Papua New Guinea Economic Perspectives

Address

by

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PNG Economic Boom: Opportunities and Challenges

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I would like to thank the School of Business Administration, UPNG, and Development Policy Centre, ANU, for the invitation to speak today.

I will present some key financial and economic information on the state of the economy and also address the prospects in the short term, which I define as up to the beginning of 2016, when the LNG project will be well into in full production and its contribution to the economy will be realised, while the outlook is the longer term.

The financial system of Papua New Guinea is very sound with very high levels of financial assets. Total assets in the financial system (i.e. including banking, superannuation and life insurance) is K38.66 billion as at the end of March 2014. Of that, the banking sector alone has K29.42 billion. Total loans in the banking sector as at end March 2014 was K12.2 billion. Non-performing loans as a ratio of total assets was 0.9%, and as a ratio of total loans was 2.2%. The system has healthy capital with capital adequacy ratio well above the minimum requirement of 12%.

As is widely known now, Papua New Guinea is enjoying the longest period of economic growth as measured by the increase in Real Gross Domestic Product (GDP) in its history as an Independent State, in the last twelve years 2002 to 2013. The real GDP growth in the five years 2002 to 2006 in real GDP was moderate, at 2.8 percent per annum. It accelerated to around 8.0 percent per annum in the seven years 2007-2013. For the twelve year period the annual growth in real GDP was 6.0 percent. It is a very strong performance by all comparisons and standards. 2014 will be another year of economic growth, not as strong as last year or when the construction phase of the LNG project was at its peak.

There is talk about the very strong performance of the mineral and petroleum sectors. It is interesting that, in the seven years to 2012, non-mineral GDP grew at a rate of 8.8 percent, faster than total GDP. The main reason for the stronger growth in the non-mineral GDP was the commencement of the construction of the LNG project in 2010 and the spin-off effects to benefiting sectors such as building & construction, transportation, hoteling-catering-other services, and manufacturing.

Because of statistical short comings, it is very difficult to get a reliable measure of the distribution of GDP by economic sectors. Information available from different sources indicate that the high mineral and petroleum commodity prices , were the driving forces behind the very high Government revenue and the increase in public consumption, an increase in the level of foreign exchange reserves, high liquidity in the financial system and very low deposit interest rates.

The real economic growth of GDP up to and including 2006, at around 2.8 percent, was somewhat below the population growth rate, and therefore the average standard of living of the population remained stagnant or even declined slightly. In the last seven years from 2007 the rate of real GDP growth was more than double the population growth rate at around 8.0 percent. On the average the per capita standard of living of the population increased, by around 5.1 percent per annum, or 35 percent during the seven years. The non- mineral sector growth rate is more indicative about the standard of living of the great majority of the population. In the non mineral sector the standard of living increased by around 6.0 percent per annum, or 42 percent for

the whole period. It is an unprecedented achievement that, to the best of my knowledge, only China can claim a higher outcome.

In many countries high economic growth, is accompanied by high inflation. In the last seven years we managed to achieve a high growth rate at relatively very moderate levels of inflation, of around 5 percent per annum. The fact that in the last couple of years prior to 2013, PNG had a very low level of inflation of around 2 percent is the outcome of, low global inflation, especially in the countries that are our main trading partners. Decline in the food and energy prices on the World Markets, as a result of the global slowdown, the appreciation of the Kina, against the currencies of our major trading partners that contributed to the decline in imported inflation. Starting in 2013, the Kina depreciated under low export receipts as a result of low commodity prices and high import demand, inflation is starting to creep up, 4.7 percent in 2013 and 3.8 (with the new CPI basket) over the twelve months to March 2014.

Being a primary commodity exporter we are always concerned about the international prices of the commodities we produce. The global demand for the Papua New Guinea's primary exports will not collapse. Even if there will be some slowdown in the economic activity in the developed economies, the growth in the major emerging markets of Brazil, Russia, India, China and South Africa (BRICS), and the other high growth developing countries such as Indonesia, Malaysia, Poland Chile, to name a few, should ensure that the slowdown in global activity will not be very severe. The international prices of some of our major export commodities will continue to decline while for others such as coffee, cocoa, copra and copra oil, prices are slowly increasing again. Overall, commodity prices will still be relatively high historically, which should benefit the agriculture, forestry and fisheries industries.

In addition, metal prices of copper, gold, nickel and cobalt will decline but will still be relatively high by historical levels, which should result in somewhat lower but stable mineral export receipts and taxes to the Government, that will in turn allow for continued high public expenditure and thus, high public sector contribution to aggregate demand, and GDP.

