectives in the following priority areas of engagement:

15. **A sequenced set of policy actions, agreed upon with both government and the PNG private sector, for promoting private sector growth based on existing development vision and plans.** Such a product would be consistent with the government strategy of diversification of output and exports, and would focus on stable fiscal rules, including rules underlying the operation of the sovereign wealth fund. It would clarify the role of the state, which appears ill-defined and replete with contradictions. A particular aspect of this work could be a comprehensive strategy for SOEs with a view to attracting private participation in various forms in activities currently reserved or with limited contestability, and to steer the trust arrangements now being designed into best-practice directions.

16. **Reinvigorate the finance sector and broaden access to finance.** A study that investigates the barriers to greater competition in the banking industry with proposals for reform would be timely. This should include ideas for central bank policies to attract fresh capital into banking. Continued reform of the secured transactions framework and implementation of reforms recently undertaken would be vital to broaden access and promote financial inclusion. A knowledge product on developing local currency markets would also help fill a vital gap. Efforts should also be undertaken to continue to expand access to microfinance. ADB's Private Sector Operations Department may also usefully explore investment opportunities in financial inclusion to further support this agenda.

17. **Improve business laws and competition.** The commercial law framework in PNG has some serious deficiencies. As a part of its continuing work in this area through the Private Sector Development Initiative (PSDI), ADB will aim to support strengthening of competition policy. The potential also exists to significantly enhance efficiency and productivity in several sectors of the economy through improved competition policy. ADB and the PSDI are well placed to provide assistance in this area. Work on the regulatory side will be critical. For example, in electricity, investors will require high standards and firm predictability in tariff regulation and pricing, and a modern electricity law. Targeted technical assistance during project preparation will be provided to address these problems.

18. **Support public–private partnerships.** After a lengthy preparation period, a PPP law was approved by Parliament in September 2014. The implementation of the law and of PPPs in general would be a major policy and institutional step forward. ADB, through the PSDI, could be a significant partner in assisting the government with its implementation. This support will require (i) significant advisory work on the preconditions necessary to win investor confidence in the PPP process and the government's intentions; and (ii) technical assistance on transactions and on how best to structure government financial and guarantee support and deal flexibly with evolving market conditions, including risk sharing with private participants.

---

[6] ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.