CHAPTER 12. THE ESTABLISHMENT OF A SOVEREIGN WEALTH FUND

12.1 OVERVIEW

The development of the Papua New Guinea Liquefied Natural Gas Project (PNG LNG project), and the prospect of others, has the potential to transform PNG's economy and substantially improve the standard of living of all Papua New Guineans. However, it is likely that the emergence of LNG as a major revenue source will give rise to macroeconomic pressures including the effects of Dutch Disease, which are more likely to be prevalent when a country relies heavily on commodity based revenues.

In light of these likely economic implications from LNG production, the Department of Treasury sought to initiate public consideration of these issues by providing a comprehensive discussion in the 2010 Budget. As a consequence of this discussion and separate advice to Government, the Department of Treasury prepared a submission to NEC on an offshore sovereign wealth fund and obtained Government agreement to the establishment of a joint Treasury – Bank of Papua New Guinea Working Group to consider alternative arrangements to help manage the significant revenues arising from this project to be used for PNG's development needs whilst promoting macroeconomic stability.

Following NEC agreement to Treasury's submission in March 2010, the Working Group was established mainly to canvass possible options for Government consideration, including the possible creation of an offshore fund to manage windfall revenues arising from the PNG LNG project.

In undertaking this work, the Working Group consulted with, and sought input from, PNG Government agencies and relevant domestic and international stakeholders including the IMF, World Bank, ADB and AusAID. Two significant workshops were also conducted in Port Moresby to gather views from the domestic and international stakeholders during the month of May 2010. The overall response from these stakeholders was good and issues raised at these workshops were further considered by the Working Group. In addition to the Working Group, the Department of Public Enterprises separately examined options relating to the management of dividends arising from the Government's equity stake in the PNG LNG project.

A joint Cabinet Submission reflecting both the Working Group's work and the separate work undertaken by the Department of Public Enterprises recommended for the establishment of a consolidated pool of offshore funds with three coordinated and integrated funds - the stabilization fund, infrastructure fund and a future (savings) fund.

12.2 ECONOMIC CONSIDERATIONS

The emergence of a new resource sector through LNG production presents an opportunity to significantly advance and develop PNG. The adoption of appropriate mechanisms to manage these revenues will allow the Government to underpin its development objectives as set out in the PNG Development Strategic Plan, 2010-2030 (DSP) and Papua New Guinea Vision 2050 (PNG Vision 2050).

Notwithstanding this opportunity, it is most likely that the scale of LNG as a new and major revenue source will give rise to major macroeconomic pressures such as exchange rate appreciation (Dutch Disease), increased liquidity and higher overall demand within the economy. This would undermine the competitiveness of the non-mineral sectors of the economy, such as agriculture, potentially having a severe impact on activity, employment and incomes in labour sensitive sectors of the economy.

Past experience from the emergence of new resource sectors and earlier commodity booms indicates that PNG has not successfully translated these revenues into improved socio-economic indicators and sustained development outcomes to the extent that might be expected. Accordingly, the country cannot afford to squander this opportunity by dismissing the macroeconomic risks that need to be managed.

Given the opportunities and economic challenges that the emergence of the LNG sector presents, it is very important to have in place a robust fiscal framework to support the management of windfall revenues to underpin social and economic development in PNG.

12.2.1 Monetary Policy

From a monetary policy perspective, an increase in domestic liquidity would have immediate and adverse implications. One major issue relates to the need for Bank of Papua New Guinea (BPNG) to mop up the excess liquidity in order to avoid large inflationary pressures building up. This would substantially increase the cost of monetary policy operations that would ultimately be financed from the Government's Budget.

If inflation breaks out, it will seriously disadvantage all Papua New Guineans, particularly those that are not direct beneficiaries of the PNG LNG project and those on lower incomes – this would be associated with a lot of discontent and there would be some big winners as well as a lot of big losers from the PNG LNG project.

In addition, an appreciation of the Kina will reduce the value of foreign reserves and may cause an unrealised loss on BPNG's holdings of foreign assets. Both issues would have serious ramifications for BPNG's operation and management of its balance sheet, requiring budgetary support to prop up BPNG's capital.

12.2.2 Exchange Rate Issue/Dutch Disease

The large inflow of foreign currency from the LNG revenue is most likely give rise to major macroeconomic pressures such as exchange rate appreciation (Dutch Disease).

