ECONOMIC ANALYSIS (SUMMARY)[1]

A. Context

1. Papua New Guinea's (PNG's) economy is dominated by a large, labor-intensive agricultural sector and a capital-intensive mining and petroleum sector (consisting mostly of oil, liquefied natural gas (LNG), gold, copper and silver extraction). The formal sector consists of enclave extractive mining and petroleum industries, cash-crop agriculture production and a small, import-substituting manufacturing sector. The informal sector, on which roughly 85% of the population derives their livelihood, is largely subsistence agriculture.

2. The agriculture sector is constrained by structural impediments that have deterred investment including weak coverage of transport networks and complex customary land ownership that inhibits private investment. The sector, including cash and subsistence crops, is dominated by small scale family farmers in rural settings although there are a number of medium to large sized enterprises which operate in oil palm, copra, tea, coffee and fisheries exports.

3. The mining and petroleum sector's share of gross domestic product (GDP) increased from negligible levels in the 1970s to about 30% in the early 1990s, before slipping to between 10%-15% between 2002 and 2014. From 2014 onwards, this share has increased to around 20% of GDP, with the country beginning to export LNG from a $19 billion Exxon-Mobil pipeline built from the Highlands region to the coast. The mining and petroleum sector is overwhelmingly foreign-owned, though the government holds equity in most projects. Previous large scale mining developments have led to conflict, particularly in the Autonomous Region of Bougainville where a large copper and gold mine (at one time providing about one-third of the country's income) was closed in 1989 due to violent disputes with landowners.

4. The manufacturing sector remains small and consists of food, soft drinks, beer, food canning, tobacco processing and furniture making. Small-scale engineering and metal processing, clothing, and other light industries are also present. Excluding tuna canneries, which now export to a number of countries, all manufactured products are targeted almost exclusively to domestic markets. The sectors expansion has been hampered by a range of structural impediments, including the shortage of skilled labor, complicated regulations, high utility and transportation overheads, and the high cost of labor relative to productivity.

B. Recent Economic Developments

5. **Economic growth**. Economic growth in PNG rose to 8.0% in 2014 as the country began its first exports of LNG. Growth in other sectors of the economy remained modest. Construction output fell by 6.4% in 2014, and this spilled over into the broader economy, stalling wholesale and retail trade growth at 5.0% and slowing utilities growth from 9.0% in 2013 to 6.0% in 2014. Long-term declines continued at a number of older mining operations, but with increasing output from a new nickel project, mining and quarrying as a whole expanded by 6% in 2014.

6. Agriculture, forestry, and fisheries growth picked up to 4% in 2014 as weather conditions for exports of cash crops—cocoa, coffee, and palm oil—improved. However, much of this growth was a recovery from weak growth in previous years with agriculture

[1] This analysis is a summary of: Asian Development Bank (ADB). 2015. *Asian Development Outlook: Papua New Guinea*. Manila; ADB. 2015. *Pacific Economic Monitor: Papua New Guinea*. Manila; and ADB. 2014. *Pacific Economic Monitor: Papua New Guinea*. Manila.

continuing to be hampered by lower global commodity prices, declining yields from aging plantations, inadequate pest control, and poor transport infrastructure.

7. **Fiscal and debt policy**. Fiscal policy remained expansionary in 2014 with government achieving its planned budget deficit of 5.9% of GDP. However, with lower than expected revenue growth and a number of unplanned expenditures, this required a sharp halt in expenditure towards the end of the fiscal year and the reappropriation of K1 billion (nearly 5% of total domestic revenue) from unspent project trust funds back into the central government account. Despite these measures, government spending still grew by 20% in 2014, continuing 4 years of rapid fiscal expansion that has seen the size of the budget grow by an average of 25% per annum.

8. Roughly 70% of government borrowing since 2012 has been sourced from local capital markets. This has begun to crowd out finance for local investment and push up local interest rates. Government borrowing costs for long-term domestic debt reached 14% per annum in 2014. While government debt levels remain modest by regional standards, rising domestic interest rates have almost doubled debt servicing costs for the budget, rising from 5.5% of domestic revenue in 2013 to an expected 9.2% in 2015.

9. **Inflation**. Easing aggregate demand linked to the completion of LNG project construction and declining global commodity prices placed downward pressure on inflation during 2014. However, these pressures were more than offset by government spending and import price pressures from a depreciating exchange rate, which led to consumer price index growth of 8.3% at the end of 2014, up from 2.9% at the end of 2013.

