

PNG's Macroeconomic Outlook

Strategies for Exiting the Boom and Bust Cycle

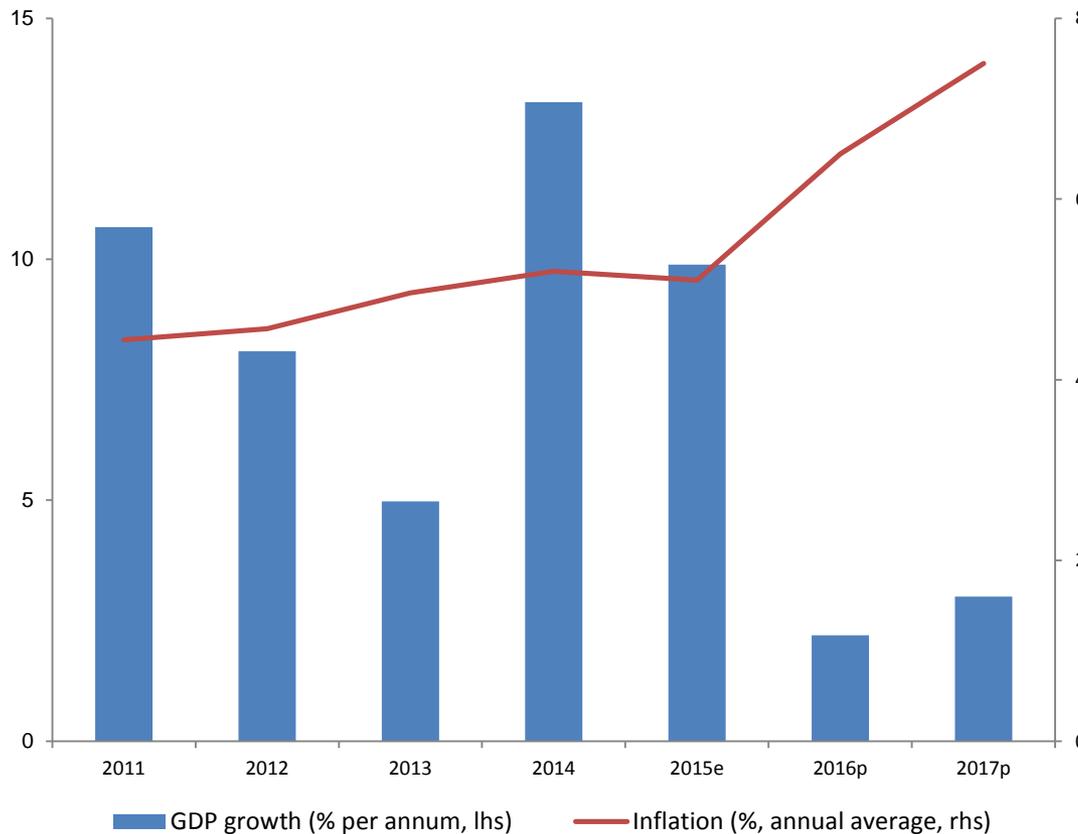
Dr. Yurendra Basnett

Country Economist

Asian Development Bank

Papua New Guinea Resident Mission

Strong Headwinds Affecting Growth

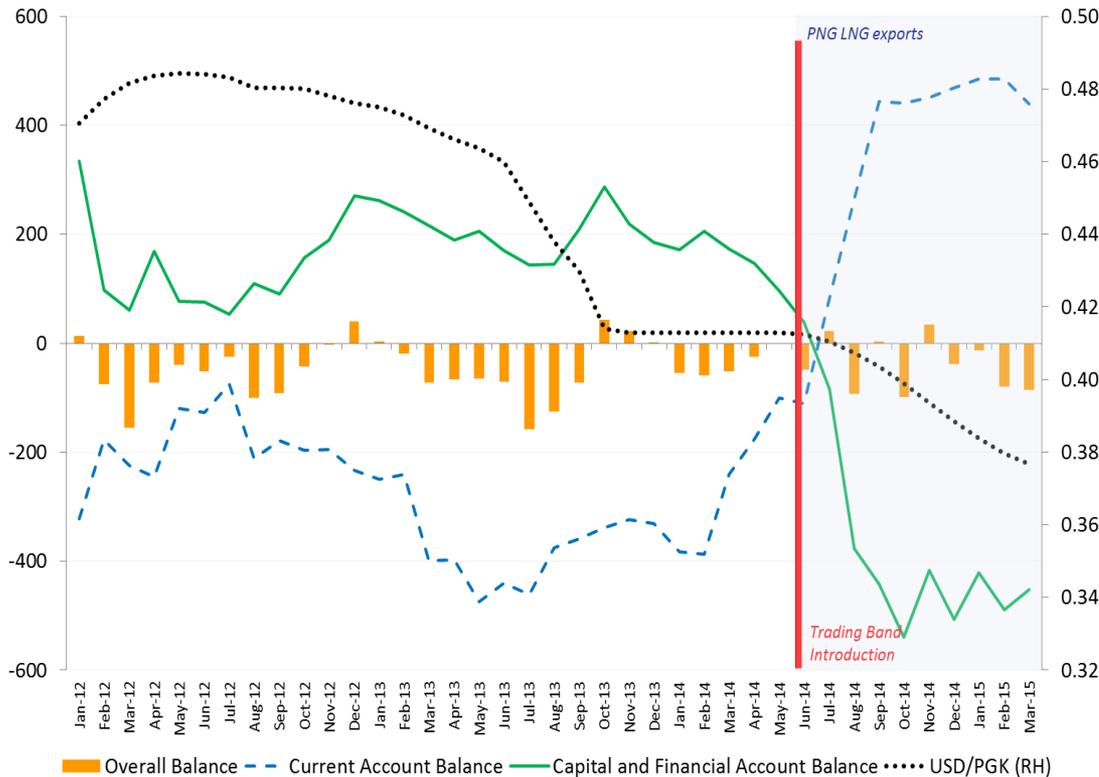


- **Economy slowing down.** Government revised 2016 GDP growth forecast to 2.2%. 2017 GDP growth expected to be 3.0%.
- **Inflationary pressure building up.** Inflation in 2016 revised up to 6.5% , and expected to rise to 7.5% in 2017.
