Loi M Bakani: PNG Economic Survey – "From Boom to Gloom"

Commentary by Mr Loi M Bakani, Deputy Governor of the Bank of Papua New Guinea, on the PNG Economic Survey: "From Boom to Gloom", at the 2009 Papua New Guinea Update, Port Moresby, 16 April 2009.

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The survey is focused on: (1) the likely end of macroeconomic stability and economic growth that the PNG economy has enjoyed in the period 2003 to 2007/08, driven by high commodity prices and prudent management of macroeconomic policies – fiscal and monetary, although the survey does not explicitly give credit to the sound management of fiscal and monetary policies; (2) the start of turbulent times arising from the adverse impact of lower commodity prices caused by lower demand for PNG's export commodities, itself the consequence of the downturn in global economy; and (3) a comparison of the National Government's management of the revenue windfalls of the 2000s and 1990s.

The primary common factor that is analyzed extensively in the survey is international prices of primary export commodities, and the secondary but also important factor is government policies, both macro (fiscal and monetary) and micro economic policies.

In the boom period, high international export commodity prices gave rise to increased foreign exchange reserves, Government revenue, steady appreciation of the kina exchange rates, and low and stable inflation rates. Government expenditure was within its means. Whether there was enough productive government expenditure as opposed to consumption expenditure is another issue. On paper, there was promotion of capital, infrastructure, and other productive expenditures. Actual effective spending of this was below budgeted levels. The survey did not explicitly give credit to prudent fiscal (balanced budget) and monetary policy management. These contributed to improved business confidence and macroeconomic stability and growth that the economy enjoyed. Government spending and private sector credit growth supported the expansion in the economy. The survey gives evidence of these; 6.5 percent real GDP growth in 2007 and 7.3 percent in 2008 quoted from the 2009 National Budget, and employment growth, using the Bank of PNG's employment index.

In the start of the gloom period, especially the second half of 2008, the declines in prices of PNG's major export commodities will be the telling factor behind reduced Government revenue, foreign exchange inflows, potential depreciation of the kina and high inflation rate. Already, total government revenue was lower than budgeted in 2008 while expenditure was within budget but higher than the revenue, which resulted in a larger budget deficit compared to a projected budget surplus.

While the Bank acknowledges that its reaction in adjusting monetary policy in 2008 to market conditions was a little late it has to be pointed out that (i) the link between monetary aggregates (money supply) and inflation is weak and not as strong as in other economies, and that (ii) the most influential variables/factors of inflation are the exchange rate and imported (foreign) inflation of PNG's major trading partners. With these in mind, while monetary expansion in the form of credit growth contributed to an extent to aggregate demand and therefore to inflation, the most influential factors on inflation in 2008 were the increased food and fuel prices in 2007 and the first half of 2008 and their lag effect, and strong domestic demand. With respect to the high credit growth, the Bank continued to closely monitor the quality of loans and as evident, there was no increase in non-performing loans by banks. It is also important to appreciate that the Bank viewed the credit growth necessary to stimulate economic growth after low growth rates of real GDP were recorded prior to 2007. Indeed, the Bank stood ready to tighten monetary policy in the event evidence of inflationary pressures emerged in the economy. Relying on the release of actual inflation data had a part in the slow response of the Bank.

Within domestic demand, monetary policy was picked on by the survey as being responsible but increased government spending and public consumption from the export earnings, both important factors contributing to strong domestic demand, were not clearly emphasized. Also, very importantly, the kina appreciated against the US and Australian dollars and the prices of fuel and food declined in the second half of 2008. These would have some positive flow on effects to domestic prices, but we have not seen business houses passed on the benefits of reduced import costs to consumers. This is something that the survey missed. BPNG hopes that there is still a lag effect of the appreciation, that is, goods bought under the appreciated rates will be sold at lower price. Firms must be fair and pass on the benefits to consumers. However, the latest (2009) depreciation of the kina against the key currencies- US and Australian dollars may give them an excuse not to reduce prices of goods and services or delay further any downward adjustment to domestic prices.