The overall balance of payments is projected to be in deficit by K1,143 million in 2014, with a deficit in current account more than offsetting a surplus in the capital and financial account. The deficit in the current account is projected to be K7,235 million, due to higher imports and net service and income payments. The surplus in the capital and financial account is projected to be K6,089 million, mainly reflecting inflows associated with the foreign direct investment relating to the completion of the PNG LNG project (see Chart 2). In the medium term, the current account is projected to record surpluses due to inflows from mineral sector revenue, including LNG revenues, and non-mineral export revenue.

The level of Foreign Exchange Reserves increased in the twelve years from 2002 to 2013 from K 1.4 billion to K 9.0 billion, of which 4.7 billion were in the last seven years 2007-2013. For 2014, the reserve level currently stands at USD2.6 billion, which is sufficient for 6.5 months of total import cover and 9.3 months of non-mineral import cover. These are very comfortable levels. Most of the increase in foreign exchange reserves resulted from foreign currency tax flows to the Government. It was the main reason for the sharp increase in the level of liquidity in the financial system.

The Bank of Papua New Guinea advised the Government to use Domestic Funding for the Infrastructure Development Program, and the planned Budget Deficit funding. There is adequate liquidity in the financial system that can be used for funding the said expenditures and meeting the demand of private sector borrowing. In respect to the Infrastructure Development Program, the use of off shore funding, conditioned on Foreign Content, will result in a substantive part of the contribution to GDP will go to the foreign country providing the finance. The use of Domestic Finance will result in much higher contribution to domestic GDP, in salaries and wages, intermediate inputs, and profits to domestic companies. We will still have some imported content of, fuel, spare parts to machinery and equipment, and some services, but the majority of the GDP will be generated in Papua New Guinea.

The Bank of Papua New Guinea has had to neutralize the increase in the level of liquidity in the financial system, through the issue of Central Bank Bills (CBB) of around K 5 Billion up to 2013. This neutralization is at a cost to the Bank of Papua

New Guinea directly, to the Government and the people of Papua New Guinea indirectly. This is why the Bank of Papua New Guinea advised the Government and requested that all Government Trust Accounts should be deposited at the Bank of Papua New Guinea that will defuse liquidity at no cost to the Government and the People.

In the concluding statement of the IMF Article IV Mission to PNG in 2013, the team reported that the external position of the economy is sound, the external public debt is sustainable under the Government's medium term policy and overall, the economy has fared well in macroeconomic terms. Going forward from here, "PNG is faced with slower growth of domestic demand and an increasingly uncertain external environment. To maintain the hard-won macroeconomic stability and make the most out of resource revenues, the Government will need to focus on a prudent fiscal policy and improvements in the efficiency of public spending, supported by stronger institutions and governance, while monetary policy should adjust to a post-construction boom environment." *(IMF Article IV Mission Concluding Statement, September 2013)*

The conclusion we can draw from the information I presented above and from IMF's assessment is that, in the last seven years Papua New Guinea is in the league of the tiger nations in respect to economic growth. All economic indicators are pointing to what could have been expected, from an economy moving from a low to a high growth rate state.

In the short term, for the next two to three years, my advice is that the Government utilizes the infrastructure implementation capacity that was built during the construction of the LNG project, to implement major infrastructure improvement and development programs.

The aim of such a program should be to open up rural Papua New Guinea to the main urban centers, as well as the international markets. With the clearly set objective to become self sufficient in food production, in all areas that the country is benefiting from a relative advantage, and there are many such products and produces. The second objective is to turn Papua New Guinea into a main

agricultural, exporter. Papua New Guinea can become a major food supplier in the world markets. It has very large mass of fertile land, excellent climatic conditions and its people are cultivating the land for many generations. The world is very short of food supplies, and food products, command high prices on the World Markets. Papua New Guinea's location in the South Pacific is close to the markets of China, Japan Taiwan, South Korea, Hong Kong and Singapore, and some other very large consumer markets, with demand for food products. Given the advantages Papua New Guinea has in regard to its location, it can easily compete with other potential suppliers.

There is talk about the Dutch Disease, the curse of the non renewable resources developments, out pricing the traditional sectors of the economy. One of the most efficient ways to counteract it is, by investing and developing the traditional production sectors. In Papua New Guinea there is no question or doubt that the only sector that can do it is agriculture. Papua New Guinea still has a very long way to go, until an advanced, intensively cultivated, agriculture producing sector, will not satisfy the level of per capita income of the great majority of the population. The claim that the agriculture sector is a low per capita income generation sector holds for high income developed countries. Most if not all developed countries of today went through the process of, advanced, intensively cultivated agriculture development before moving into the technologically advanced producing industries.