- New mining projects in the medium-term provide upside risks.

Source: Asian Development Outlook Update (2016).

Weakened External Position

BOP Accounts (3-mths moving average, USD millions) and USD/PGK

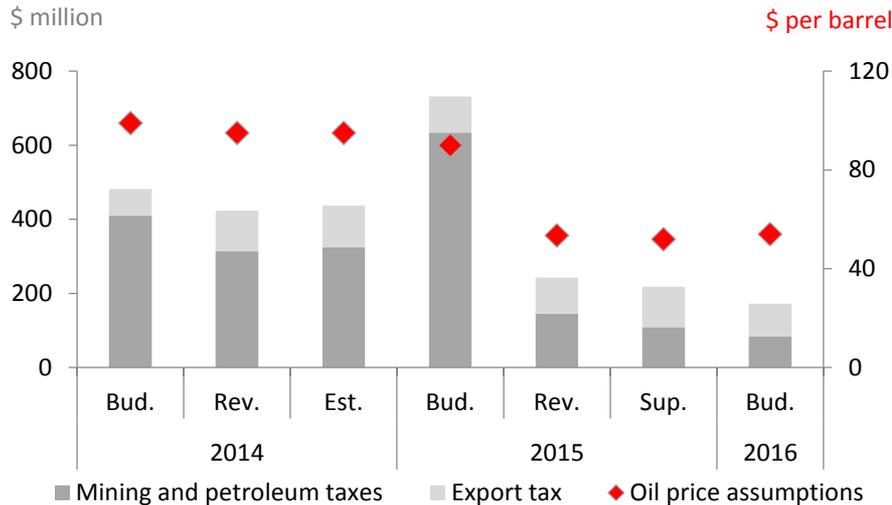


- **Limited FX inflows** relative to exports from the mineral sector.
- **Loose fiscal policy** had contributed to the relatively strong demand for imports and hence foreign exchange.
- FX trading band led to an appreciation of the USD/kina exchange rate and an increase in the outstanding sell kina orders.

