

PNG – Pathways from Potential Crisis

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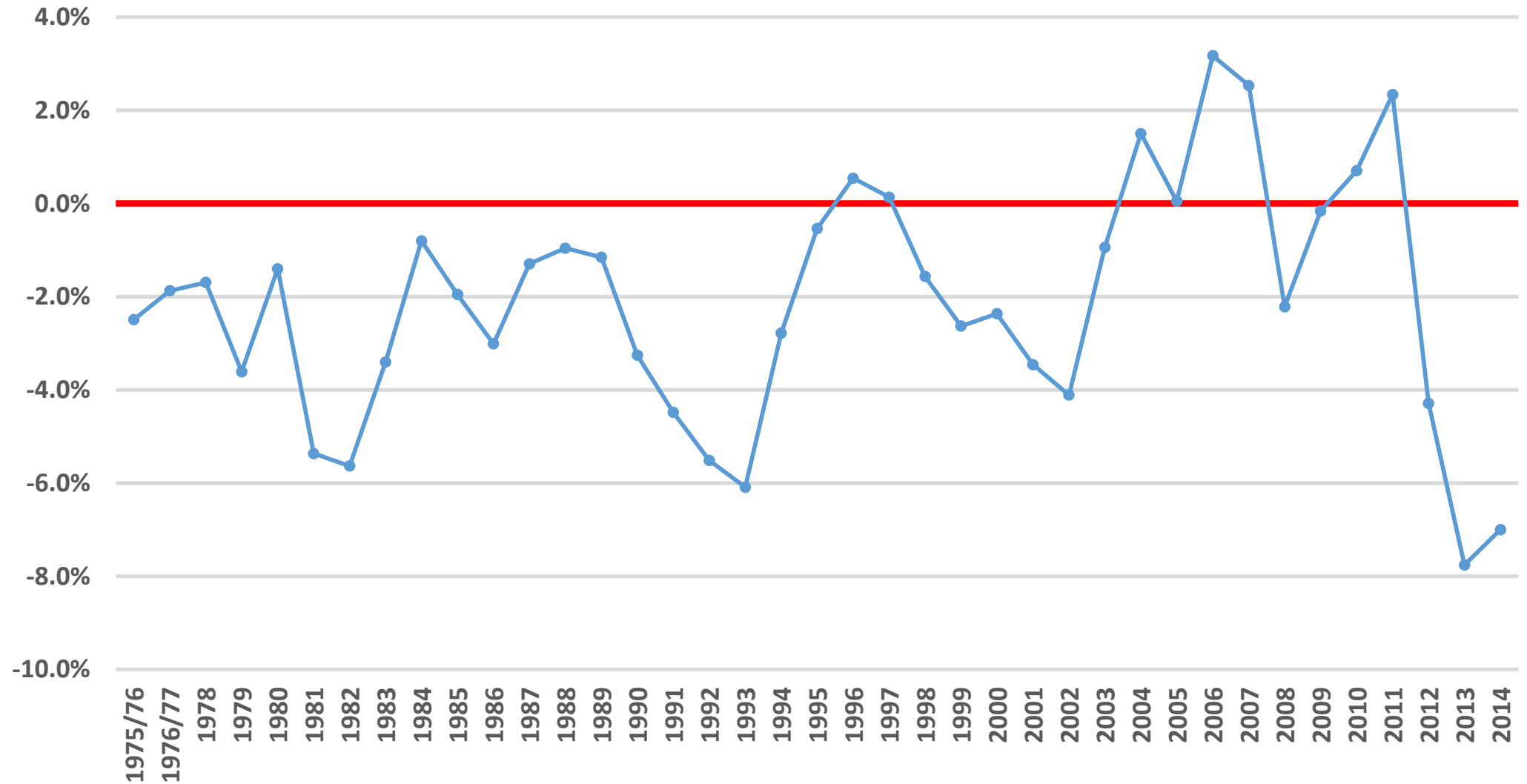
Overview

- Potential crisis - types
- Fiscal challenge
 - International Comparisons
 - PNG fiscal history
 - Very hard talk - 2016 Budget Strategy
 - Revenue
 - Expenditure
 - Debt and financing
 - Hard talk
 - Real talk
- External challenge (international reserves)
 - Balance of payments outlook
 - The real effective exchange rate
- Criteria for a good 2016 budget

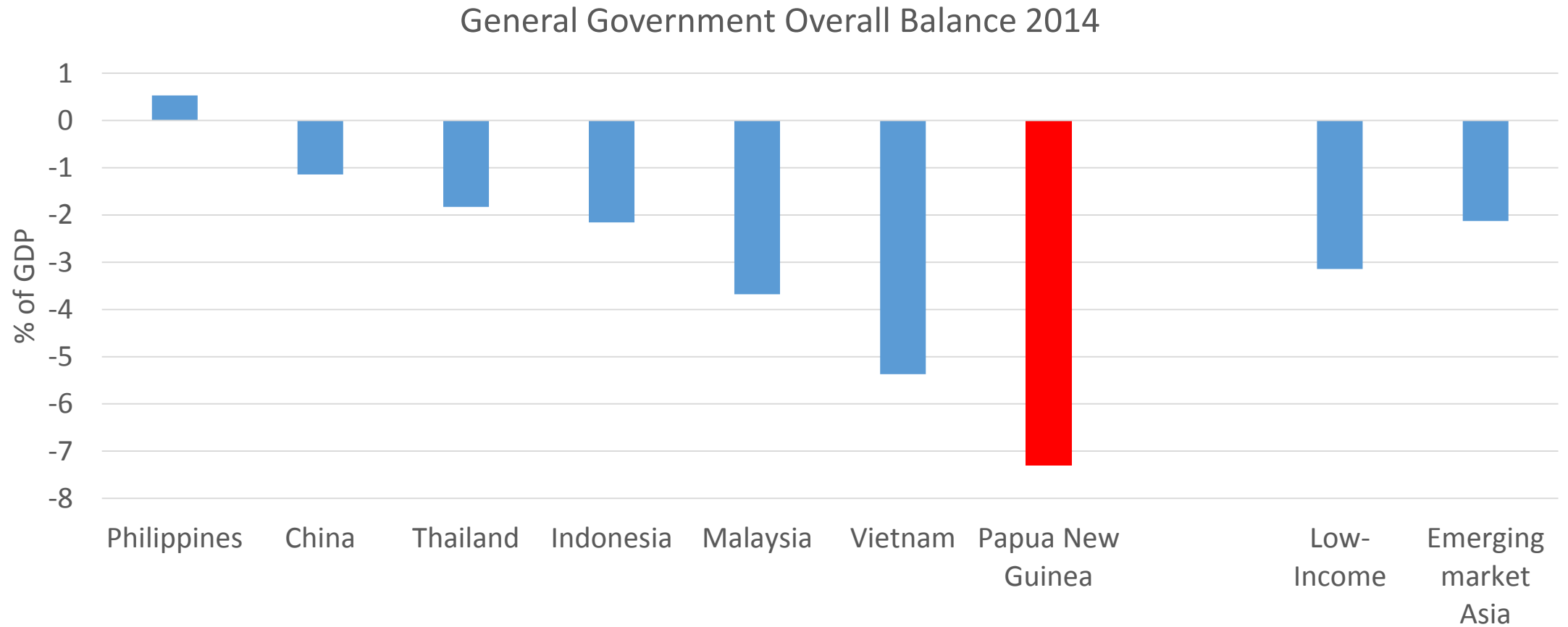
Potential crisis – what does this mean?

- 3 types of crisis observed in countries through time (talk will focus on first, and some comments on second)
- Fiscal crisis (PNG – first and second 1990s crises)
 - Government runs out of money to pay its bills.
 - Potentially manifested by shortage of government cash, 'out of the ordinary' borrowings, printing money, much higher government security interest rates.
- External crisis (PNG – first and second 1990s crises)
 - Running out of foreign currency to pay bills (either private or more particularly government)
 - Potentially manifested by various forms of exchange rate controls, tariffs and quotas, foreign currency borrowings.
- Muddling down crisis (more African and South American examples)
 - Pattern of continuing poor decision making undermining sustainable growth.
 - Medium to long-term timeframe – a slow bubbling crisis that may extend over a decade.
 - Potentially manifested by pattern of poor economic policy decisions, increasing corruption, declining levels of private investment, declining international credit ratings, falling growth rates, growing poverty.

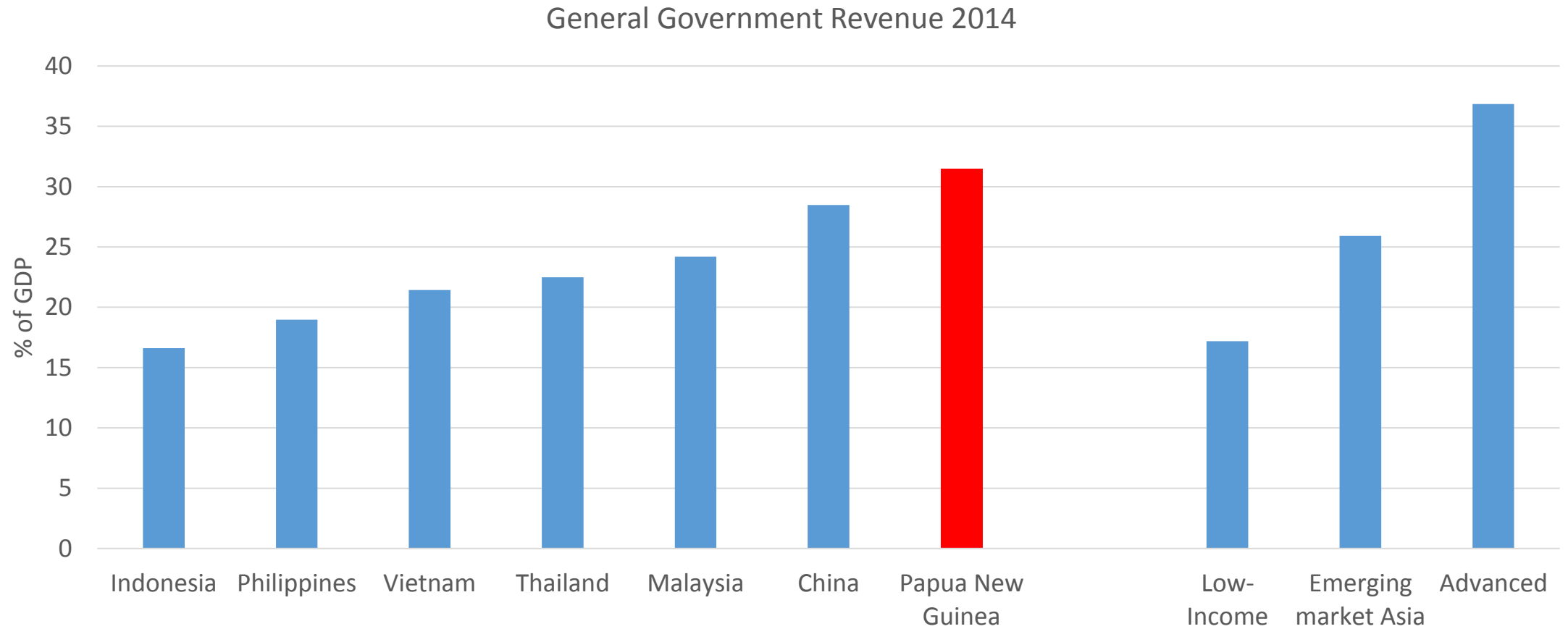
PNG budget balance – 2013 and 2014 largest deficits in PNG's history



