

Presentation to the PNG Institute of Directors

Proposed Sovereign Wealth Fund for the Future Management of LNG Revenue

The Department of Treasury and Bank of Papua New Guinea
Joint Sovereign Wealth Fund Working Group

Tuesday, 20 July 2010

Background Information

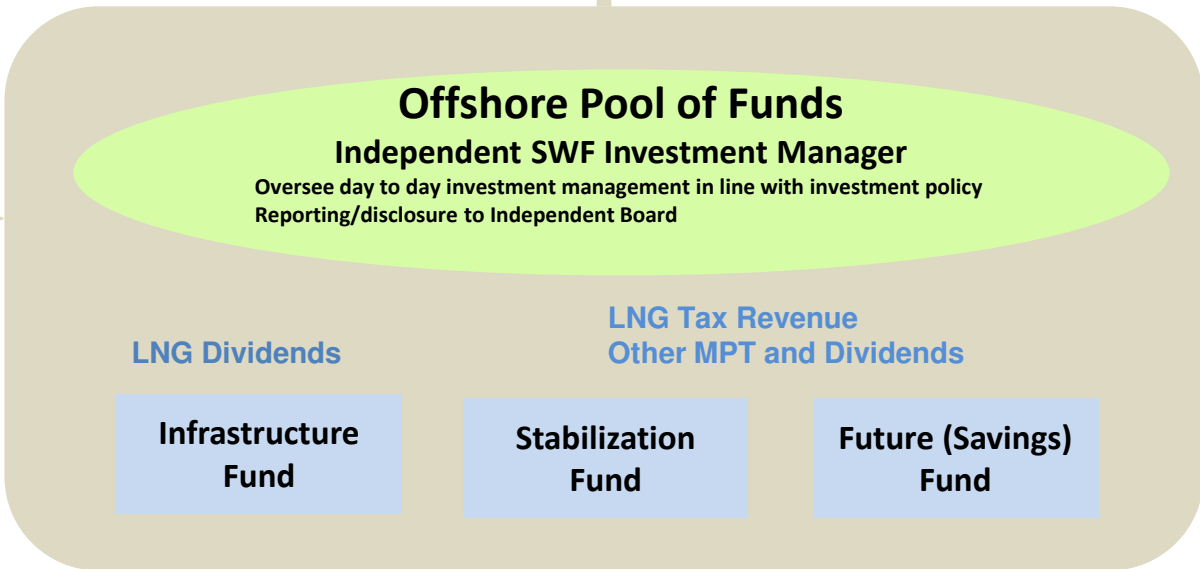
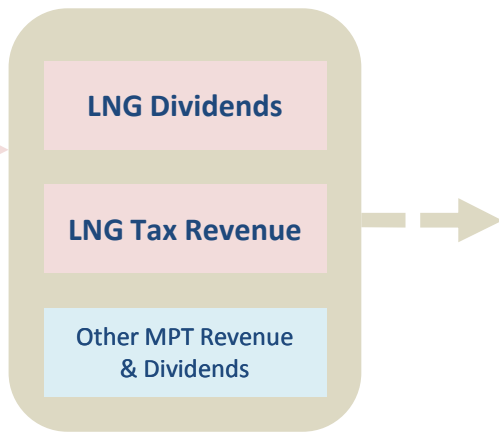
- Emergence of the PNG LNG project has major economic and development implications
 - Substantial long term revenues from PNG LNG project
 - Potential to transform economy
 - Opportunity to underpin national development
- In March 2010, NEC established a joint Treasury-Bank of PNG Working Group to develop options to manage these revenues.

Recommended Model

- Establish a consolidated pool of offshore funds with three coordinated and integrated Funds
 - Stabilization Fund;
 - Infrastructure Fund; and
 - Future (Savings) Fund
- Fully integrating SWF with the budget and fiscal framework
- Governance, transparency, disclosure, accountability and asset management rules be based on international best practice
- Drawdown rules be developed to ensure prudent macroeconomic management while supporting development objectives
- SWF to be overseen by an independent board
- Investment be undertaken by offshore investment manager

Offshore SWF to be overseen by Independent Board

Offshore funds management by independent investment manager
Reporting and disclosure of investment activities and fund performance