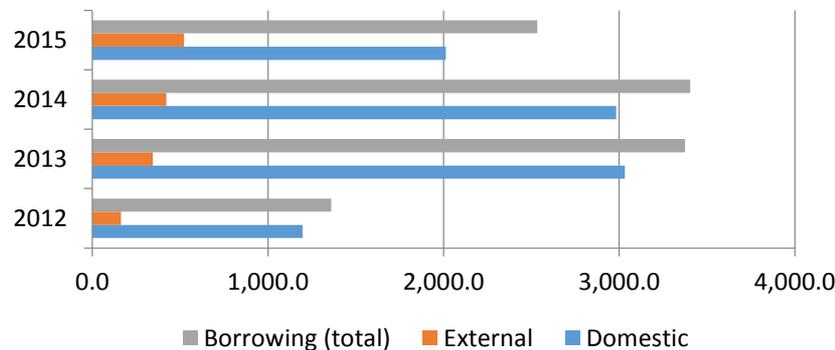
Source: BPNG data; Estimates based on ADB, World Bank & BPNG joint analysis

Weakened Fiscal Position

Revenue performance and projections



Total borrowing and sources (in Kina millions)

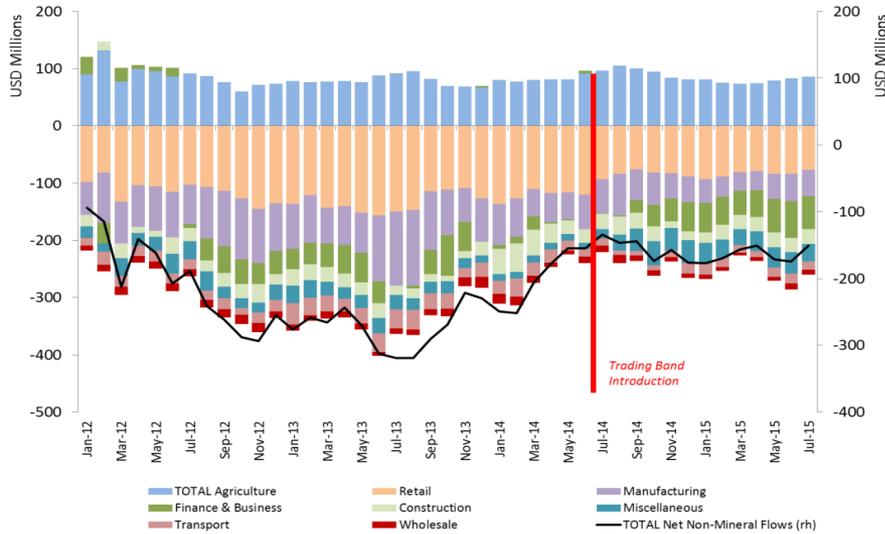


- **Sustained fall in commodity prices drastically reduced public revenue.** In 2015, overall revenue fell by PGK 2.5 billion (or 21% total revenue), with the largest reduction being in Mining and Petroleum Tax (91%).
- **Expansionary fiscal policy started in 2012 led to a large structural fiscal deficit.** The deficit increased from 0.3% of GDP in 2012 to 9.6% in 2013 and 8.3% in 2014, which was largely financed through domestic borrowing.
- **Existing budget financing measures have reached their limit.** Little market appetite for new government securities as financial institutions reach their technical limit on exposure to public debt.
- **2016 Revenue shortfall of PGK 1.9 billion (US\$ 633 million).**

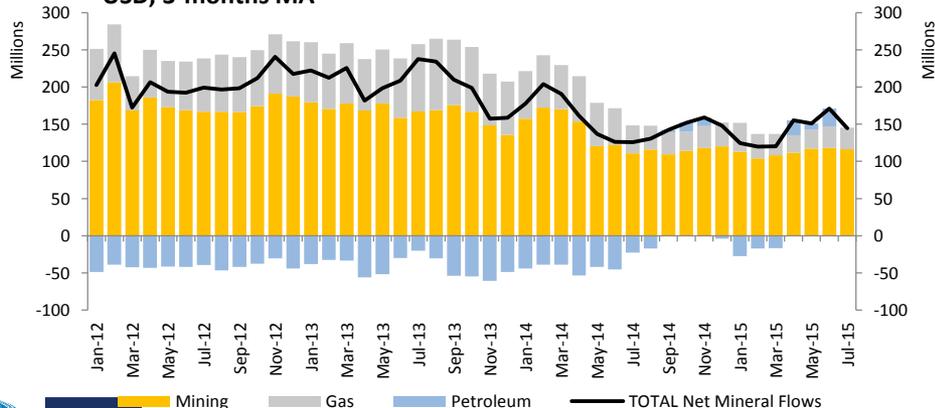
Source: Asian Development Outlook Update (2016).