International - Very large deficit

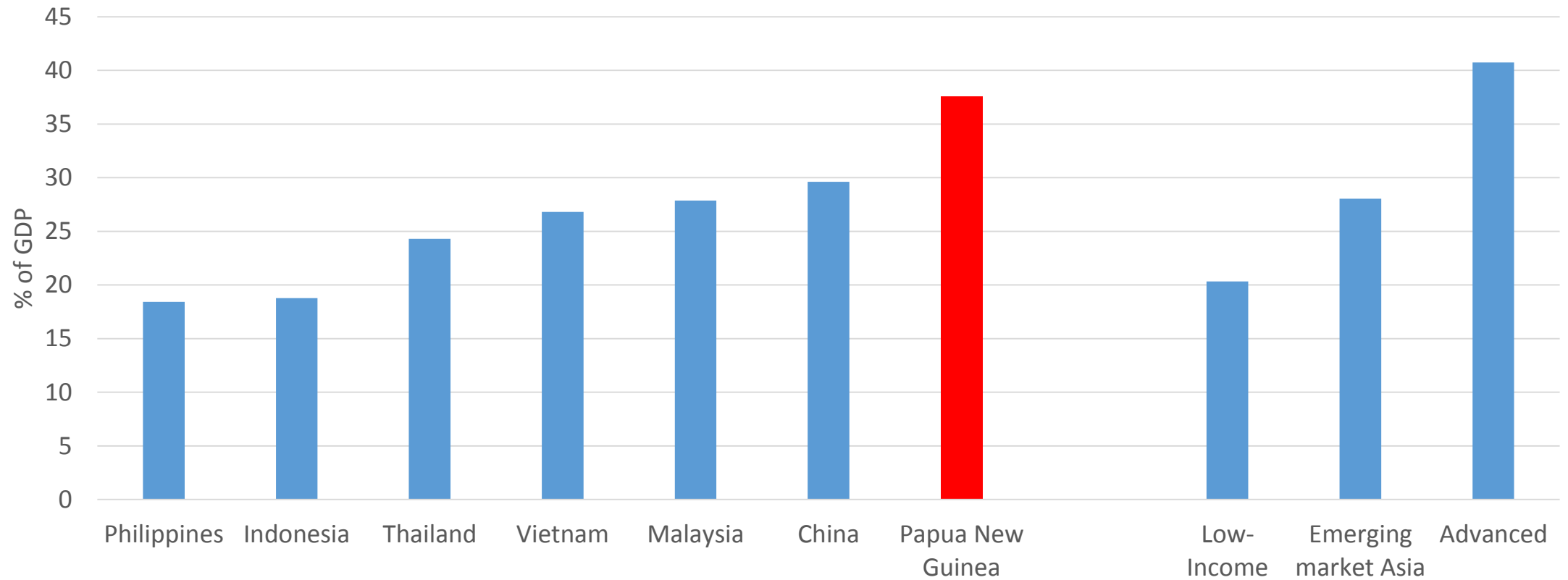


International – PNG high taxing



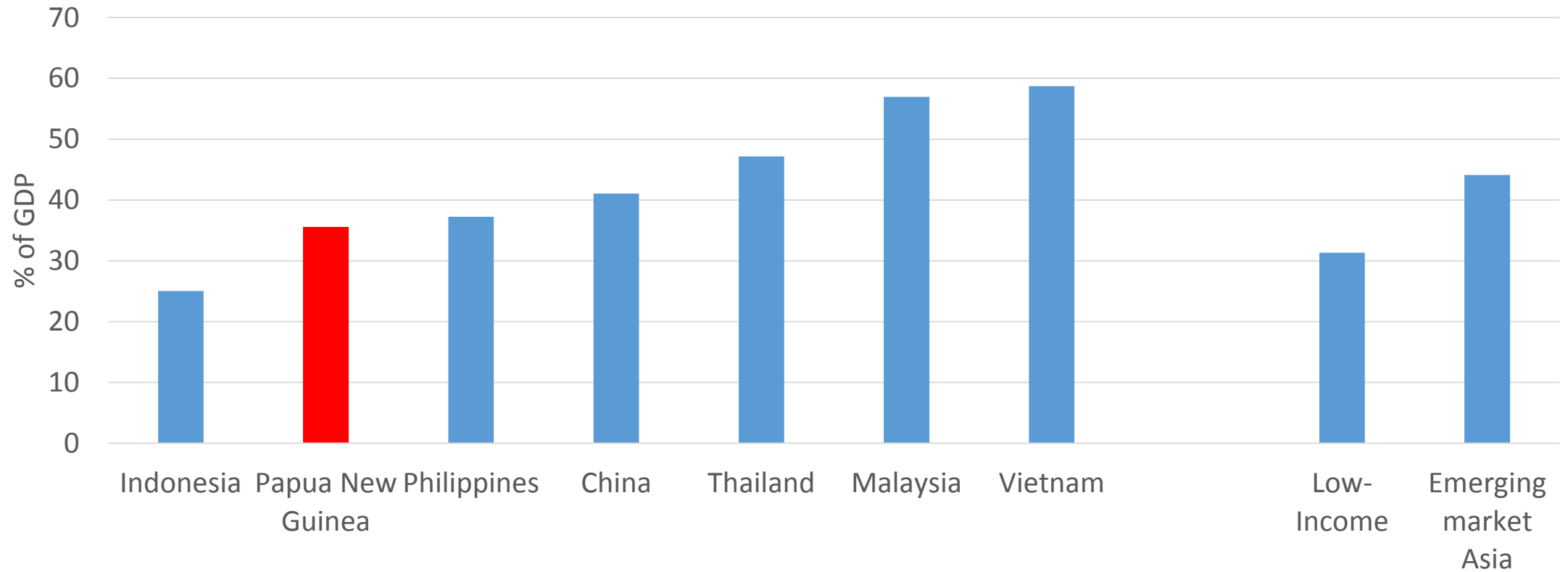
International – PNG very high spending

Central Government Expenditure 2014



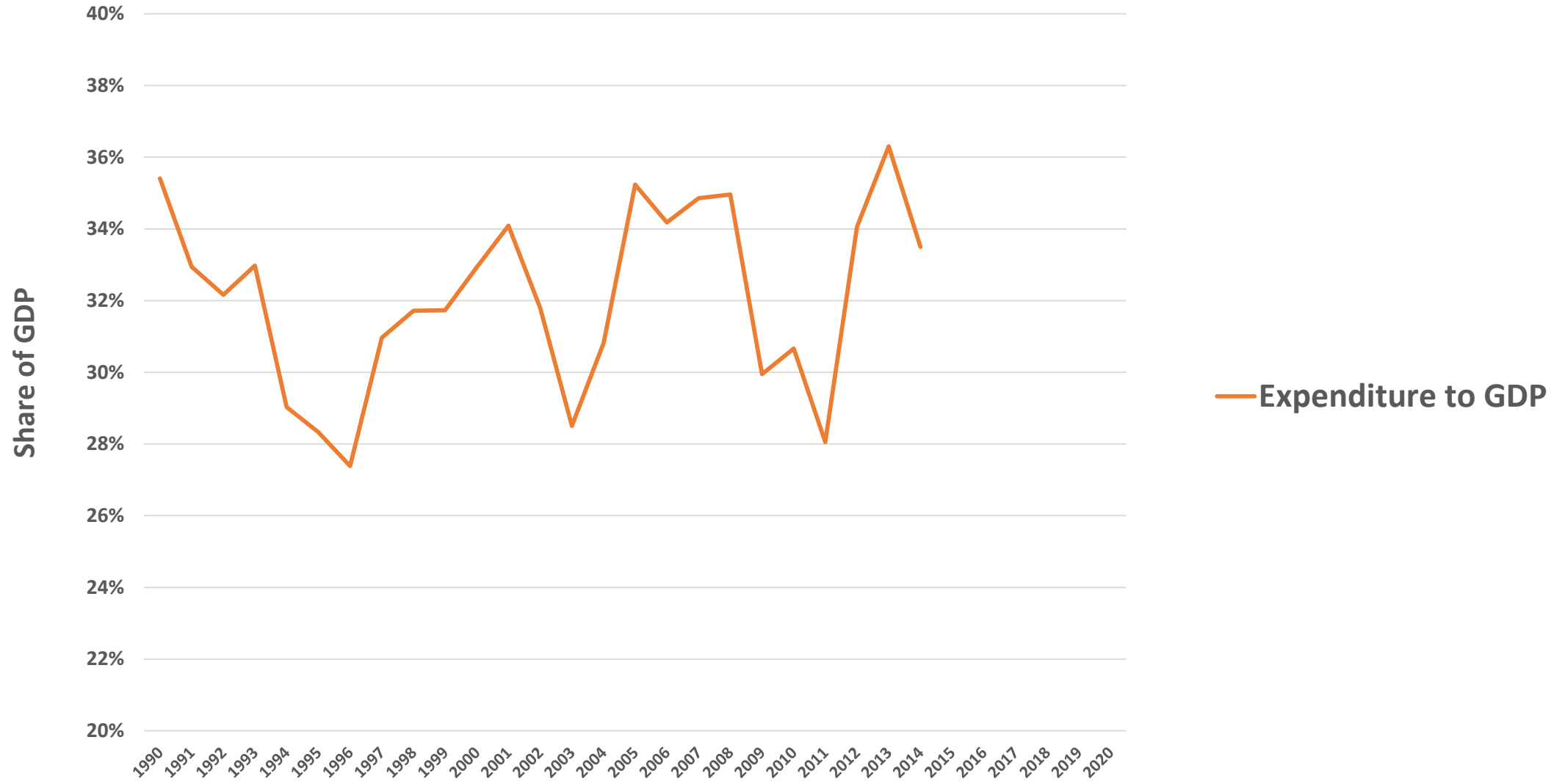
International - Moderate public debt levels