Consistency with Government Policy

Infrastructure Fund – Kroton No. 2
Stabilization & Savings Funds

SWF Revenue Streams

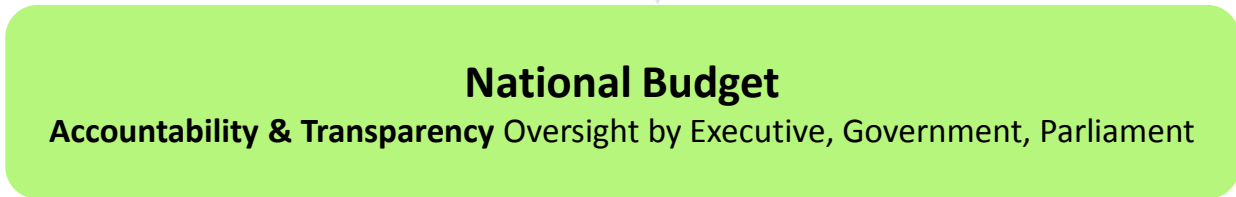
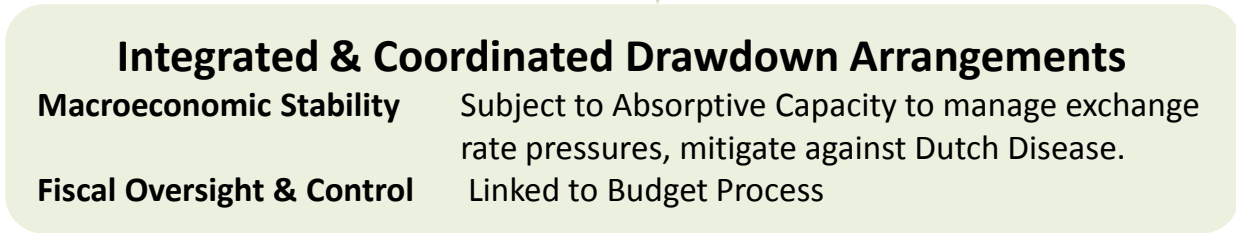
LNG Dividends – Kroton No. 2
LNG Tax Revenue / Other MPT & Dividends – Financing Fund

Coordinated Drawdown Arrangements

Promotes Macroeconomic stability, manages exchange rate pressures/Dutch Disease risks
Clear link to Budget Process – allocation and reporting of 3 Funds
Promotes Government oversight of the allocation of funds

Next Steps – Second Phase Work

Whole of Government effort to develop SWF in line with design principles - *detailed development of all aspects of SWF*
Overseen by Secretaries Committee, report to Govt



Key Issues

- Onshore versus Offshore
- Macroeconomic Stability
 - Exchange Rate Appreciation / Dutch Disease
 - Monetary Policy Issues
 - Absorptive Capacity
- Drawdown arrangements
- Single pool of funds versus multiple funds
- Key design issues

Onshore SWFs

- PNG has used onshore funds in the past:
 - Mineral Resource Stabilization Fund (MRSF)
 - Trust Accounts
- Limitations:
 - Funds invested onshore
 - Inefficient management arrangements
 - Lack of flexibility
 - Poor transparency, accountability and governance arrangements
 - Funds from LNG will be much higher

Offshore SWFs

- Size of LNG revenues have substantial macroeconomic implications that need to be carefully managed.
 - Exchange rate appreciation / Dutch disease
 - Cost and operation of Monetary Policy
 - Risk of overheating the domestic economy
 - Adverse effects in non-mineral sectors of the economy
- Offshore arrangements:
 - State will retain full ownership and control
 - Promote macroeconomic stability;
 - Underpin long term development and socio-economic objectives
 - Help protect non-mineral sector industries
 - Are robust, transparent and effective