Cyclical Factors

Total net inflows according to activities associated with resource sector

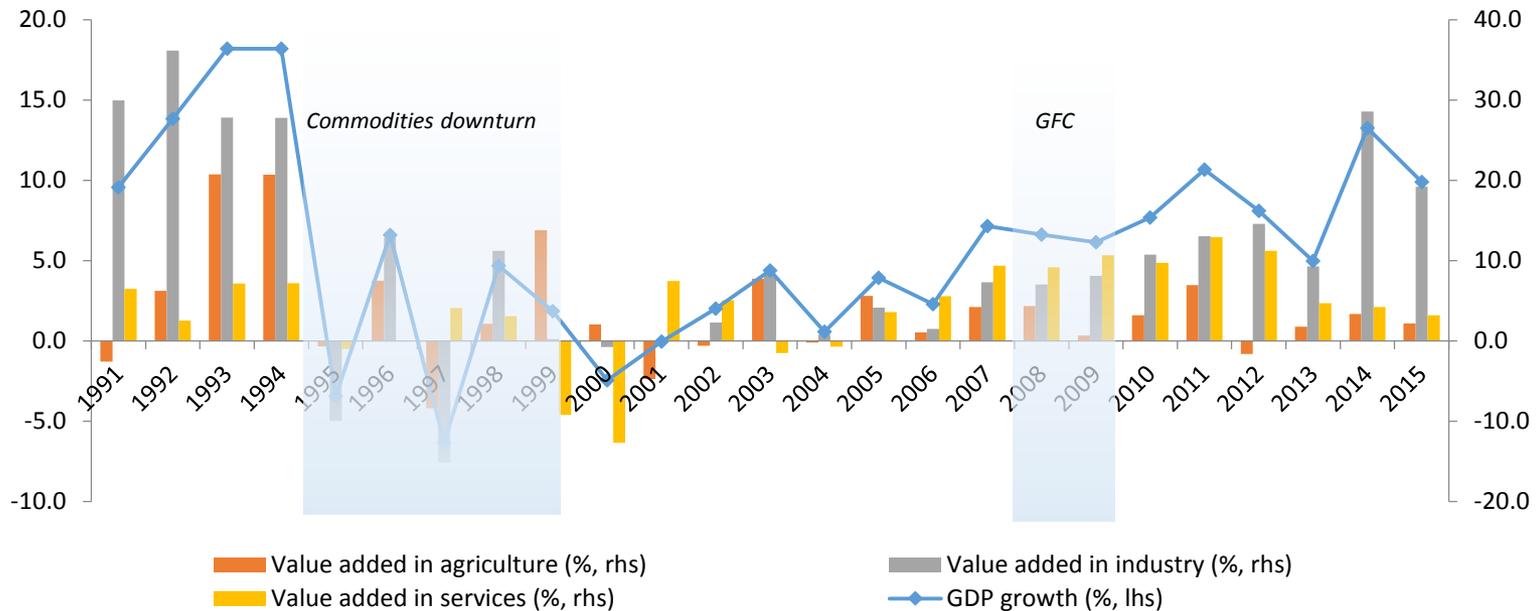


Total Net Mineral Flows USD, 3-months MA



- **Declining international commodity prices**, which started in 2012, generated lower inflows from key export commodities such as copper, gold and oil.
- The **El Niño weather phenomenon** which began in 2015 reduced mining and agricultural exports and consequently FX inflows and reserves.
- Capital and financial inflows previously associated with PNG LNG construction phase have ceased.

Structural Factors



Source: ADO (various years)

- Increasing reliance on resource exports has made the economy vulnerable to external shocks.
- Low productivity in non-mining sector: agriculture, manufacturing and services.
- Key constraint to economic diversification include:
 - Limited infrastructure.
 - High/inflated operating costs.
 - Weak business environment.

Historical Experiences

- **1997 to 1998 (Asian Financial Crisis and El Nino):**
 - Depreciation of the kina from PGK 0.75/USD to PGK 0.37/USD, but exports did not pick up.
 - FX reserves deteriorated from 2.6 months to 1.2 months of import cover (US\$ 213 million).
 - Tax revenue fell by 4½% of GDP in 1998.
 - Despite cuts in capital spending, overall deficit widened (equivalent to 2.1% of GDP in 1998 from near balance in 1997).
 - The non-resource sector contracted by 2.3 percent (in real terms) in 2000.
- **2008 Global Financial Crisis:**
 - Strong fiscal buffers (built over much of 2000) and growth momentum helped PNG withstand the impact.
 - Swift recovery in global commodity prices.

Source: Based on ADB and World Bank joint analysis

Key Lessons

- Economy susceptible to external economic and natural shocks.
- Global commodity price key transmitter of external economic shock.
- Pro cyclical policy stance and reduced fiscal buffers.
- Investments in productive infrastructure and human development.