General Government Gross Debt 2014



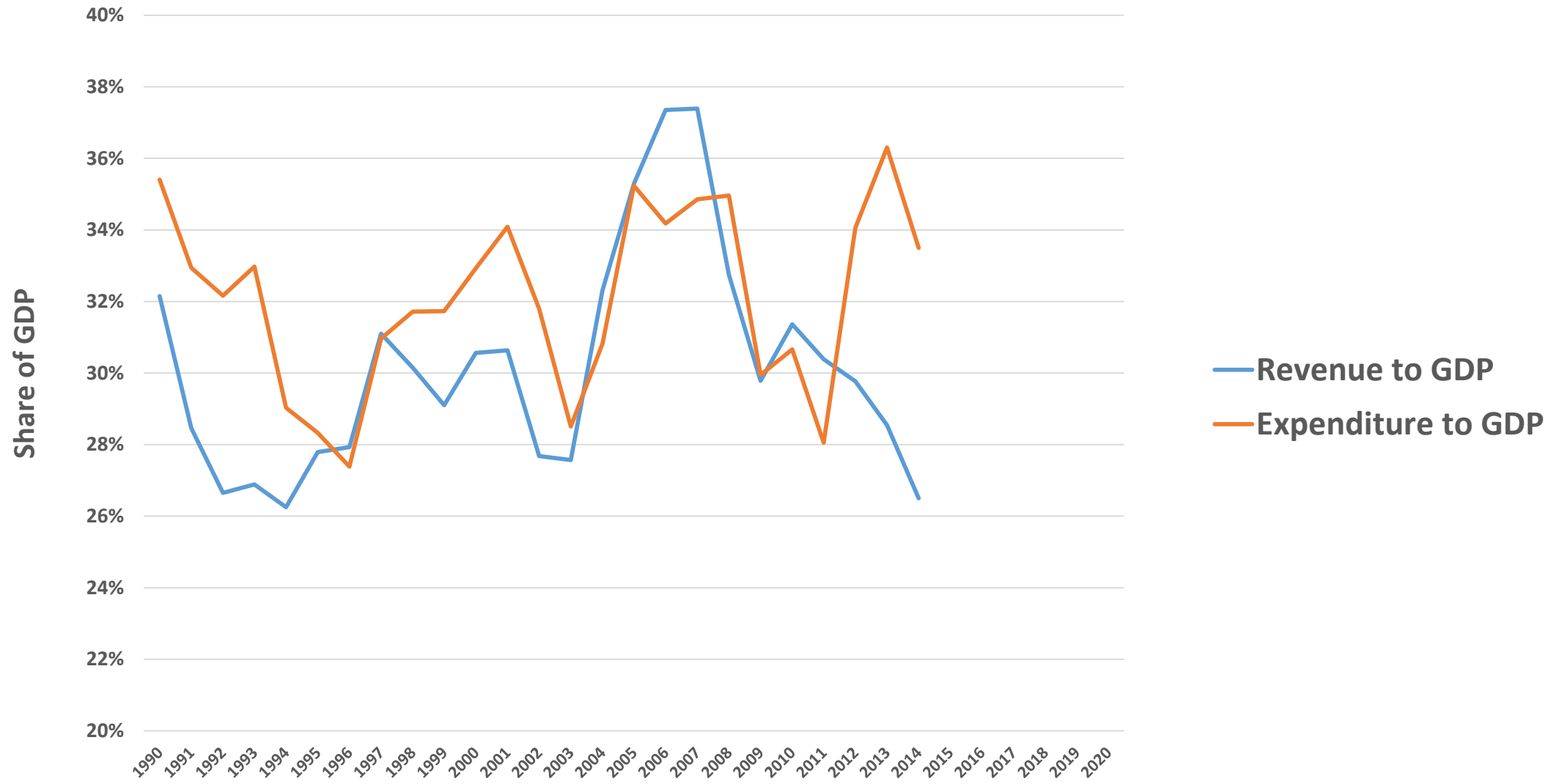
PNG Budget over 30 Years

Expenditure and Revenue as shares of the Economy



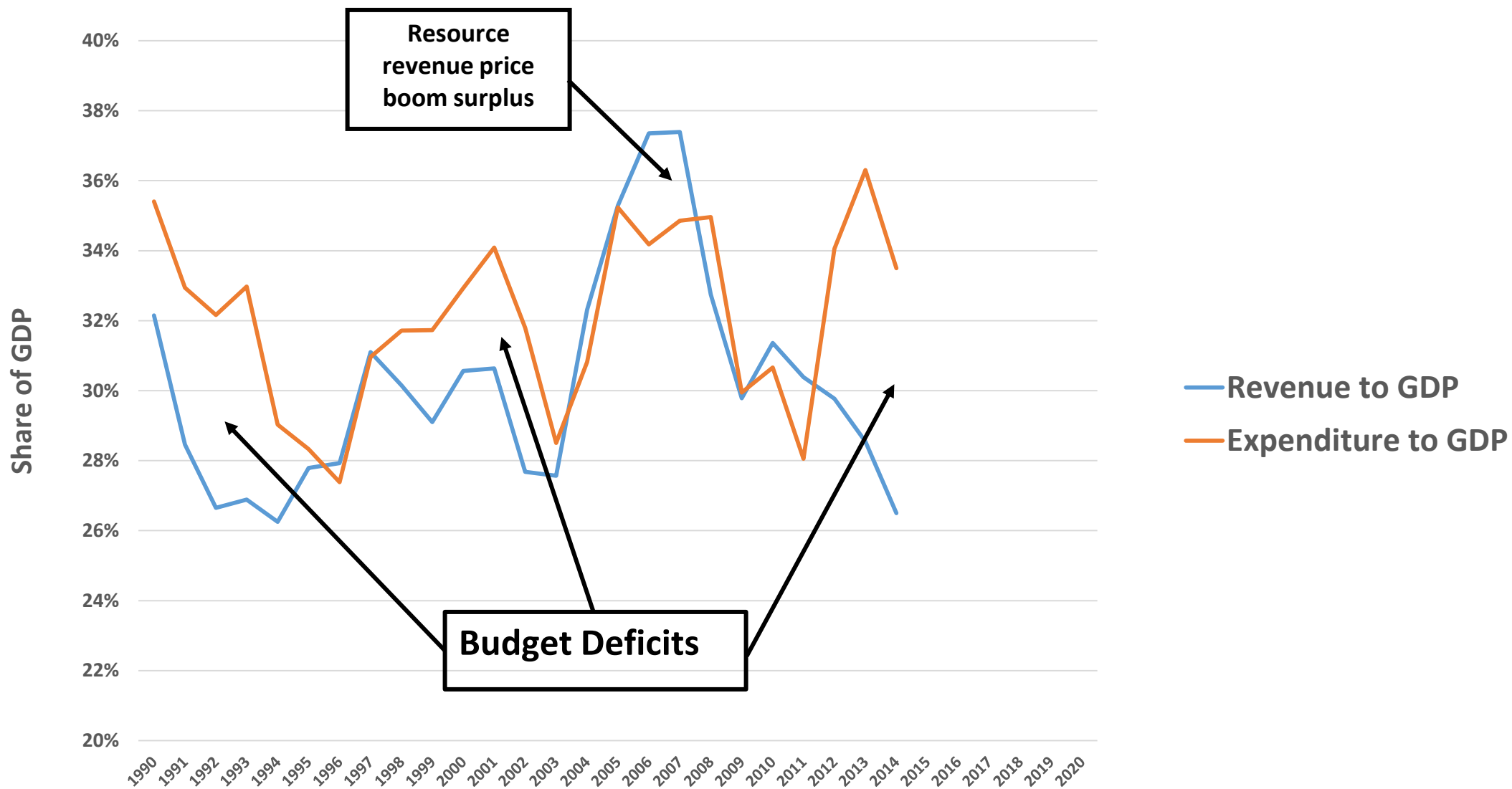
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Expenditure and Revenue as shares of the Economy



2016 Budget Strategy context – Very hard talk

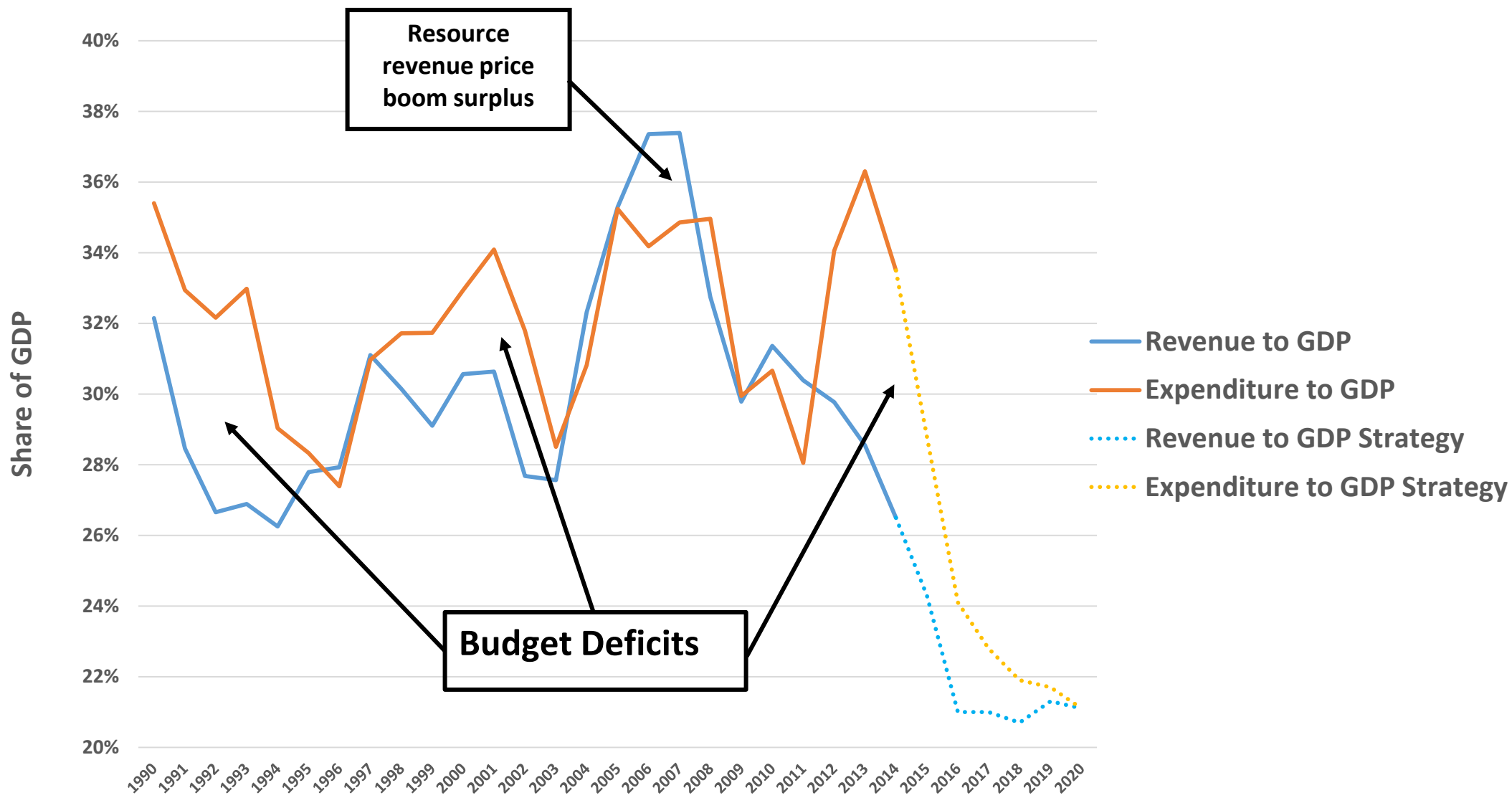
- Key elements of medium term fiscal strategy
 - Return to surplus by 2020 (rather than 2017)
 - Lower public debt to GDP to 30% by 2020 (down from 35%)
 - Major cuts to expenditure, especially in 2015 and 2016
- Overdue but sensible response to:
 - Lack of credibility in 2015 budget (massive cuts in priority political areas etc)
 - Falls in key commodity prices – especially LNG
 - MYEFO – 20% revenue cut
 - Large drop in resource revenues of K1.6 billion
 - Large drop in other revenues of K1.0 billion
 - Negative outlook from credit ratings agencies at a time of seeking a sovereign bond

