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Papua New Guinea

Growth is forecast at 6.0% in 2014 and a record 21.0% in 2015, led by the commencement of gas exports in late 2014. In contrast with mining and petroleum, the rest of the economy will grow by just 1.6% in 2014. A challenge for the government is to share the benefits of growth and to narrow regional inequality by expanding services in rural areas and employment through a more conducive business environment.

Economic performance

Economic growth in Papua New Guinea (PNG) slowed to 5.1% in 2013 as construction on a $20 billion liquefied natural gas (LNG) project wound down toward completion in mid-2014 (Figure 3.33.1). Growth in construction halved from 24% in 2012 to 12% in 2013, and this deceleration spilled over into the broader economy, slowing growth in wholesale and retail trade from 20% in 2012 to 5% in 2013. Long-term declines continued at a number of older mining and oil operations, but they were more than offset by increased output from a new nickel project, such that mining and quarrying as a whole expanded by 15% in 2013.

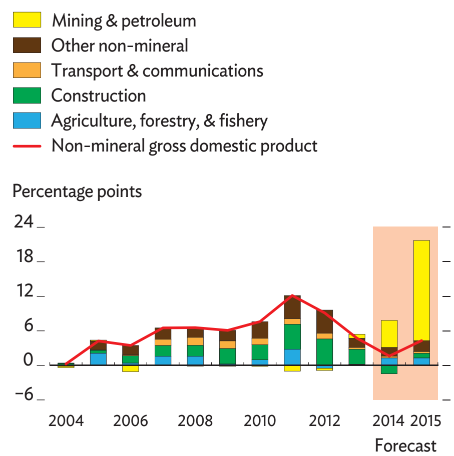
Agriculture, forestry, and fisheries grew at a modest 0.5% in 2013. Although this improved on the 1.6% contraction in 2012, conditions in the sector continue to be hampered by falling commodity prices, declining yields from aging plantations, inadequate pest control, and poor transport infrastructure. Further, an elevated exchange rate for much of the year discouraged farm output, especially of labor-intensive cash crops like copra, cocoa, and coffee.

National budget appropriations grew by 20% in 2013, while revenue growth was a more modest 9.5%. This widened the official fiscal gap to the equivalent of 7.9% of GDP and brought central government debt to 31% of GDP, up from 26% in 2012 (Figure 3.33.2). Funding for the government's four priority "development enablers"—infrastructure, education, health, and law and order—continued to grow rapidly, increasing by 38% over 2012 (Figure 3.33.3). The share of total funding for these four priorities doubled from 20% of the budget in 2003 to 40% in 2013.

A major challenge to budget execution continues to be implementation capacity, particularly for new national infrastructure projects, which suffer weak monitoring and oversight. Allocations continue to be assigned to many projects before the completion of their feasibility studies and preparatory design. As of November 2013, only 35% of the budget allocation for new capital projects had been spent, with most allocations sitting unused in project trust accounts rather

This chapter was written by Aaron Batten of the Papua New Guinea Resident Mission, ADB, Port Moresby.

3.33.1 Supply-side contributions to growth



Sources: PNG Department of Treasury. *National Budget.* various years; ADB estimates.

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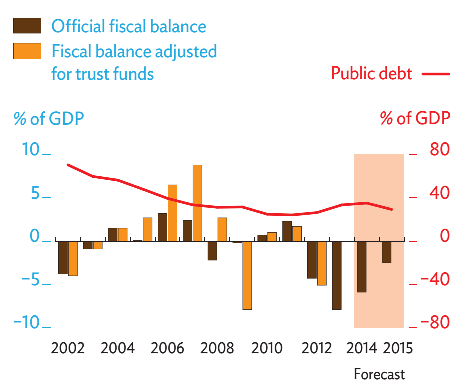
3.33.2 Fiscal balance and public debt



Sources: PNG Department of Treasury. *National Budget*, various years; ADB estimates.

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than flowing into the economy (Figure 3.33.4). As a result, the planned fiscal stimulus for 2013 had only a limited effect on economic activity during the year.

Inflation continued to remain moderate in 2013, with the consumer price index estimated to have risen by 4% at year-end (Figure 3.33.5). Subdued international food and commodity prices and low inflation in key trading partners, notably Australia, contributed to this outcome. The relatively high value of the PNG kina helped restrain import prices (Figure 3.33.6).