10. **Monetary and exchange rate policy**. In June 2014, the Central Bank attempted to stem the kina depreciation by placing a trading band around an official rate that was 20%–30% higher than prevailing market rates. This triggered a shortage in the supply of foreign exchange as residents and business attempted to move currency offshore. Although the official rate was allowed to depreciate slowly in the latter half of the year, shortages continued, with commercial banks all reporting order backlogs. Ongoing intervention by the Central Bank in the foreign exchange market led to a drop in foreign exchange reserves during 2014. By the end of the year reserves were sufficient to cover 4.6 months of total imports, down from 5.9 months at the end of 2013 and a peak of 10.5 months cover at the end of 2011.

11. **Balance of payments**. PNG’s overall current account balance strengthened significantly in 2014, recording a deficit equal to 11.4% of GDP, compared to a deficit of 31.0% of GDP in 2013. This improvement reflected growing surpluses in the goods balance driven by the onset of LNG exports and strengthening agricultural exports partially offsetting the large deficits in both the services and income balances.

C. Economic Prospects

12. GDP growth is forecast at 15% in 2015, slowing to 5% in 2016. Leading this growth is the oil and gas sector, with the country’s first full calendar year of LNG production in 2015. A rebound in mining and quarrying is also expected as operations at a new nickel mine continue to expand, more than offsetting declines at a number of other older operations. Real growth in mining and quarrying will reach 12% in 2015, falling to 3% in 2016.

13. In contrast with mining and petroleum, activity in the rest of the economy is expected to remain modest, with nonmineral growth forecast at 4% in 2015 and 2016. After contracting by 6.4% in 2014, construction will grow by 3.8% in 2015, boosted by government investment in transport and energy infrastructure and new sporting facilities. The transport

and logistics sector is expected to grow by 5% in 2015, boosted by lower fuel prices flowing from the global oil price slump.

14. Growth in wholesale and retail trade and financial services will return to long-run averages of 5%–6% during 2015 and 2016. The agriculture, forestry, and fisheries sector is expected to continue its recovery, with growth of 3.6% in 2015 and 3.7% in 2016. Although international prices remain subdued, the lower kina exchange rate combined with transport cost savings generated by lower fuel prices will provide a particularly important boost to the sector as it is dominated by export-focused commodities of logs, tuna, crustaceans, coffee, cocoa, and palm oil.

15. The 2015 budget targets a much-needed fiscal consolidation. The budget deficit is planned at 4.4% of GDP in 2015, and aims for a return to budget balance by 2017. Achieving this target will, however, be challenging. Personal, company, and sales taxes, which make up roughly 80% of domestic revenue, are all expected to remain stable over the coming years, as the benefits of enhanced compliance measures fade and growth in nonmineral sectors of the economy remains weak. Further, with global LNG prices following the slump in oil prices, revenues received by the first shipments of PNG LNG are likely to be significantly lower than expected. If lower LNG prices persist, current government plans to cut nominal expenditure by more than 10% by 2017 may have to be made larger if it is to achieve its balanced budget target.

16. Inflation is anticipated to moderate to around 7% in 2015 and then 6% in 2016, as the pass-through of a lower kina exchange rate is offset by a slowing domestic nonmineral economy and lower commodity prices. This forecast is, however, highly dependent on the government's ability to rein in expenditure growth and on the central bank maintaining prudent monetary policies. Domestic deposit rates are anticipated to remain near zero for the foreseeable future unless the central bank can undertake monetary interventions sufficient to soak up liquidity in the banking system.

17. After a number of years of large deficits, the current account is expected to record a surplus of 13% in 2015 and 15% in 2016. The improvement in the external balance is driven largely by a 49% increase in exports during 2015, driven by the first full calendar year of LNG exports and expanding nickel production at a new mine. In contrast, with LNG construction work completed and plans for fiscal consolidation under way, imports are expected to fall by 8.2% in 2015 and 12.9% in 2016. Meanwhile, payments from abroad are expected to increase substantially from 2015, mainly through income and dividend payments to the government as a result of LNG exports.