Analysis of 2016 Budget Strategy – Very hard talk 1

- Historic fiscal consolidation
 - PNG heading for a much smaller size of government than ever in its history
 - Very, very rapid fiscal consolidation
 - Extraordinary collapse in revenues
 - Matched by very sharp contractions in expenditure
 - Higher than Indonesia or Philippines and Low income country averages
 - Lower than Malaysia, Thailand and Vietnam and Emerging market Asia

PNG Budget over 30 Years

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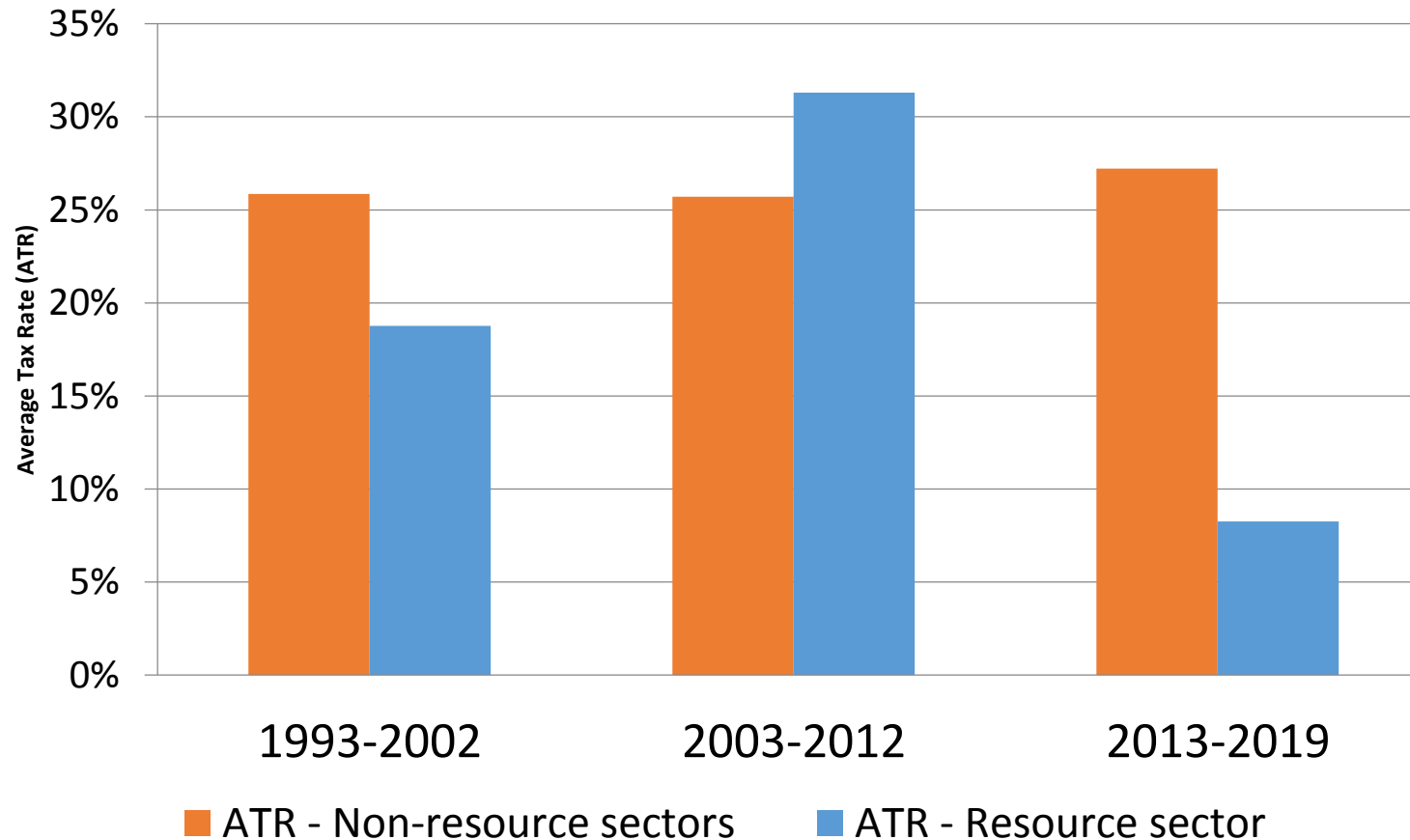


Analysis of 2016 Budget Strategy – Very hard talk 2

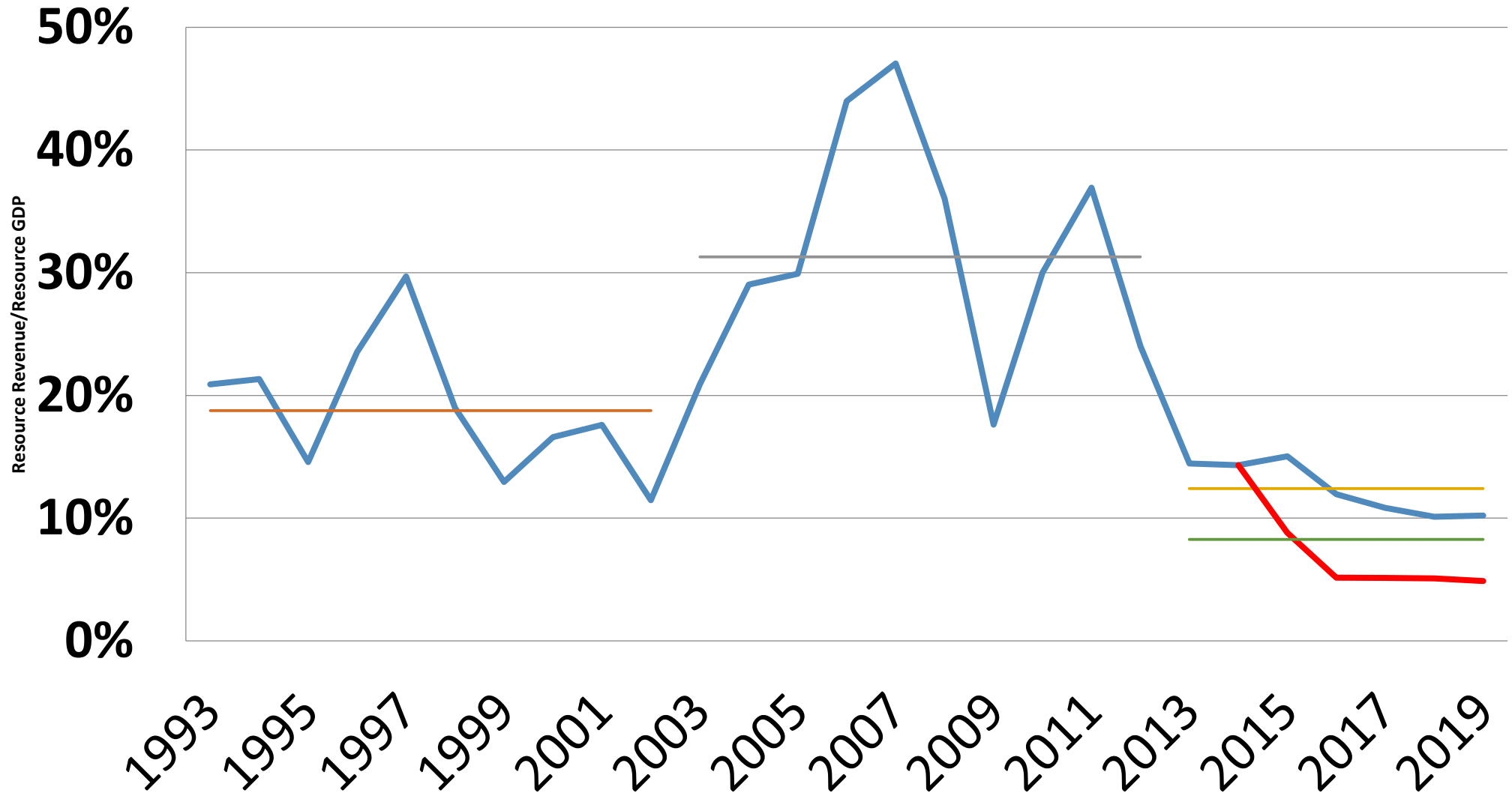
- Drivers for fall in revenue
 - Fall in commodity prices, but also issues with resource tax structure in PNG being too low.
 - Fall in other revenues a particular concern – leading indicator of growth
- Revenue drop seems too large in the out-years
 - Falling as a share of GDP when normal tax effort should hold the revenue to GDP ratio (more on this below)
- Private sector response today to Budget Strategy (Business Council of PNG (BC PNG) and Manufacturers Council of PNG (MCPNG) sets priorities as:
 - Transparency in revenue calculations and assumptions
 - Significantly improved revenue collection arrangements
 - ‘it is in the interest of businesses to have sufficient resources committed to the collection of taxes and other revenue arrangements.’

Resource tax incentives undermining tax base

Taxes - Resource Sector vs Non-resource Sector
Average Tax Rates (ATR)