Motivated by moderate inflation and slowing growth in the economy, the central bank continued to ease monetary policy during 2013, lowering the target policy rate to 6.25% in March 2013 from a peak of 7.75% in September 2011. However, persistently high excess liquidity in the commercial banking system keeps policy rates largely disconnected from actual market rates. Even as aggregate output growth slowed during the year, growth in credit to the private sector accelerated, expanding by 18% in 2013, up from 7% in 2012. This somewhat counterintuitive trend reflects the winding back of runaway profit growth in many sectors resulting from investment in the LNG project. As profit growth has slowed, many firms are now looking again to the commercial banking system to fund their investment plans, rather than self-financing them through retained earnings.

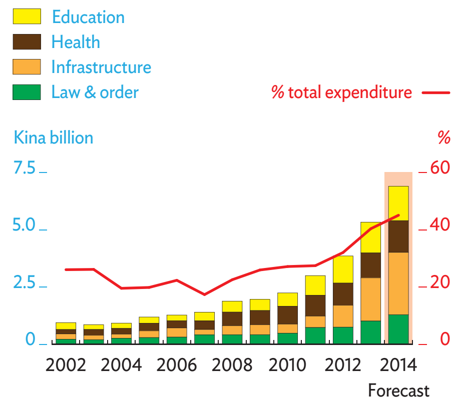
The current account recorded a deficit of 13.7% of GDP in 2013, driven by large capital imports and service payments related to LNG project construction (Figure 3.33.7). As these payments are primarily funded by foreign direct investment and medium- and long-term loans, they pose little risk to PNG's external stability. Although international reserves declined by 18.0% during the first half of 2013, they remain healthy, sufficient for 10.9 months of import coverage.

Economic prospects

GDP growth is forecast at 6.0% in 2014, picking up to a record 21.0% in the following year, though persistent challenges with the quality of macroeconomic data continue to limit the accuracy of these forecasts (Box 3.33.1). Leading this growth is oil and gas, as LNG production is expected to commence in late 2014, making 2015 the first full year of production. The rebound in mining and quarrying is expected to continue as new operations further expand production, boosting real growth in that sector to 14.0% in 2014 before it falls back to 3.1% in 2015.

In contrast with mining and petroleum extraction, activity in the rest of the economy is expected to continue to slow, with growth forecast at just 1.6% in 2014. Construction is forecast to contract by 6.4% in 2014, following the completion of the LNG production facilities and pipeline by the middle of the year. Growth in transport and logistics, wholesale and retail trade, and financial services will ease from the highs recorded over the previous 3 years. The agriculture, forestry, and fisheries sector is expected to recover, with growth of 4.0% in both 2014 and 2015. Agricultural output is expected to be boosted by the kina's decline at the end of 2013, which has improved the export competitiveness of cash crops.

3.33.3 Expenditure by development enabler



Sources: PNG Department of Treasury. *National Budget*, various years; ADB estimates.
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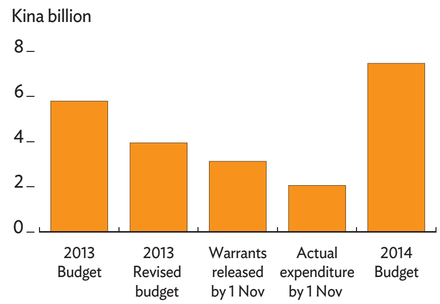
3.33.4 Budget implementation



Sources: Department of National Planning and Monitoring. *National Budget*, various years; ADB estimates.
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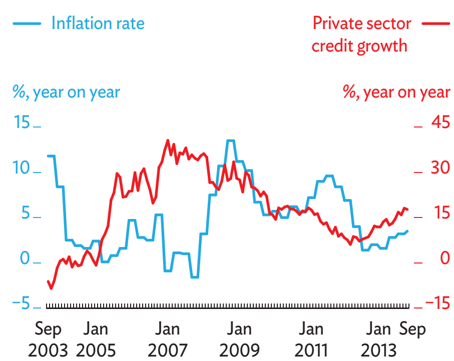
3.33.5 Inflation and private sector credit



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*, various issues.
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3.33.1 Macroeconomic data limitations

The accuracy of macroeconomic monitoring and forecasting in PNG is increasingly hampered by deficiencies in official data collection and compilation. GDP data were last published by the National Statistics Office for 2006 and last reported to the International Monetary Fund for 2004. The Treasury Department has made do with its own GDP estimates since 2002, but they suffer from extremely limited source data and their coverage from the perspective only of sector-based production. Income and expenditure accounts have remained unavailable since 2007.