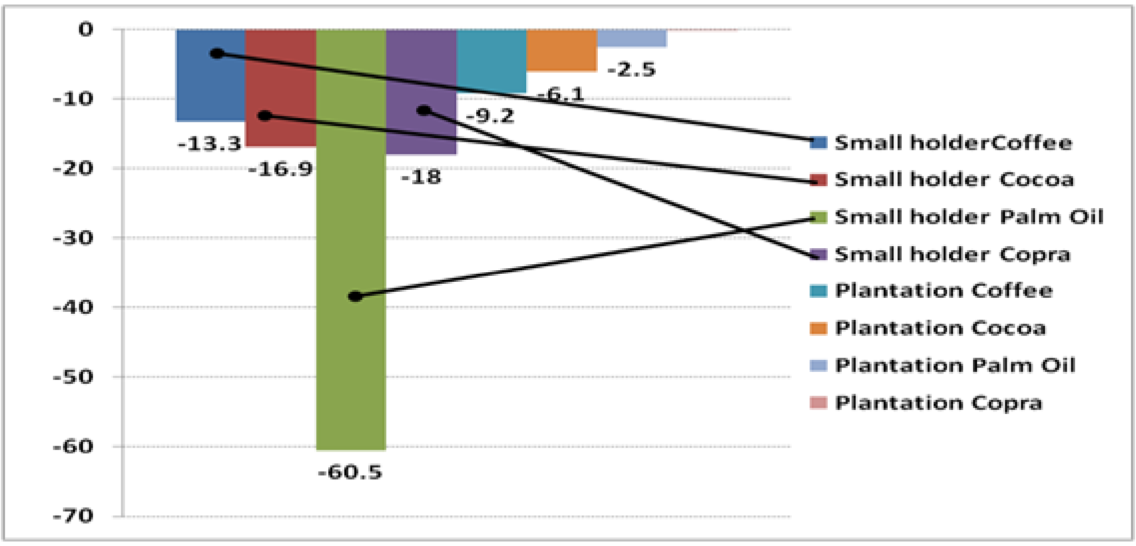
PNG LNG exports are expected to be large relative to current GDP, trade flows and foreign income and capital flows, which makes PNG highly susceptible to Dutch Disease.

A substantial increase in exports from the PNG LNG project will cause the real exchange rate to appreciate, all else being equal. This reduces the price of imported goods and increases the price of exports on international markets. This decreases the competitiveness of non-mineral sectors of the economy, such as agriculture, leading to lower economic activity and employment in these sectors across most provinces in PNG.

The ACIL Tasman analysis of the economic impacts of the PNG LNG project highlights that while the Project will have a massive impact on the PNG economy as a whole, it will not directly benefit all sectors of the economy.

ACIL Tasman estimated that the Kina would appreciate by around 11.0 per cent over the life of the project (which Treasury regards as a very conservative estimate), which has the potential to reduce the external competitiveness of the non-mineral sectors like agriculture and forestry.

Figure 44: ACIL Tasman modeled the impact of PNG LNG project in the Agricultural Sector (%)



Source: ACIL Tasman Report on "PNG LNG Economic Impact Study", 2008

Figure 44 shows the findings by the ACIL Tasman on the impact of PNG LNG project in the agricultural sector in the long run. Value added in the smallholder sector potentially declines at much higher rates than in plantations, ranging from 13.0 per cent (smallholder coffee) to 61.0 per cent (smallholder palm oil). Value added in the plantation crop sector could decline in the long run at rates ranging from 3.0 to 9.0 per cent.

This adverse modeled impact on the agriculture sector is a classic example of the potential impacts of Dutch Disease.

12.2.3 Fiscal Policy – Absorptive Capacity of the Economy

From a fiscal policy perspective, notwithstanding the country's substantial development and investment needs, the domestic economy has a limited capacity to absorb large amounts of additional Government spending in the short-term that would be financed from LNG revenues.

Government spending will be increased in order to achieve development objectives. However, in order to maintain macroeconomic control, any increased spending needs to be set in accordance with the absorptive capacity of the economy.

The absorptive capacity of the economy relates to the ability of the PNG economy to absorb increased Government spending. It can be broadly categorized under three distinct measurement constraints. These include:

1. *Macroeconomic constraints* – productive capacity;
2. *Quantitative constraints* – skilled workers to deliver services, physical capital and infrastructure; and

3. *Institutional constraints* – management of budget, regulatory and legislative institutions, the limited ability of the public service to translate funds into high quality development projects and service delivery to front line users.

If increased spending causes the economy to overheat, excess demand pressures will increase imports and inflation, causing investments in the economy to represent poor value for money and worsen rather than improve development prospects.