Resource Revenue/Resource GDP



— Resource Revenue/Resource GDP

— Average 1993-2002

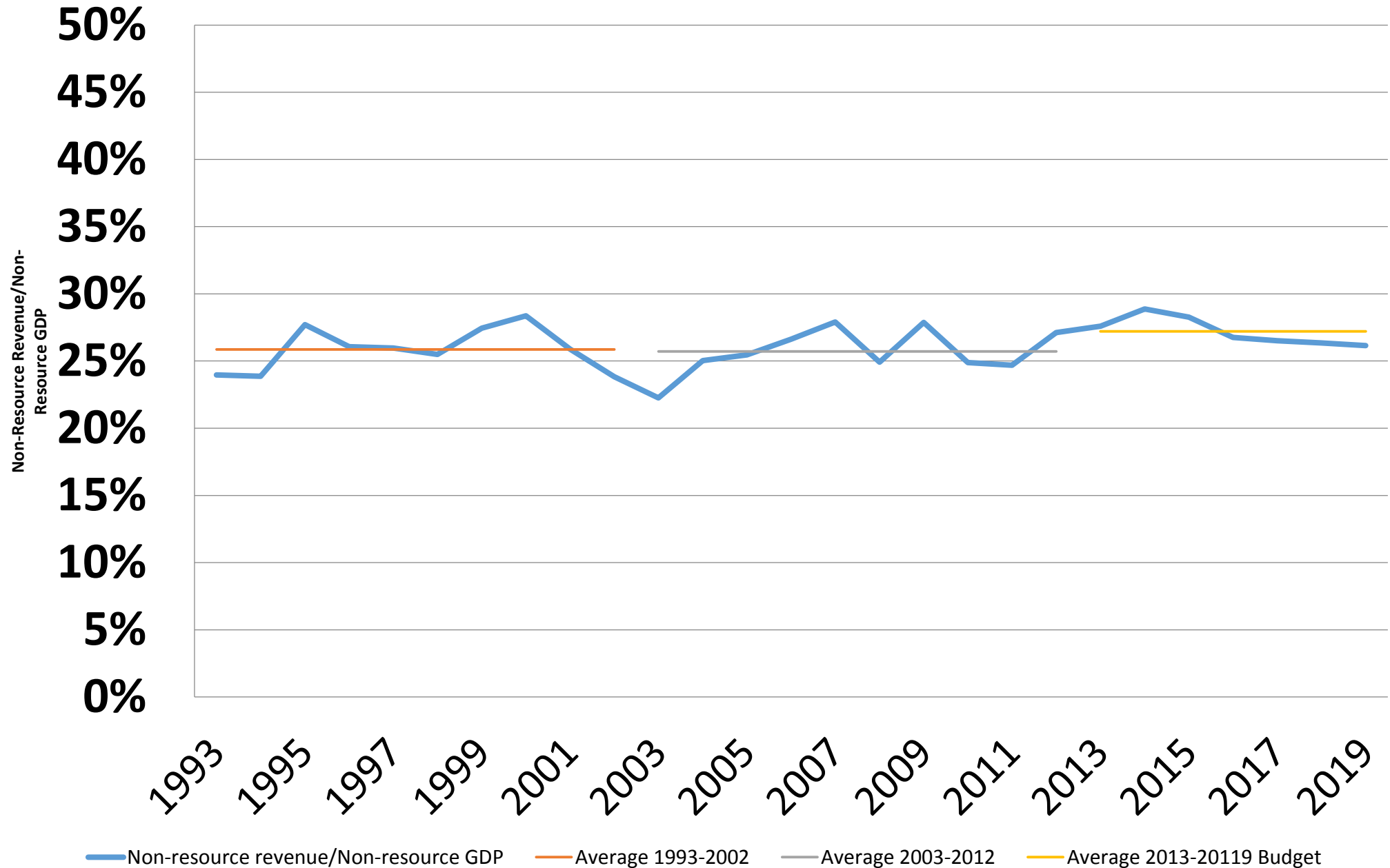
— Average 2003-2012

— Average 2013-2019 Budget

— Adjusted Resource Revenue/Resource GDP

— Adjusted 2013-2019 average

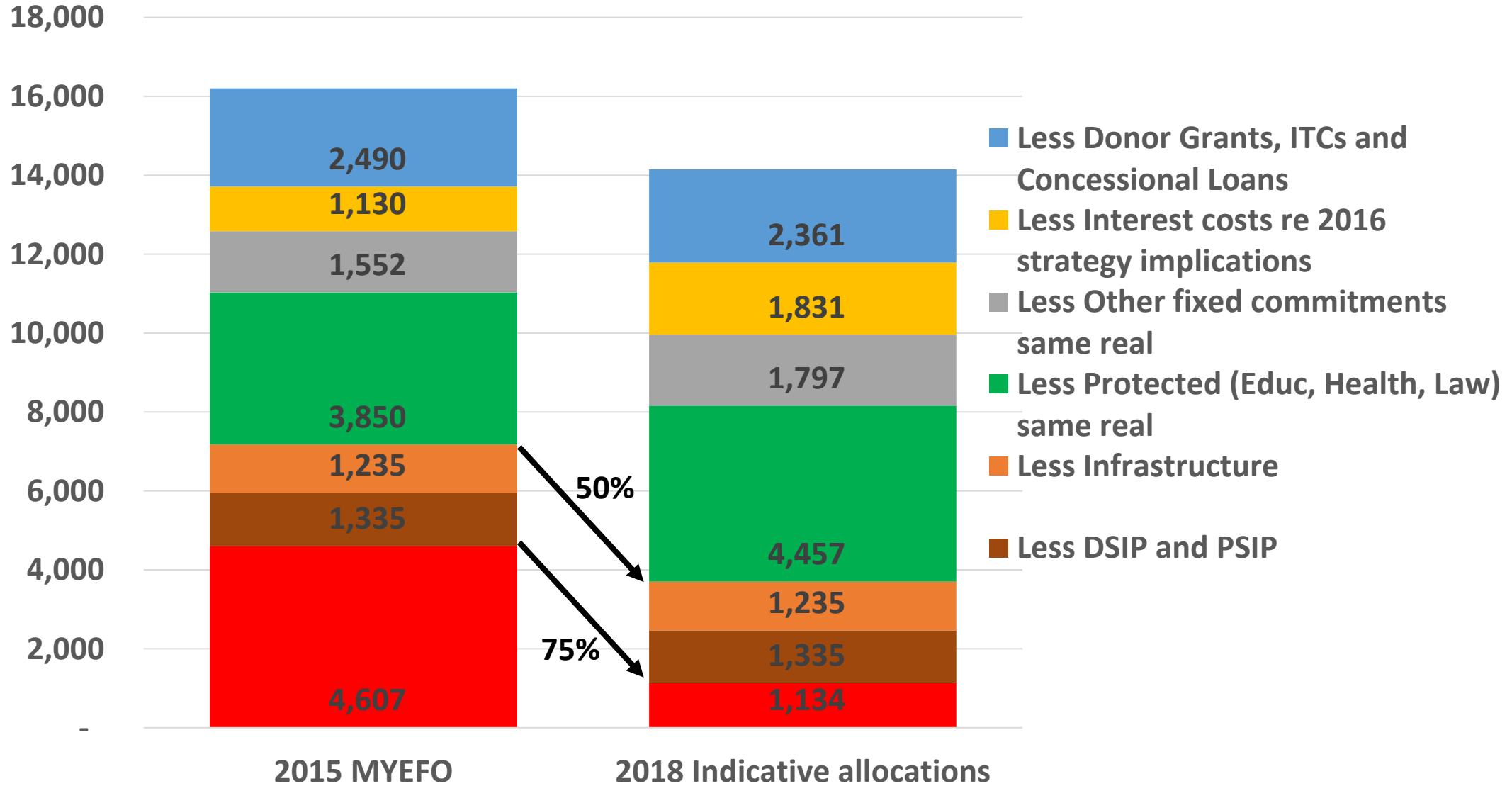
Non-Resource Revenue/Non-Resource GDP



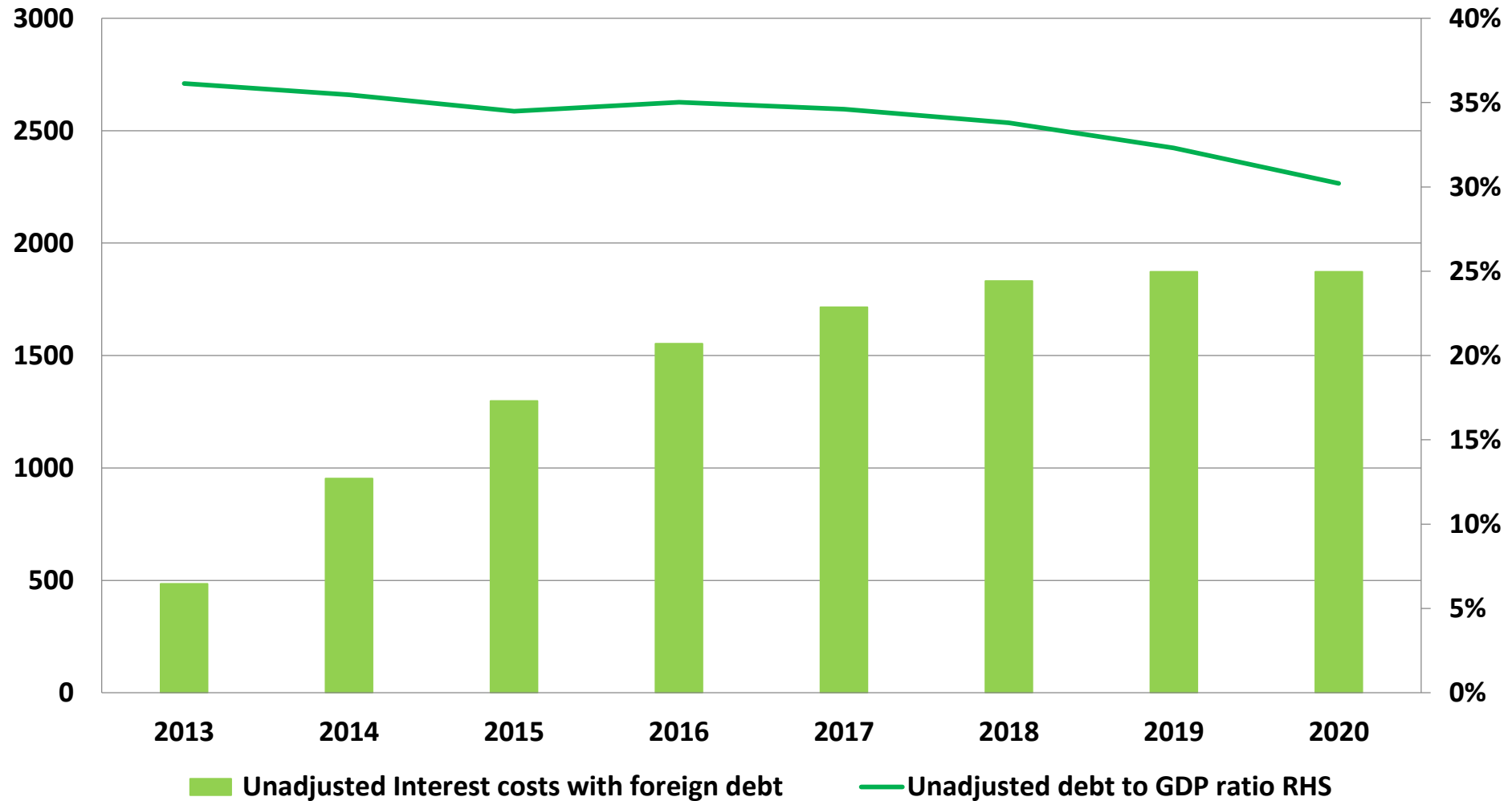
Analysis of 2016 Budget Strategy – Very hard talk 3

- Expenditure cuts
 - These will be revealed tomorrow in Supplementary Budget for 2015
 - And in outyears in the 2016 Budget presented on 3 November (1 week early)
 - Government has indicated a number of areas will be protected
 - A full analysis is not possible until the details are provided over the next 8 days
 - The foreshadowed cuts will be very tough
 - Do not seem credible (with cuts in non-protected areas averaging between 50 and 75% by 2018 depending on definition of “protected) – so looking forward to the detail
 - But also an opportunity for a major reform of the role of government
 - Possibly more scope for public-private partnerships in sectors such as health and education
 - and reform of the structure of the public service
 - ‘Reforms need to also reflect the change in the mode of service delivery through the promulgation of the PSIP and DSIP programs; reforms programs to date are yet to reflect the Waigani based positions this arrangement makes redundant; (BCPNG and MCPNG).