To ensure that the country is ready and prepared for the next stage in its development endeavors, in addition to the infrastructure and agriculture development, the Government should rigorously pursue the improvement in the provision of health and education services. The preconditions to the achievement of any development agenda is, having a healthy, educated and productive population. Both those sectors provide a very high and fast pay back in economic returns. There are many examples that the healthier and better educated the population is, the country achieves higher per capita income and standards of living. It is also impacting of income distribution, equitable wealth distribution and reduction of poverty.

This brings me to the Outlook part of my presentation. Once the LNG project commences production, royalty and tax payments will be realized, the country might have the resources to increase spending on the areas I outlined. We have to be aware that throwing money at a problem, not always solves it. There are instances in which it just compounds the problem. The LNG project has the potential to significantly raise standards of living in PNG. However, it will generate structural adjustment pressures. These will depend on how PNG manages its LNG revenues accruing to the Government. The Government will have to ensure that it sets clearly defined well understood goals. Each and every spending authority has well designed detailed plans and the capacity to implement them. We saw many times in the past that resources were not efficiently and productively used.

I want to stress two points relating to the LNG project that I see as very important and the PNG public must know this.

The first is that, many a times, commentators and the media tend to give too much emphasis on economic growth that the project will generate. There is an important distinction between GDP growth and Gross National Product (GNP) growth. GDP growth includes payments or income accruing to foreign factors of production, including foreign labour. What is relevant for PNG is the growth in GNP- payments or income accruing to domestic factors of production and the consequent potential for increases in public and private consumption within PNG.

The second point is that we can have all the good increases in GDP and GNP but the growth may be skewed towards certain industries and classes of workers because like any mineral project, it is in an enclave industry. How can then the rural majority of the PNG population benefit? The answer lies in efficient and effective implementation of fiscal policy- the national budget, year after year, subject to the capacity issues in the delivery service mechanism. The Government and its civil service machinery must deliver and redistribute the revenue gain to improve basic health, education and infrastructure services to empower the people to be partners and not spectators in the development process.

This is where in my view the Sovereign Wealth Fund comes into play. It should be used as the parking place for the resources that the Government of the day, is not confident that the detailed plans to implement the expenditure programs are ready. The money is available, can be allocated, on the condition that the implementing agency can convince, beyond reasonable doubt that, the resources will be used productively and efficiently, for the purpose they were allocated for. The structure of the fund, with an Independent Board, that the Government of the day, trusts its professional judgment can serve as an assessment mechanism of the implementing agencies capacity and competence.

Last, but not the least for the Bank of Papua New Guinea. We at the Central Bank will strive for the Financial Inclusion of all Papua New Guineans in the cash economy. I look forward to the day that all our population has access to the banking system in one way or another. We will play our role in educating the population on financial matters, and ensure that every one, that so desires could become financially literate.

The Bank of Papua New Guinea, in collaboration with the Pacific Financial Inclusion Program, had prepared a Financial Service Sector Assessment report in August last year. The report identified gaps and issues as to why eighty five percent (85%) of the population continues to be unbanked. Out of this, a National Strategy on financial inclusion was formulated. The intention is to to achieve financial inclusion and education, enabling the great majority of the population to be financially literate and included in the formal financial sector. Improved financial literacy and access to financial services increase economic participation and social inclusion, drive competition and market efficiency. Even more so, they unleash a hitherto hugely untapped market that gives access to a larger consumer base, which for all investors, in any business, is a positive development.

Finally, BPNG and the financial system key players such as the commercial banks are at an advanced stage in the implementation of the national payments system. The system will improve the financial infrastructure of the country, mitigate risks, increase efficiency, and reduce costs to both the Government and the private sector. The objective is, to achieve real time settlement, of all payments and transfers carried out by and through the financial system. A safe and reliable payment system

strengthens consumer and business confidence and supports the creation of an enabling environment for economic growth.

The initiatives by the Government for the establishment of the SWF and increased spending on infrastructures, and by the Central Bank on financial inclusion and payment system will assist towards inclusive and broad-based growth and development for the mass of our population, but these on their own won't be enough to achieve desired results. More is required: of the public service delivery mechanism in effectiveness and efficiency of spending and in good governance; and of the private sector to generate competition and fairness in passing down goods and services at reasonable prices for the people of PNG experience tangible benefits.

Thank you