Assistance from the Australian Government and the IMF/World Bank to prepare economic modeling on the absorptive capacity of the economy was sought. Given time constraints and complexity of the modeling work, firm conclusions could not be drawn from this preliminary work and more modeling is expected to be undertaken.

The input provided by the Australian Government did not provide any substantive conclusions about the absorptive capacity of the economy. Moreover, the IMF/World Bank modeling suggested that additional Government spending arising from LNG revenues could grow sustainably in accordance with growth in non-mineral GDP. This equates to an increase in Government investment spending of up to about 6.0 per cent per annum over the medium term. The Working Group considers this recommendation by the IMF/World Bank to be conservative. Some other domestic stakeholders argue that development needs in PNG are such that all funds should be brought onshore and spent immediately. This is a radical and dangerous view that would be very likely to result in severe economic instability and losses for the majority of the population. The Working Group recommends a balanced approach that will allow for a substantial lift in development spending while maintaining macroeconomic stability.

Subject to further economic modeling being completed and considered by Government, preliminary analysis by the Working Group suggested a revised Medium Term Fiscal Strategy (MTFS) rule concerning Government spending from mineral revenue (including LNG revenue into the future) provides a possible start point for determining future Government spending.

This could mean that a large boost to the economy by LNG Project(s) would also allow for a large increase in Government spending in absolute terms. This would allow for a potential substantial boost to targeted development spending without putting macroeconomic stability at undue risk. This matter will be further considered in the context of a new MTFS by the Department of Treasury as the current MTFS will expire in 2012.

It is important to recognise that over recent years, the shortage of funds has not been an obstacle that has prevented effective development spending on infrastructure projects. Instead, it has been the poor ability of the public sector to establish and deliver credible project plans that has seen funds languish rather than being put to effective use. The availability of higher LNG funds will not see this problem disappear and it may intensify. This strongly argues against allocating excessive funds that cannot be effectively used. Moreover, recent experience indicates a poor track record of successfully translating development funds into effective infrastructure programs.

12.3 ESTABLISHING AN OFFSHORE SOVEREIGN WEALTH FUND (SWF)

One of the most fundamental economic issues the Government has considered is whether the fund should be an offshore or onshore entity. This is not a matter of sovereignty, as the

State will retain full ownership and control over its assets irrespective of whether they are held onshore or offshore. Rather, it is a choice about reducing macroeconomic risks and promoting macroeconomic stability, in addition to diversifying and maximising investment returns.

In considering this, the Government is conscious of the country's major development needs and the desirability of using LNG revenues in a manner that promotes macroeconomic stability while underpinning the DSP, PNG Vision 2050 and improving socio-economic outcomes. This is consistent with DSP's recognition of the importance of maintaining macroeconomic stability to underpin success of DSP.

It is critical in this respect that the cost and benefit of having an offshore fund as opposed to an onshore fund are fully debated in a rational and realistic manner.

12.4 MAJOR IMPEDIMENTS OF ONSHORE FUNDS

A major issue associated with onshore funds, as has been experienced in the past with the Mineral Resource Stabilization Fund and trust accounts, is that they are all held in domestic currency. This has major ramifications for the exchange rate and the cost and difficulty of managing monetary policy given the high liquidity levels. The size of LNG revenue will be much higher than those that had to be dealt with in the past, and so will have much greater macroeconomic impacts. In addition, the delinking of actual Government spending from budget processes has weakened fiscal policy control, which tends to cause a range of serious macroeconomic pressures.

The ability of any onshore fund as an effective policy tool to manage or mitigate these important macroeconomic pressures is very limited.

The likely emergence of these issues, particularly excessive demand pressures, sizable appreciation of the Kina, and increased liquidity, is expected to have major ramifications for the operation of monetary and fiscal policy, as highlighted earlier – these pressures will be extreme if onshore rather than offshore funds are used.

In this regard, establishing an offshore fund will allow the Government to maximise its development spending while at the same time maintaining macroeconomic stability, including avoiding overheating the economy. Crucial macroeconomic stability objectives cannot be achieved with an onshore fund – this would be likely to result in activity and employment in our non-mineral sectors declining, and ordinary Papua New Guineans suffering needlessly across most provinces, either through reduced incomes, higher inflation or both. A key theme behind both DSP and PNG Vision 2050 is the expansion of the non-mineral sectors of the economy, especially in agriculture, manufacturing and tourism. In order to be able to assist rather than set back our export and import competing industries, it will be critical to establish an offshore rather than onshore SWF.