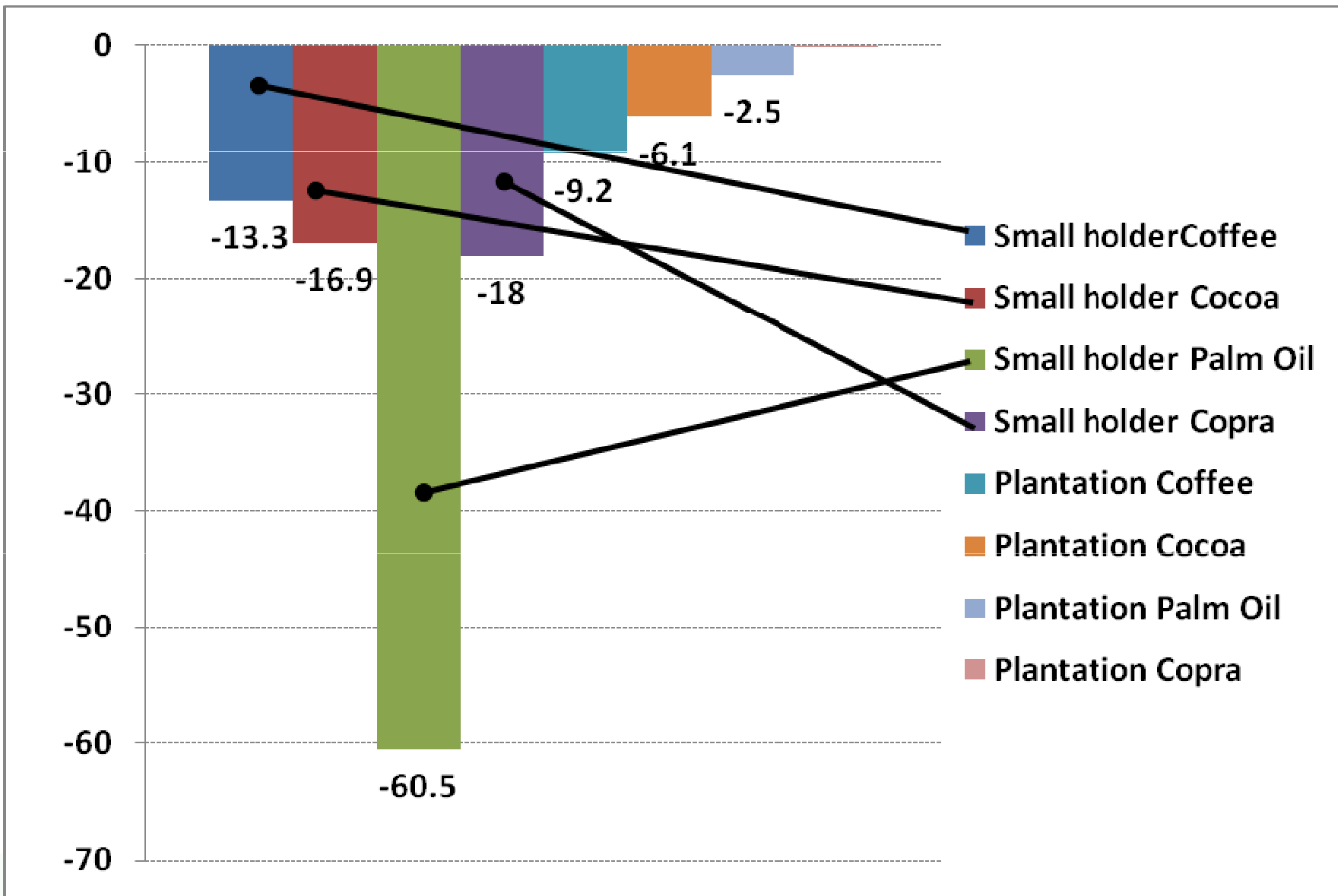
The Exchange Rate / Dutch Disease

- Caused by a large inflow of foreign currency
- The significant revenues from LNG project makes PNG susceptible to a stronger exchange rate
- The effects of Dutch Disease:
 - Decrease in competitiveness of non-mineral sectors of the economy
- Effects can be minimized through the creation of an offshore SWF