D. Development Challenges

18. PNG has reached an important economic crossroad. The commencement of LNG production and exports marks an end to the large foreign direct investment inflows that fueled a period of construction-led growth. What has emerged is a significantly more resource-dependent economy with modest growth of the job-intensive nonmineral sector. During 2015, the share of total output generated by the resources sector will jump from 12% to 22% of GDP, while the share of budget revenue obtained directly from mining, oil, and gas operations will increase from 11% to 20%. With a number of new resource projects in the pipeline, it is possible that this dependency will grow further over the coming decade. As the current sharp unexpected drop in global oil and other commodity prices demonstrates, managing the volatility associated with this resource dependence will be increasingly important for maintaining macroeconomic stability. To ensure growth is sustainable, a number of adjustments to economic policy are needed.

19. Firstly, fiscal consolidation is required to enhance the economy's resilience to adverse economic shocks. As PNG's dependency on mining, oil, and gas exports grows, so too will its vulnerability to global economic shocks, particularly those related to commodity price downturns. After a decade of commendable fiscal discipline which lowered public debt from 72% of GDP in 2002 to 22% of GDP in 2011, expansionary fiscal policy has seen public debt rebound to 35.5% of GDP by the end of 2014. This debt level slightly exceeds the government's own Medium-Term Debt Strategy, 2013–2017 of 35% of GDP ceiling, which had already been revised from an original 30% of GDP ceiling in 2013. This borrowing, which has been heavily sourced from local capital markets, has begun to create a number of macroeconomic pressures. This includes crowding out local investment, placing further downward pressure on the kina exchange rate, and spurring inflationary pressures. It has also reduced the government's fiscal space to undertake countercyclical fiscal measures. With LNG revenues expected to be modest over the medium term, lower spending growth and returning the budget to near balance will be vital for maintaining macroeconomic stability.

20. Secondly, strong institutions need to be established to ensure transparent and accountable resource revenue management. Transparency provides the basis for accountability and is essential for informed decision making and for providing the community with confidence that resource revenues are being used appropriately. Since 2009, the government has been working towards the establishment of a sovereign wealth fund (SWF), not only to insulate the budget from commodity price volatility but also to provide a clear and transparent process for managing resource revenues. After several unsuccessful attempts, a policy framework has been established for the establishment of such a fund. Efforts are now needed to establish the fund in a timely manner so that robust institutional settings can be applied at the earliest stages of LNG exports and revenues. In addition, with current policy proposals suggesting a portion of resource revenues will be channeled to off-budget government institutions, further efforts are needed to ensure the SWF design is credible. In 2013 the government also signaled its intention to comply with the Extractive Industries Transparency Initiative (EITI). This is a positive step, however progress has also been slow, suggesting a greater effort is needed to ensure PNG is able to meet these standards in a timely manner. Also of importance to the PNG context is a need to improve the transparency of subnational resource revenue flows, something that the EITI is not designed to address. This includes creating a mechanism to inform communities about the flow of revenues from resource extraction to provincial governments and landowner groups who hold equity in, or receive royalties from, resource projects.

21. Thirdly, a greater focus needs to be placed on enhancing the quality and impact of public expenditure. Capacity shortfalls are often seen as the major challenge facing the public sector's ability to implement ambitious budgetary plans, however other factors also contribute. Sector agencies highlight frequent disconnects between sector budget submissions and the approved budget, often forcing project staff to hurriedly design and implement unfamiliar projects. A lack of feasibility and design work before projects are financed has led to unrealistic cost estimates, tendering delays, and difficulties in attracting private sector construction capacity. Further, increased funding is being given to provincial and district governments, yet they often lack the expertise to effectively plan, procure, and maintain infrastructure assets. In addition, funding for new capital projects continues to be prioritized over recurrent operations. Between 2009 and 2014, recurrent budget allocations fell from 60% of total allocations to 51%. This limits the abilities of sector agencies to expand human resources to meet growing investment demands, and jeopardizes sustainability because routine maintenance is underfunded.

22. Taken together, these three priorities represent an ambitious reform agenda for ensuring PNG is able to transition to a more resource-dependent but inclusive economy. The moderate funding growth outlined in the 2015 budget presents an opportunity to make

progress against all of these targets. Sector agencies will have to catch up with investment backlogs and focus on building the technical and institutional capacity for delivering cost-effective and sustainable infrastructure and services. Meanwhile, a period of fiscal consolidation would allow central agencies to focus on improved budget coordination and planning, including enhanced efforts to establish the institutions and policies to ensure future resource revenues are managed in a transparent and accountable manner.