Improving Fiscal Stance

- Calibrated move to balanced budget by 2020/2021.
- Proactive measures taken to rein ballooning of the deficit.
- Introductions of revenue measures.
- Cutting of non-essential and non-productive expenditures.
- Going forward effective implementation of reforms identified by the Government will be key.

Public Finance Management Reforms

- Planning and Monitoring Responsibility Act (2016) aims to strengthen the link between annual budget and medium-term development plan.
- National Budget Framework (2016) will bind annual budget allocation (appropriations) to the national development priorities.
- Public Finance Management Act Amendment (2016): Stronger controls on issuance of warrants and financial reporting, better monitoring of statutory authorities, controls on trust fund accounts, strengthening financial management at sub-national level.
- Reform to Budget Process: Unified budget (recurrent and capital expenditure), Multi-year budget, and two-stage budget process (design and cost approval for capital expenditure). The 2017 Budget will consider SDG priorities.

Prognosis:

- Fiscal consolidation is welcomed, but needs to be done prudently to safeguard development priorities.
- Execution of PFM reform and monitoring of outcomes will be important.

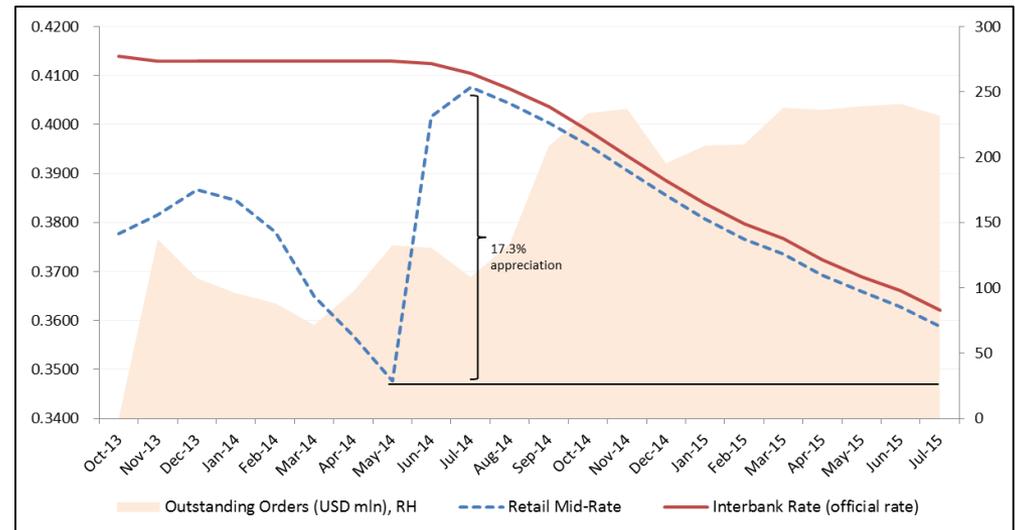
Central Bank's Monetary Position

- Central Bank maintains neutral policy stance to support economic activity.
- Kina depreciating at a policy determined speed.
- Central Bank plans to purchase of 63 day Treasury Bills for monetary policy signaling rate.

Prognosis:

- The neutral policy stance may not be adequate to reduce the excess liquidity.
- Trading band around the exchange rate is not sustainable.
- Proposed reform to monetary policy signaling rate could reduce fiscal discipline and stoke inflationary pressures.

Retail vs Interbank USD/PGK Rate & Outstanding Sell Kina Orders



Source: BPNG data; Estimates based on ADB, World Bank & BPNG joint analysis

Economic Diversification Vital for Reducing Growth Volatility

- Weak institutions undermine structural economic transformation.
- Increasing reliance on resource exports has made the economy vulnerable to external shocks.
- Important to increase productivity in non-mining sector: agriculture, manufacturing and services.
- Key constraint to economic diversification include:
 - Limited infrastructure.
 - High/inflated operating costs.
 - Weak business environment leads to high mark ups resulting from high concentration ratios.

Source: *Asian Development Outlook (2016)*

Measures Needed to Avoid Boom and Bust Cycle

1. Sustain investment in infrastructure to support productive sectors.
2. Expand opportunities for private sector participation in non-mineral sector.
3. Invest in human development.
4. Improve performance of public expenditure and increase budget efficiency.

Source: Asian Development Outlook (2016)



Em tasol