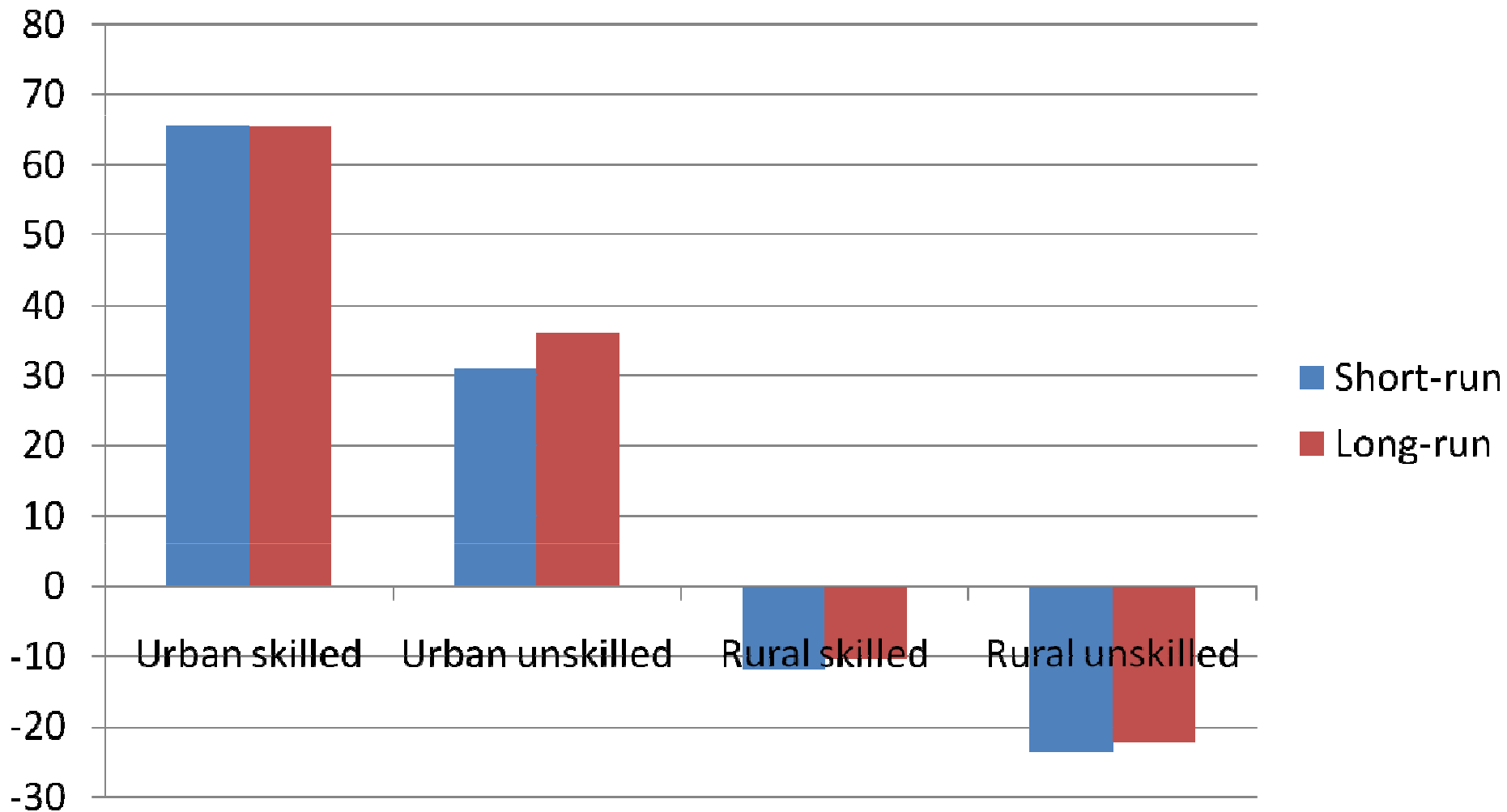
Sectoral Impacts of the LNG

- LNG may disadvantage export and import competing sectors of the economy
 - Agriculture, manufacturing and tourism could be badly affected if not managed properly
 - Negative impacts of a higher exchange rate would reduce economic activity and employment across most provinces in PNG.
- Analysis and modelling by ACIL Tasman indicates:
 - Real Exchange Rate may appreciate by 11 per cent in the long run
 - Reduce the external competitiveness of domestic non-mineral export sectors eg. agriculture and forestry
 - Potential large adverse impact on value added in the Agricultural sector

ACIL Tasman - Modelled impact of PNG LNG in the Agricultural sector (%)



ACIL Tasman - Modelled impact of PNG LNG in on Employment (%)



Monetary Policy Issues

- Objective: achieve and maintain price stability
 - Low inflation supported by stable interest and exchange rates
- Increase in domestic liquidity has adverse implications
 - Increase inflationary pressures
- BPNG mopping up excess liquidity increases the cost of monetary policy operations
- Appreciation of Kina reduces the value of foreign reserves
- High inflation would hurt the poorest in the community the most

Absorptive Capacity of the Economy

- PNG economy has limited capacity to absorb additional Government spending from LNG revenues
- Too much Government spending can cause the economy to overheat and inflation to get out of control
- Excess demand pressures increase imports and inflation
- Absorptive capacity can be categorized under 3 distinct measurement constraint:
 - Macro-economic constraints
 - Quantitative constraints
 - Institutional constraints
- Economic modeling on absorptive capacity is very complex
 - Preliminary modeling provided by IMF/World Bank and AusAID provides no basis for firm conclusions
 - Further economic modelling could be undertaken

Drawdown arrangements

- Coordinated and integrated drawdown arrangements underpin the effective operation of any SWF.
 - Arrangements vary between SWFs
- Balanced and reasonable approach is recommended
- **This will allow a very large boost to actual Government spending without unduly jeopardising macroeconomic stability**

Single fund or multiple funds?

- Working Group recommends that all LNG revenue and investment earnings should be channelled through a single pool of funds.
 - Minimises transaction costs
 - Maximise efficiency of investment
 - Facilitates control over the size of the overall drawdown
 - As needed, separate control can be established by separate investment mandates

Key Design Elements

- Fully integrating the SWF with the budget and fiscal framework
- Governance, transparency, disclosure, accountability and asset management rules based on international best practice
- Ensure proper surveillance by Parliament.

Next Steps

- Agreement to SWF structure and design elements sought
- Significant further detailed work required
 - Priority tasks include legal, constitutional, budgetary, taxation, investment and planning issues and the establishment of the independent board.
- Secretaries Committee and Interdepartmental Working Group proposed
 - All government departments and agencies need to work together
- Public information, education and awareness program



For more information

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