12.5 DESIGN OF SOVEREIGN WEALTH FUND/S

The design and institutional framework of an appropriate SWF/s has been guided by international best practice, the Sovereign Wealth Fund Generally Accepted Principles and Practices (Santiago Principles), and domestic requirements.

12.5.1 Objectives of a SWF in PNG

PNG's circumstances suggest that the following are the most important considerations in establishing a SWF:

- Macroeconomic stabilization - volatile and unpredictable mineral and non-mineral resource revenue, contributing to short-term macroeconomic stability (including the cost and operation of monetary policy) and avoiding deterioration in the quality of public spending;
- Improve economic and social development – to improve socio-economic development indicators through appropriate investment of the LNG revenue;
- Fiscal transparency and oversight – to enhance accountability, transparency and governance and to promote greater awareness of public financial management;
- Mitigation of Dutch disease - to counteract upward pressure on and volatility of the level of the real exchange rate, which affect the competitiveness of the non resource tradable sectors;
- Asset management - to help manage (rising) financial assets accrued from natural resource revenue; and
- Savings - to build up wealth for future generations, ensuring intergenerational equality and long-term fiscal sustainability.

12.5.2 Recommended SWF Model for PNG

In light of the above circumstances, the Government has agreed to establish a consolidated pool of offshore funds with three coordinated and integrated Funds:

1. A Stabilization Fund (Stabilization SWF) established from LNG tax revenue and other mineral and petroleum revenue,
2. Future (Savings) Fund established from LNG tax revenue and other mineral and petroleum revenue, and
3. An Infrastructure Fund (Infrastructure SWF) established from LNG dividends.

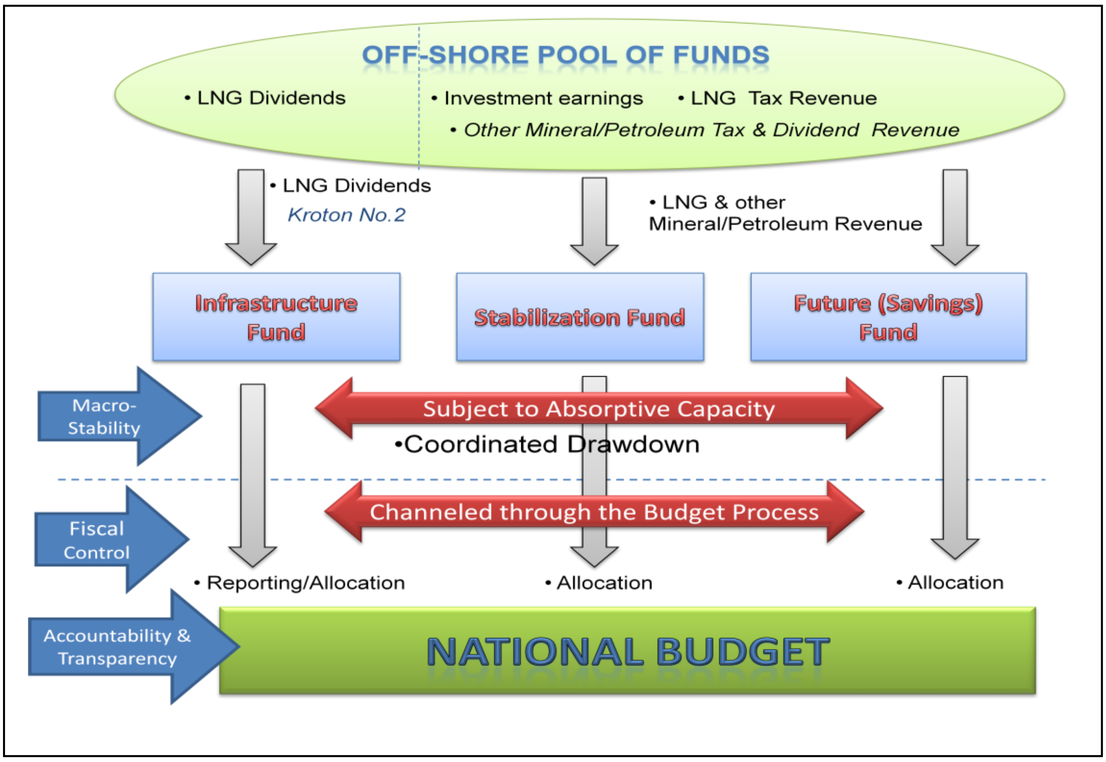
These three funds will have three separate purposes:

- The purpose of the Stabilization Fund is to help reduce the impact of volatile and unpredictable mineral and resource revenues on the domestic economy to promote macroeconomic stability. The primary objective is to insulate the budget and the economy against movements in commodity prices and by ensuring that Government spending is in-line with the absorptive capacity of the economy.