Very hard talk - Potential cuts of 50 to 75% of "non-protected" areas by 2018 (50% if DSIP, PSIP and infrastructure not protected)



Interest costs and debt/GDP of Strategy

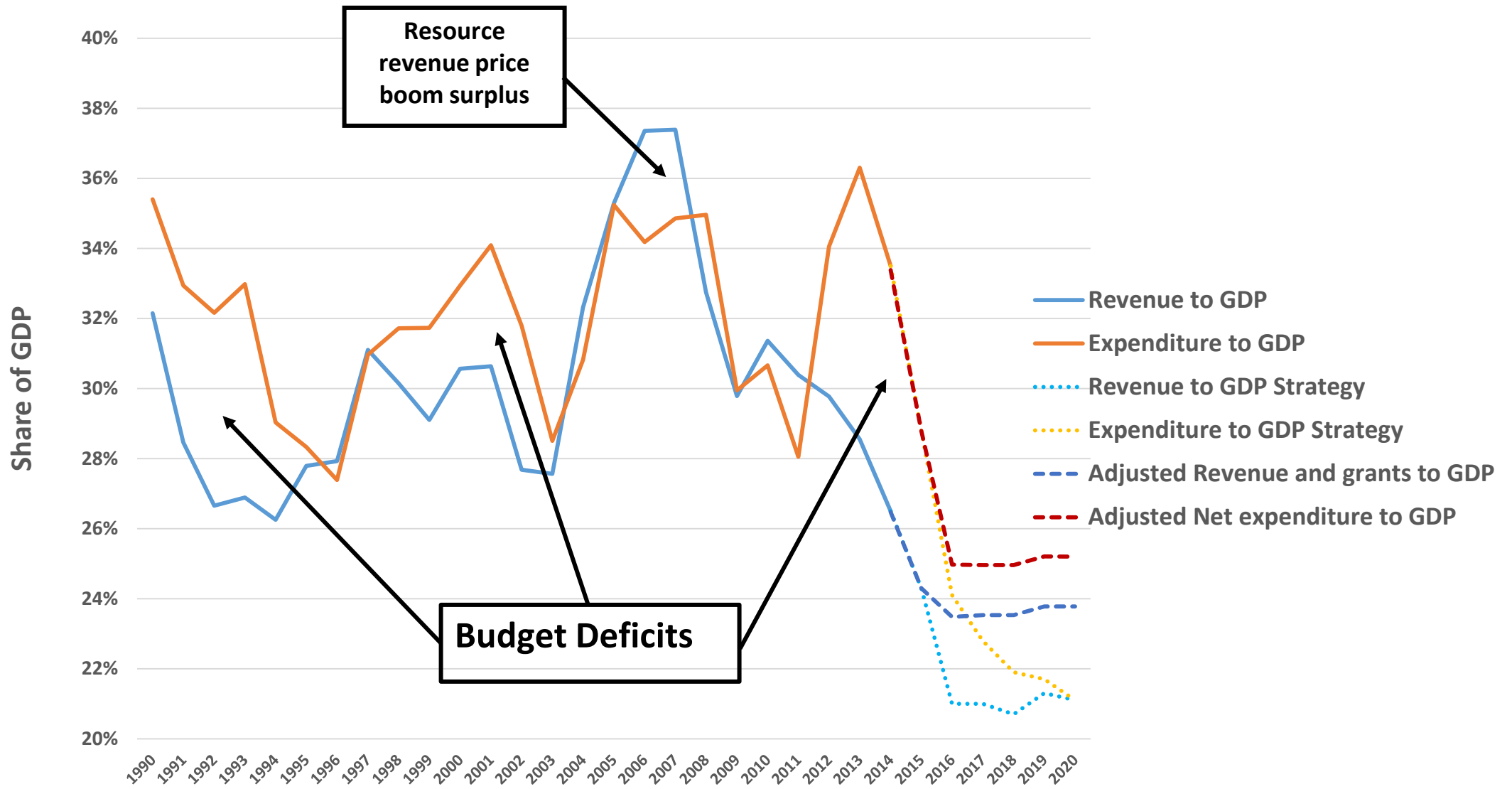


Still 'hard talk' - Example of an alternative softer medium-term fiscal consolidation

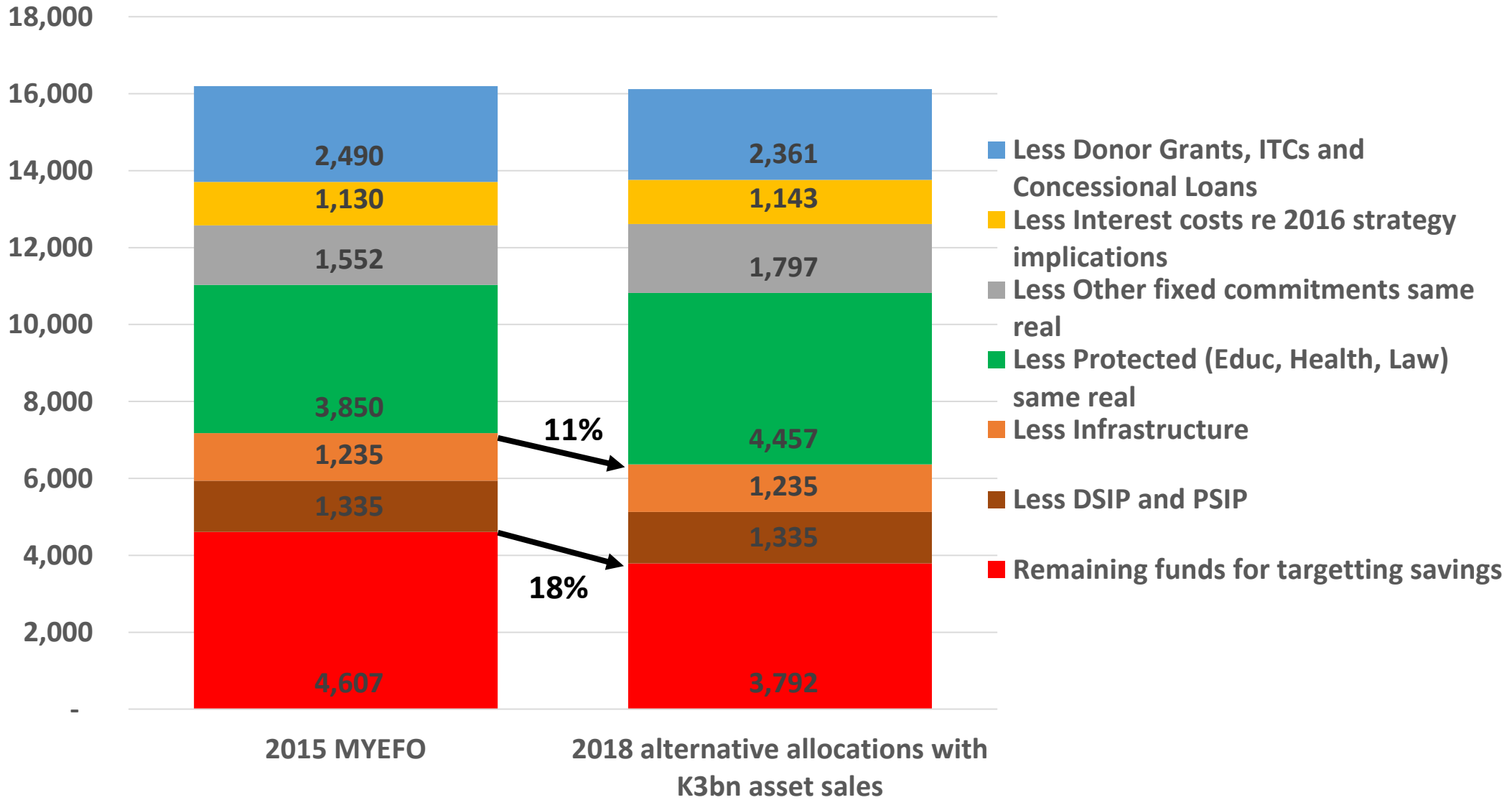
- Revenue
 - 2015 should encompass the full impacts of the commodity price drop
 - And unexpected fall in non-resource revenue
 - From 2016 onwards, take measures to ensure revenue growth in line with economic growth rate (8% nominal)
 - Aim is to hold the 2015 GoPNG revenue level constant in GDP terms
 - Will mean important decisions on LNG dividends to ensure they all flow into the budget
 - Sovereign Wealth Fund legislation a concern as it diverts a share of resource dividends to Kumul entities
 - Media links also to UBS loan and purchase of Oilsearch shares – may need to sell these to free up the LNG dividend flows
- Expenditure
 - Reduce size of 2016 cuts by K500m and also then grow expenditure in line with GDP (8% nominal)
- Financing
 - Asset sales would halve interest costs and lower public debt levels
- GDP growth
 - Note recent differences in measures between overall GDP and non-resource GDP per capita
 - Need to lift the longer-term growth rate – more fundamental issues of structural reform to the economy especially enhancing agriculture sector growth of relevance to small-holders
 - Lifting growth rate can lift revenues faster – given other fiscal options

PNG Budget over 30 Years

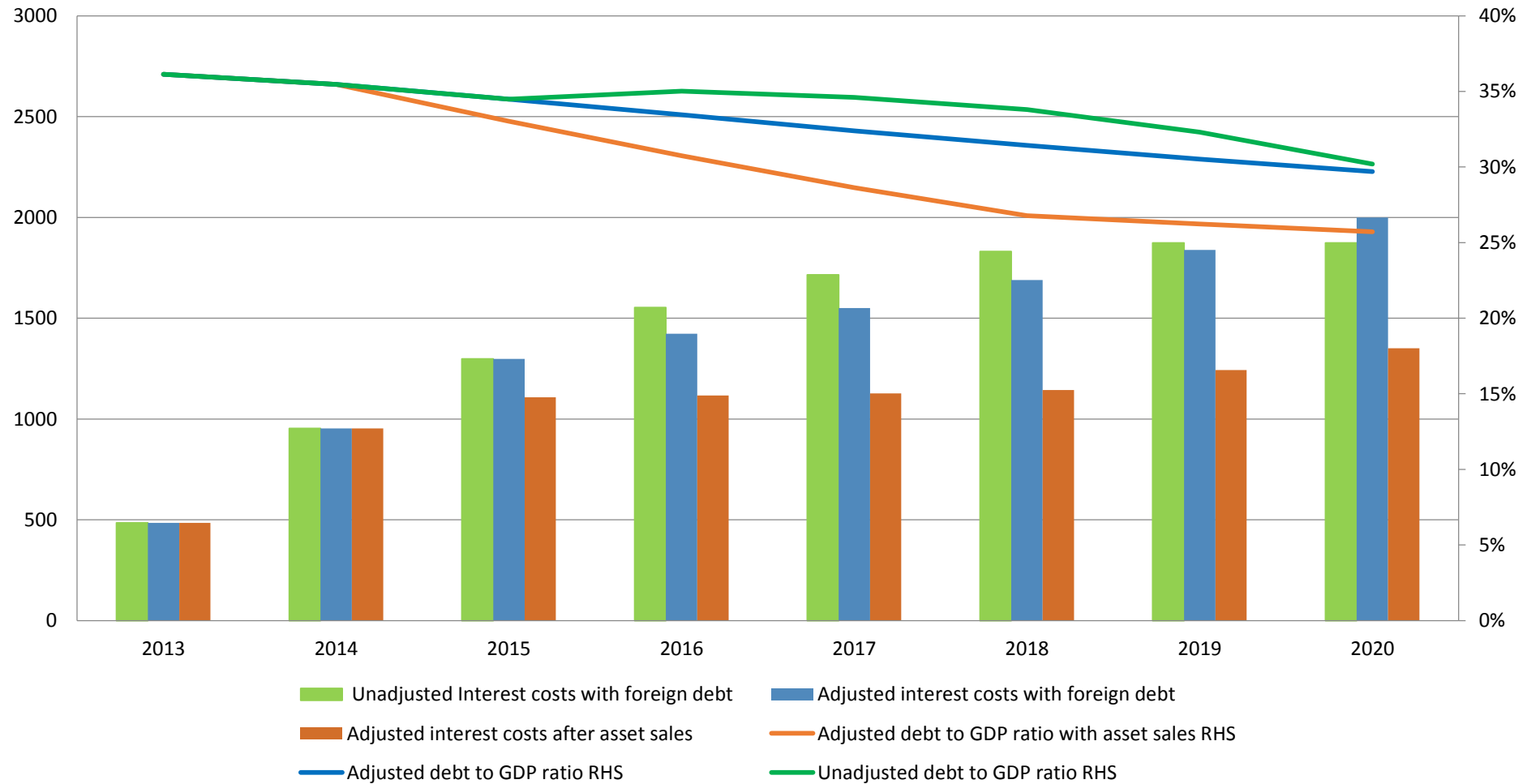
Expenditure and Revenue as shares of the Economy