Coinciding with the declining commodity prices in 2008 was an increase in total government spending in excess of total revenue. Experience of the 1990s show that when there is excessive Government spending there can be downward pressure on the exchange rate and high inflation. And monetary policy is burdened with the task of restoring macroeconomic stability. That is, monetary policy could become preoccupied with the Government's debt management. We have to avoid this. We may be going through this cycle again. In this respect, the survey then makes some comparison of the revenue windfall and its management in the 1990s with that of the 2000s.

In the 1991 to 1994 period the main growth area in expenditure were salaries and benefits and current transfers or simply – recurrent expenditure which were financed by substantial amounts of domestic debt.

In the 2000's, there was restraint on public sector salaries and current transfers, especially in 2003, although revenue had already increased substantially. Also starting in 2003, the reduction in public debt took place. By 2007, the public debt/GDP ratio had been reduced to around 33 percent from 63 percent in 2003. This decline reflected the increase in nominal GDP and also a deliberate and prudent debt management policy to prepay expensive overseas loans using the windfall revenue. But then recurrent expenditure started increasing and by 2007, salaries and benefits increased by 40% from 2002. This is unproductive expenditure and I agree with the survey that it would be difficult to reduce it under a situation where budget revenue is declining, unless drastic reforms in the public service to achieve efficiency are undertaken.

We hope to avoid the experience of the 1990s where monetary policy became burdened with Government's debt management. The difference now is that the Central Banking Act 2000 safeguards monetary policy from any political interference and influence. But to achieve macroeconomic stability and growth, it requires close coordination between fiscal and monetary policies.

Overall, the survey pointed out that the Government managed the revenue windfalls of the 2000s better than in the 1990s. But we have to be mindful that some of the windfall revenue are kept in trust accounts with commercial banks and Bank of PNG. Whether these funds will be effectively spent for the intended purposes remains to be seen. More time will lapse before we know. Good management of the windfall revenue and effective spending for improvement in the delivery of goods and services also requires good governance and micro reforms. While the Government should be acknowledged in the survey for putting aside in trust accounts some of the windfall revenue, and also coming up with long term development plans (National Strategic Plan 2010-2050), which should be supported with resources. Prudent management of the windfall revenue held in the trust accounts is a challenge for Government to ensure that it is used efficiently and for areas that will enhance revenue generation in future. But a closer assessment of most of these trust accounts show that they are likely to end up as recurrent expenditure, and not of investment type. The issue of efficiency in delivery of services requires micro reforms.

This is where the survey also deliberated on some areas of micro reform necessary to sustain economic growth in future. They are: (i) competition in mobile telecommunications, about which the survey acknowledges the gains in the competition between Telikom and Dicigel, (ii) competition in air transportation, about which the survey pointed out benefits for travelers on certain travel routes (e.g., Brisbane-Port Moresby-Brisbane) served Qantas/Air Niugini and Virgin Blue/Airlines PNG (iii) business regulations (iv) dealing with construction permits (v) reducing costs of trade (vi) streamlining contract enforcement. These reforms should be pursued as the benefits for the economy are substantial. The Bank has consistently called for these reforms in its six-monthly monetary policy statements.

In concluding, the survey focused on the appropriate theme that is relevant today for the Government as it is already experiencing the effects of low commodity prices on its budgeted revenue for 2009. It is a challenge not to repeat the experiences of previous years where expenditure is not adjusted whenever there is a shortfall in revenue. The Government should not resort to debt financing but take a strong stand to cut expenditure in non essential areas. The effective use of the trust funds has to be undertaken in an orderly manner so that it does not exert pressure on liquidity and inflation. This is a form of Government's fiscal stimulus required to keep the economic momentum going. Close coordination between fiscal and monetary policies is therefore necessary in order to achieve long term macroeconomic stability and sustainable growth.

In terms of the timing of the survey, it is early to assess the full impact of the decline in export commodity prices on the economy. It is desirable thus to assess this impact later and how the Government had reacted to such impact. This could be looked at in the next survey of the economy. But raising these issues now as the Government is starting to experience the effects of lower commodity prices is important, and the authors should be commended for undertaking this survey at this time. Lessons drawn from the past commodity boom and gloom should be used as a guide as we face the challenge of a commodity gloom in 2009.

Thank you.