Further undermining GDP data is the use of the outdated base year of 1998 for calculating real GDP figures. As the structure of the PNG economy has changed rapidly over the past decade—a trend that will likely continue during the forecast period—this problem continues to create significant biases in GDP growth rates overall and by sector.

The National Statistics Office compiles a quarterly consumer price index and an unpublished wholesale price index. Both are based on expenditure weights that are 39 years old, and the lack of data collection means the index now excludes a number of key items such as accommodation. These limitations significantly hinder the reliability of inflation calculations and estimates.

Regarding external accounts, official data on exports and imports of goods differ markedly from those reported by trading partners. Financial accounts data suffer from deficiencies in collection, especially regarding private external debt and foreign direct investment.

Poor macroeconomic data significantly hamper the ability of policy makers to monitor emerging economic trends and risks, or to implement in a timely way countercyclical monetary policies. They also create financial costs for the economy. Standard and Poor's highlighted in its January 2014 update that gaps in PNG macroeconomic statistics constrained the country's creditworthiness.

In partnership with the International Monetary Fund, the government has begun to address some of these issues. Prioritizing this effort during 2014 will be vital to ensure that official macroeconomic statistics are able to give more accurate insights into PNG's real economy and to improve the quality of macroeconomic management in the future.

Although GDP growth is expected to hit record highs in 2015, this will have only limited immediate impact on the broader economy and job creation. As international investors own some 80% of the LNG project, it is likely most earnings will remain offshore. And, as the project comes onstream, employment in the project will drop dramatically, from a peak of about 16,000 workers during construction to a few hundred once the project is fully operational. As a result, the project will have much less impact on gross national income than on GDP. The project's key transmission mechanism to the domestic economy will be dividend and tax payments to the national government, which are expected to peak in the early 2020s. During the initial years of production, some of these revenues will likely be required to service loans that fund the state's equity holding in the project. They may also be used for investment in further resource development.

3.33.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.0	21.0
Inflation	6.5	5.0
Current account balance (share of GDP)	–7.0	13.0

Source: ADB estimates.

The 2014 budget remains expansionary, with a planned fiscal deficit equivalent to 5.9% of GDP. Despite the dampening effect of lower global commodity prices and a growth slowdown in the non-mineral economy, revenue collection is forecast to grow by a record 23% in 2014, underpinned by planned improvements in tax compliance and enforcement. The depreciation of the kina against major currencies such as the Australian and US dollar during the latter part of 2013 is expected to bolster tax receipts from commodity exports and development assistance, both of which are largely denominated in these foreign currencies.

Despite the implementation challenges experienced in 2013, infrastructure is again a major recipient of new funding in 2014, with allocations increasing by 42%. Additional expenditure in the 2014 budget remains broadly aligned with the government's other medium-term development enablers: education, health, and law and order.

Central government debt is expected to reach 35% of GDP in 2014. While this is broadly sustainable and in line with the limits established in the government's medium-term fiscal strategy for 2012–2017, a number of additional liabilities raise fiscal risks. Unpaid superannuation arrears and the financing of the government's equity stake in the LNG project bring gross public debt to approximately 56% of GDP. Further, the inclusion of public enterprise debt estimated at 7.5% of GDP (as recorded in 2010) would bring combined indebtedness to over 63%.

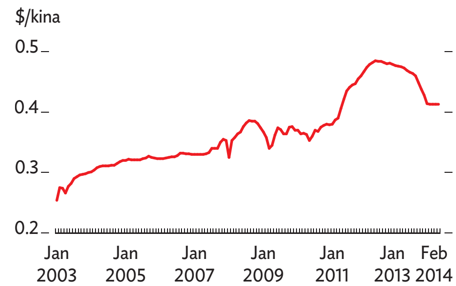
Inflation is anticipated to accelerate to 6.5% in 2014, as public investments originally planned for 2013 finally roll out and as kina depreciation in late 2013 passes through to import prices. In 2015 inflation is expected to return to its long-run average and is forecast at 5.0%, but this depends on the government reining 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 undertakes monetary interventions sufficient to soak up liquidity in the banking system.

The current account deficit is expected to narrow to 7.0% of GDP in 2014 before becoming a surplus of 13.0% in 2015. The improvement in the external balance is driven largely by the commencement of LNG exports in late 2014, but also by expanding nickel production at the new mine. In line with LNG exports, payments from abroad are expected to increase substantially from 2015, mainly through income and dividend payments to the government.