- The purpose of the Infrastructure Fund is to provide capital towards the delivery of strategic national-building infrastructure projects to promote the development goals of Papua New Guinea and ensure the aspirations of its people are met.

- The purpose of the Savings Fund is to promote savings to finance future spending and in order to smooth Government spending over the long term.

Figure 45: The relationship between the three funds



Under this model, drawdown arrangements from each fund needs to be coordinated and subject to the absorptive capacity of the economy in order to ensure prudent macroeconomic management while directly supporting the Government's development objectives.

12.5.3 Next Steps

Following Cabinet's agreement, a Secretaries Committee on Sovereign Wealth Funds will be establish to oversee the establishment of the offshore Sovereign Wealth Fund for PNG with membership comprising the Secretary of PM and NEC, Secretary of Treasury, Governor Bank of PNG, Secretary of Public Enterprises, Secretary of National Planning and Monitoring, and Secretary of Justice and Attorney General. The Committee is to be chaired by the Secretary of Treasury.

In addition, an Inter-departmental Sovereign Wealth Fund Working Group will also be established to support the Secretaries Committee, with membership comprising the Department of Treasury, Bank of Papua New Guinea, Department of National Planning and Monitoring and Department of Public Enterprises, chaired by the Department of Treasury.

The design and establishment of Stabilization and Future (Savings) SWFs will be led by the Department of Treasury and Bank of Papua New Guinea in conjunction with key Government departments including the Department of Public Enterprises and the Department of National Planning and Monitoring. These four (4) departments will make up the Inter-departmental Sovereign Wealth Fund Working Group (ISWFWG) under the oversight and guidance of the Secretaries Committee on Sovereign Wealth Funds.

While the design and establishment of Infrastructure SWF will be led by the Department of Public Enterprises in conjunction with key Government departments including the Department of Treasury, the Department of National Planning and Monitoring and other key Government departments through the (ISWFWG) under the oversight and guidance of the Secretaries Committee on Sovereign Wealth Funds.

Within the SWF, the PNG LNG dividends will be accounted for separately and held for ultimate distribution through the budget for the purpose of strategic nation-building infrastructure, with details to be led by the Department of Public Enterprises in conjunction with Department of Treasury and other key departments and agencies.

Drawing on international best practice and past experience, key design elements of all SWFs will include:

a) Establishing a consolidated pool of offshore funds.
b) Fully integrating the SWF with the budget and fiscal framework.
c) Governance, transparency, disclosure, accountability and asset management rules should be based on international best practice and Sovereign Wealth Fund Generally Accepted Principles and Practices.
d) Drawdown rules need to be developed in order to ensure prudent macroeconomic management while directly supporting the Government's development objectives.
e) The SWF should be overseen by an independent board which is established to act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions. The independent board should be supported by a secretariat from the Department of Treasury and the Bank of Papua New Guinea.
f) Investments by offshore fund managers should be guided by a set of investment policies and guidelines that achieve a risk return trade-off acceptable to the independent board.
g) Investment should be undertaken by an offshore investment manager/s who should invest only in foreign assets and be restricted from purchasing PNG government debt or investing or lending directly domestically.
h) To minimise transaction costs and maximise efficiency, offshore investment of all LNG and mineral and petroleum tax revenue and related investment earnings should be channelled through a single pool of funds.
i) Investment, management, and coordinated drawdown rules for the three funds.

The Secretaries Committee on Sovereign Wealth Funds will take all necessary steps to establish all three funds, including:

a) Establishing funds in strict accordance with the design elements outlined above.
b) Developing a detailed implementation schedule for the three funds.
c) Identifying all legal, constitutional, budgetary, taxation, investment, planning and all other relevant considerations associated with the establishment of operation and drawdown of funds and seeking expert advice from government, development partners or other experts to identify and address any associated issues.

d) Taking all necessary steps to establish an independent board and secretariat to support the establishment and operation of the funds, including criteria and arrangements for the establishment of a board.

e) Undertaking a public information, education and awareness program across the country to foster understanding on this matter of national importance.

The Secretaries Committee on Sovereign Wealth Funds will provide regular updates to the Ministerial Committee for the Economic Sector and NEC.

Given the level of public interest in this issue, the Department of Treasury will provide annual updates on progress in establishing these Sovereign Wealth Funds in the annual Budget documents.