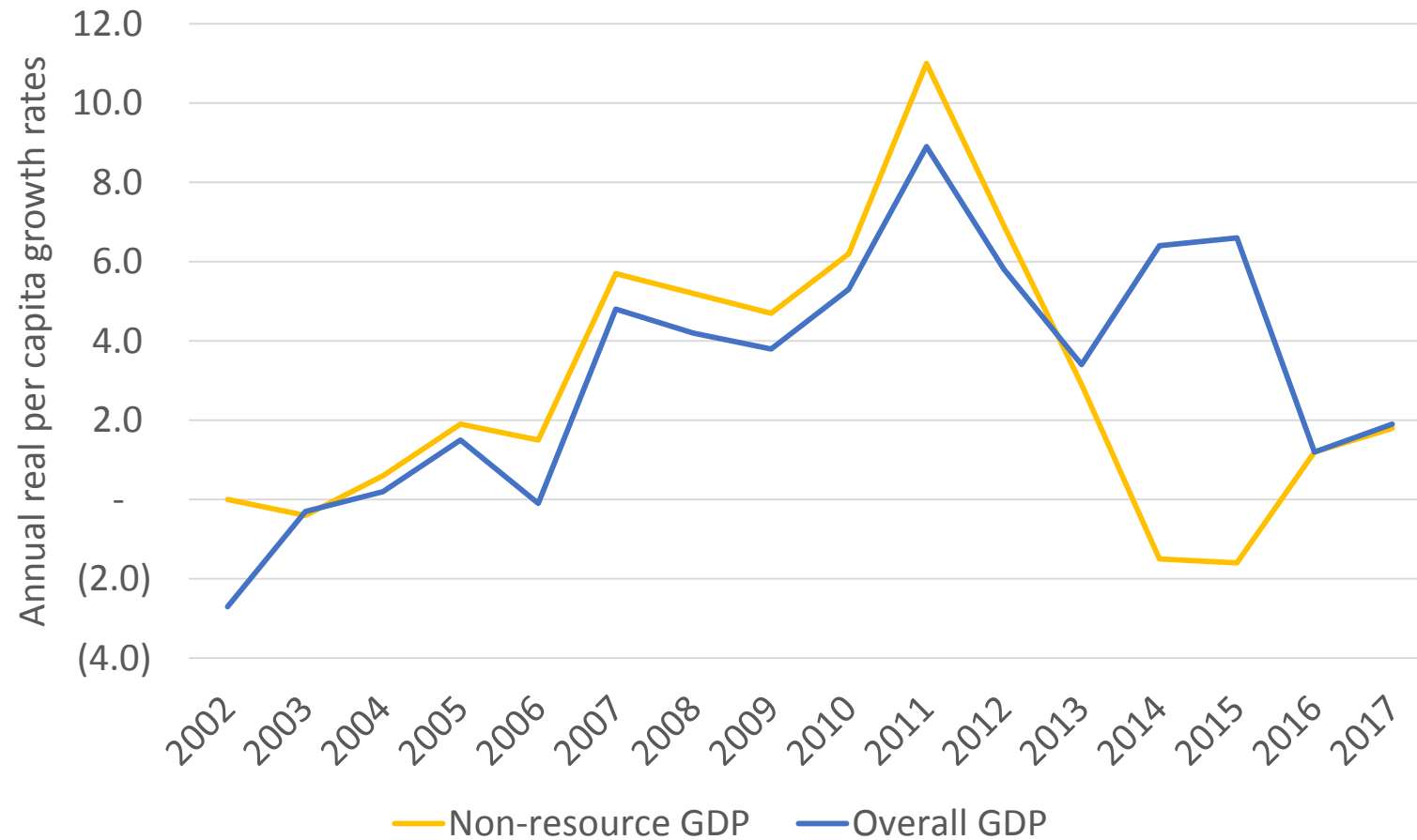
Hard talk - potential cuts of 11 to 18% of "non-protected" areas by 2018 with K3bn asset sales (11% if DSIP, PSIP and infrastructure not protected)



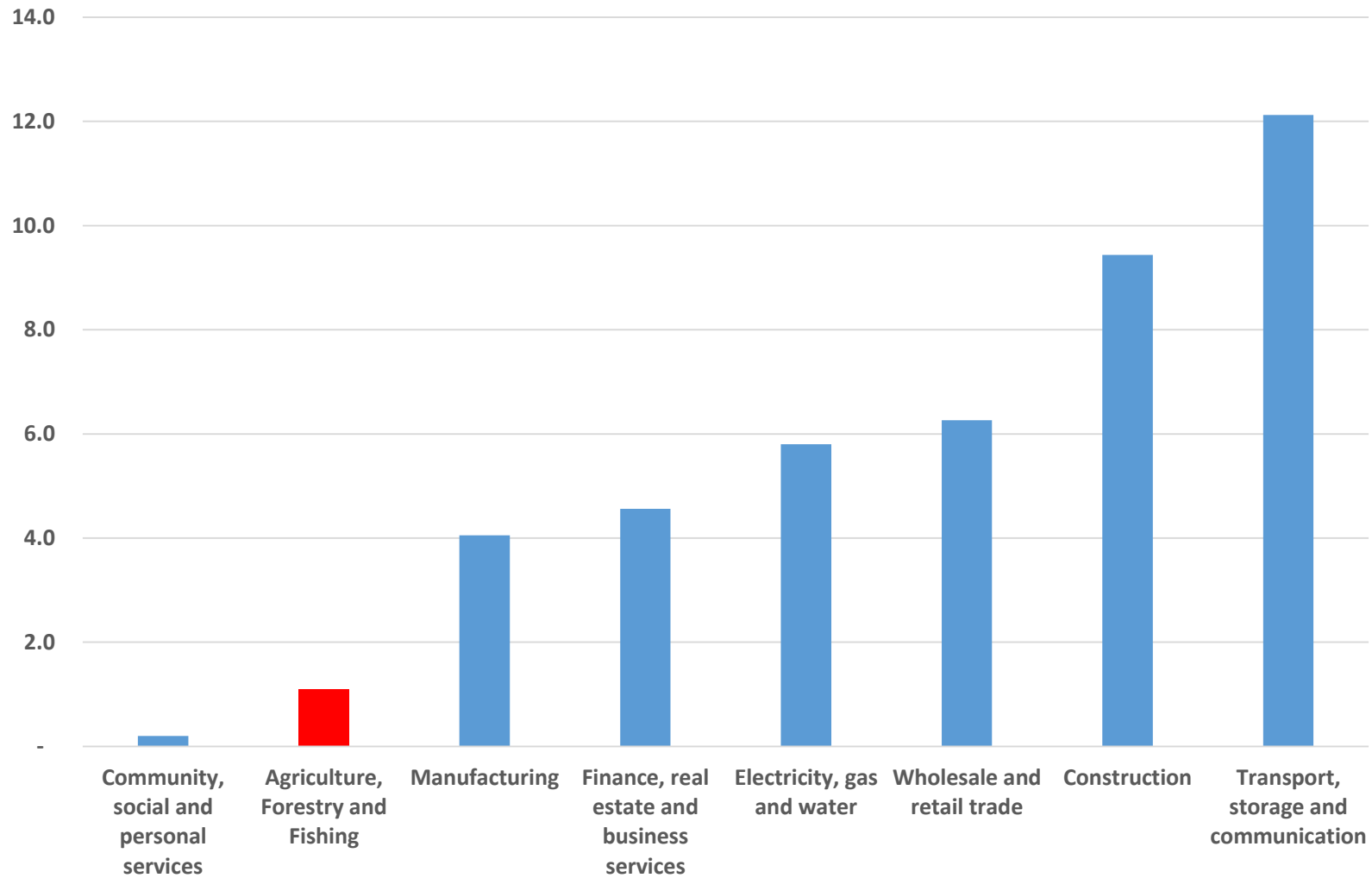
Interest costs, financing and debt/GDP of Strategy