Policy challenge—addressing regional fiscal inequality for inclusive growth

Royalty payments from resource projects and larger value-added tax collections in major urban centers mean that the ability of PNG's 22 provincial governments to raise own-source revenues varies significantly. In 2009, the Government of PNG undertook reforms to address this, allocating 5.6% of non-mineral revenues to create a pool of national funds to compensate poorer provinces with higher national government grants. The compensation provided to each province would

3.33.6 Exchange rate



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*, various issues.

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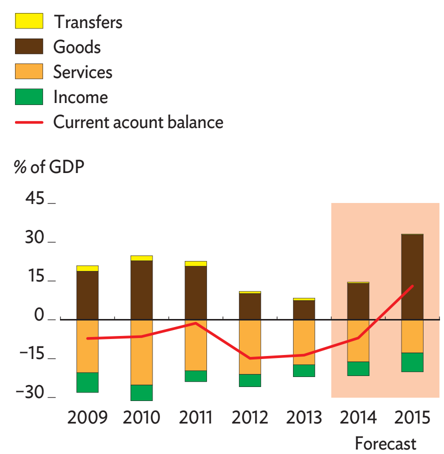
3.33.7 Current account components



Sources: PNG Department of Treasury. *National Budget*, various years; ADB estimates.

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be based on its ability to raise own-source revenue relative to what the government's National Economic and Fiscal Commission estimates it should cost the province to deliver 11 minimum priority activities: the provision of school materials, the supervision of education staff, district education office operations, rural health facility operation, integrated health patrols, medical supply distribution, road and bridge maintenance, airstrip maintenance, wharf and jetty maintenance, agricultural extension services, and stocking operational materials.

Following these reforms, significant progress has been made in narrowing provincial fiscal inequality. Prior to reform, six provinces received less than half of what the commission calculated they needed to fund the minimum set of activities, and another four received less than 70%. By 2012, only three provinces received less than 70% of their needs, with the lowest-funded province receiving 65% (Figure 3.33.8). This has placed previously marginalized provinces in a much stronger fiscal position to fund routine service delivery.

Further, because provinces rely increasingly on so-called function grants from the national government, and because function grant spending is tied to a priority list of activities, the proportion of provincial government spending on key development activities has increased. Spending on the national government's development enablers has increased by 160% since the reforms.

Yet, while provincial fiscal reform has helped to equalize the financial capability of provincial governments, a number of challenges remain to translating this additional money into inclusive development outcomes.

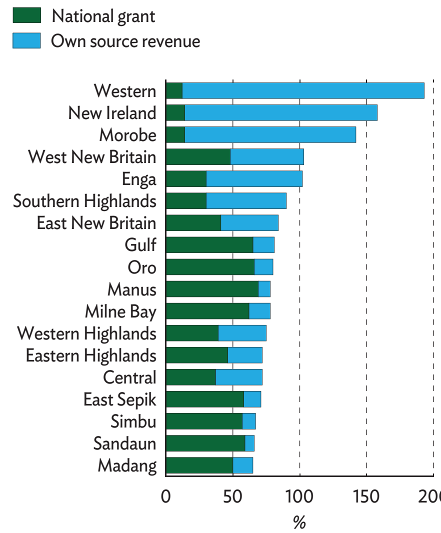
One challenge is the allocation of the provincial government's own source revenues that continue to fund non-priority activities—in particular those related to the wages and salaries of government staff. The National Economic and Fiscal Commission calculates that in 2012 provincial governments overspent on administration by 123%.

Another challenge is the timing of function grant release, which is often slow and unpredictable. In many cases, provinces receive their allocations too late in the year to use them effectively. In 2012, for example, eight provinces had to wait until the final fiscal quarter to receive more than 40% of their annual allocations.

Yet another challenge is weak implementation capacity in provincial governments, which lack skills for project costing, contracting, and management. Greatly expanded funding has strained procurement systems, while control and accountability mechanisms are rarely able to account for funds once they have been released.

Ensuring that improved provincial fiscal equity translates into inclusive development outcomes will require focusing not just on financing capacity but also on improving provincial governments' underlying systems of accountability and implementation for essential public services.

3.33.8 Provincial fiscal capacity, 2012



Source: National Economic and Fiscal Commission. 2013. *Provincial Expenditure Review.*

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