PNG economic growth measures - +25% or -3%



PNG per capita sectoral growth rates 2003 to 2015



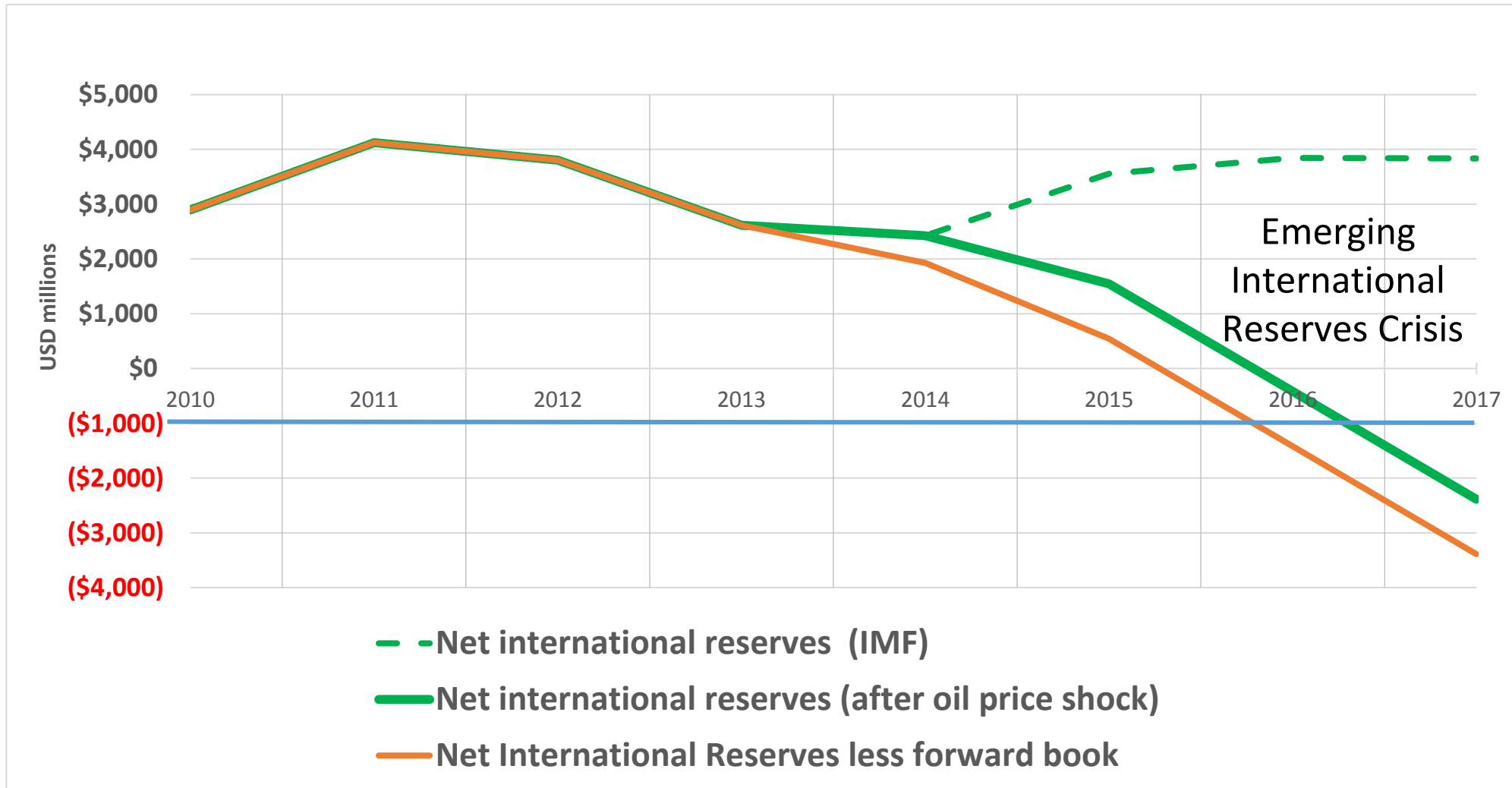
Real talk

- Fiscal consolidation will be extremely challenging
 - Australia has never accomplished such a fiscal transformation
 - Especially at the same time as a major devolution of funding to sub-national levels
 - Challenges of a 2017 election and current political discussions
 - Drought and economic slowdown also makes fiscal consolidation more difficult.
- Observations since “Very tough talk” 2016 budget strategy
 - K1,600m airport expansion plan (over 9 years)
 - K600m courthouse
 - K178m “drought relief” delivered through DSIP (so not a national needs-based program)
 - US2 billion rice project proposed backed by tax concessions, quotas and tariffs
 - As well as recent tax concessions for new capital developments (Paga Hill, Star Mountain Plaza, Ela Beach, Hubert Murray stadium), delay in announced excise tax increases for alcohol and cigarettes, proposed diversion of resource dividends away from the budget and towards Kumul entities through the Sovereign Wealth Fund.
 - No concluding statement from IMF Article IV visit, concerns about freedom of discussion of policy issues.
- Business Council of PNG (BC PNG) and Manufacturers Council of PNG (MCPNG)
 - projects should focus solely on those that will best increase capacity and reduce most the cost of doing business (re SOEs).
 - immediate reforms of the procurement systems to curtail opportunities for graft and ensure value for money
- International investors will put emphasis on observed behaviour as well as hard talking plans.
- Quality of government spending remains a major concern with continuing questions about corruption (legal processes to be followed), strains on different levels of government and poor service delivery.

Balance of payments challenges

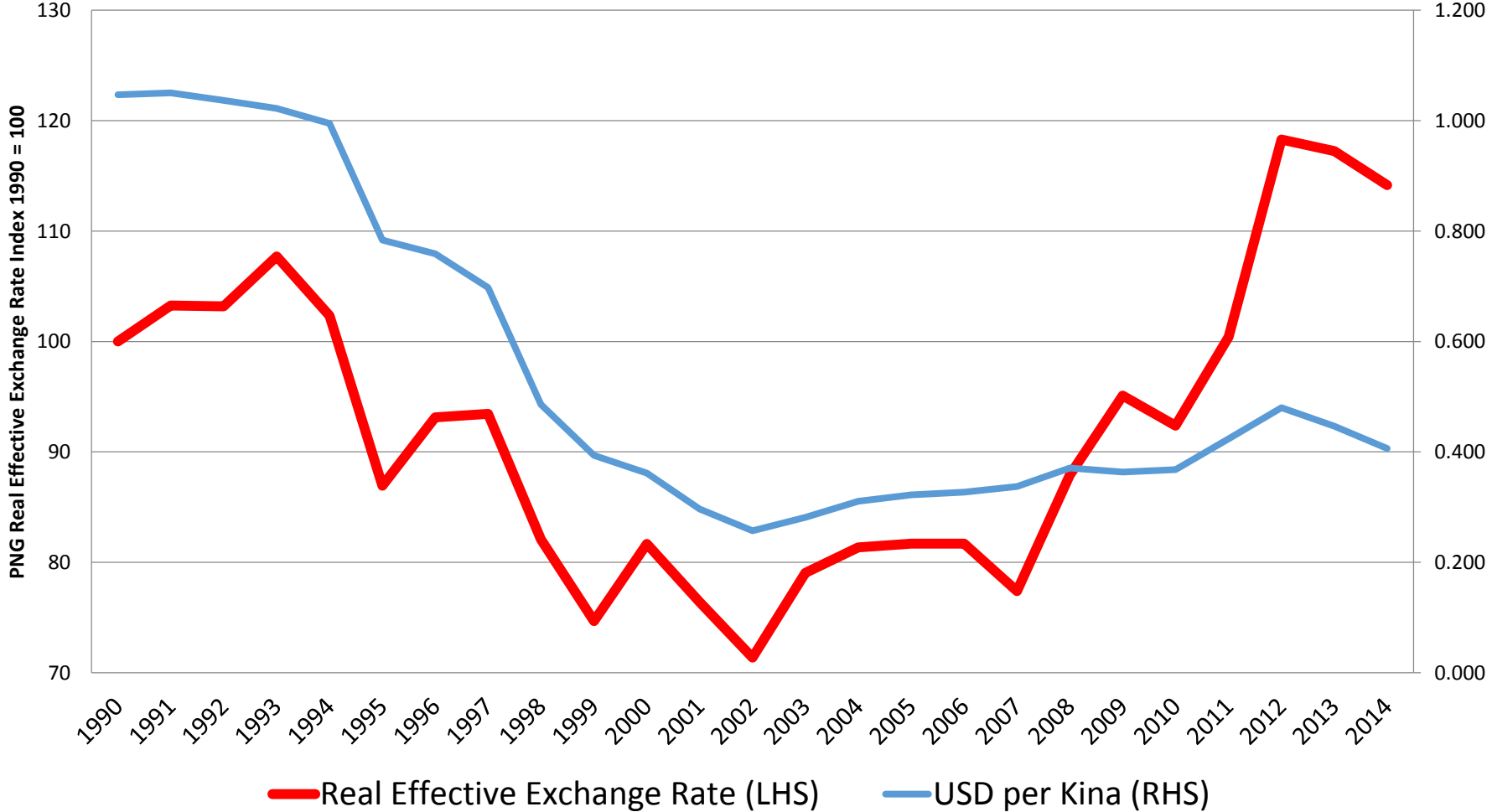
- Latest Monetary Policy statement acknowledged Balance of Payments will remain in a deficit situation for 2015
 - Although predicted a small surplus in 2016
- Foreign exchange reserves have levelled out about US2 billion
 - Possibly an informal target
 - Sovereign bond issuance will assist if successful – but note re-financing risk for UBS collared loan for Oil Search shares
- Good import coverage
 - Although in part due to record low level of imports (Q1 2015 lowest since 2005 Q4)
- Foreign exchange restrictions
 - Almost a crisis management tool before there is a clear external crisis
 - Large overhang of orders
 - Damaging for growth and PNG's international reputation
- Link between government expenditure and government imports (so this has helped create a link between the fiscal and external crises in PNG's history).
- Medium-term challenge – restoring PNG's international competitiveness
 - Calls for a faster depreciation of the Kina
 - and using the TWI basket of currencies rather than just the US dollar/Kina rate

Foreign reserves pressures



Exchange rate uncompetitive

PNG Exchange Rates since 1990



	2015 Budget Criteria	2016 specifics
1	Have the right expenditure priorities been chosen?	Pattern of cuts – expect to see DSIP/PSIP share. Drought.
2	Is a sustainable fiscal policy set out?	Details to inform judgement on 2016 Budget Strategy
3	Is the deficit financing strategy appropriate?	Sale of assets including landowner shares at realistic price with right debt treatment, coverage of off-budget loans, potential roll-over risk of UBS collared loan for Oil Search
4	Is the budget structure supporting good development?	GFS 2014, spread of integrated budget and IFMS, sub-national details
5	Is the budget sufficiently transparent?	Broader transparency information such as release of warrant information and BPNG timeliness
6	Is there enough accountability for performance?	Especially on major new initiatives such as DSIP
7	How will assets be treated, including updates on the sovereign wealth fund (SWF) and Kumul arrangements and their impacts on revenues?	Kumul details esp re dividend flows to SWF
8	Are there revenue policy improvements flowing from the Tax Review?	More details – a potential opportunity for serious structural reform
9	Is there needed action on public sector reform?	Actions starting from budget night
10	Overall, is this a credible budget?	Context - Observed actions. Integrate with other announcements on expenditure and policy settings.

Conclusions

- There are several different interpretations of potential crisis – this talk has explored two of them.
- PNG faces short-term challenges which if not managed will lead to a crisis. The deficit is at historic levels as is the real exchange rate. These settings are out of step with PNG's own history and its Asian neighbours.
- On the fiscal challenge, MYEFO revealed the rapidly deteriorating revenue situation. The 2016 Budget Strategy was too much, too late but has responded to concerns about a lack of a medium-term plan. Good the Supplementary Budget is going to Parliament.
- The fiscal crisis may be managed but this will at a minimum involve very hard choices – key details to be released in the next 8 days to inform analysis on 10 criteria. Action is welcome but its lateness possibly rules out discussion of other less harsh (but still hard) options. Credibility of the plans will be crucial and this will depend on actions as well as words – the real talk.
- The external crisis can be managed with a major depreciation in the real exchange rate – this will also need restraint on wages.
- These are very difficult issues and will require discussions in PNG about how best to handle the required adjustment to avoid a potential crisis. Sustainable growth policy will be a key.

Thank you

And time for questions