



MINISTERIAL STATEMENT

ON

THE STATE OF THE DOWNTURN IN THE WORLD ECONOMY, WHAT IT MEANS FOR THE PNG ECONOMY AND THE GOVERNMENT'S RESPONSE TO SUPPORT ECONOMIC GROWTH.

MARCH, 2009

INTRODUCTION

Mr. Speaker, it is a great honour for me to present to Parliament an update on the state of the downturn in the world economy, what that means for the PNG economy and what the Government is doing to support economic growth in PNG in the context of the bleak international backdrop.

THE INTERNATIONAL FINANCIAL CRISIS

Mr. Speaker, as we are all too well aware, after years of strong economic growth, the world economy has now slowed very sharply. The disruptive effects of the global financial crisis, which wreaked havoc throughout the global financial system and resulted in a near halving of global equity prices, are now being transmitted through to the world's real economy. The US is now officially in recession, as is the UK, Japan and much of Western Europe.

Mr. Speaker, the severity and nature of this crisis should not be underestimated. This is the largest financial crisis since the 1930's Great Depression. A number of the world's largest banks and financial institutions, including Lehman Brothers, Lloyds, Bear Stearns, American International Group, Northern Rock, Fannie Mae and Freddie Mac have either failed or are teetering on the edge of bankruptcy.

The financial crisis has spread widely across the world from the United States where it began with the sub prime debacle. Financial institutions across the developed world have collapsed, in countries such as the United Kingdom, Germany, France, Ireland, Belgium, Luxembourg, Iceland and Holland.

Across the world, equity prices have fallen sharply and the cost of borrowing has risen significantly – even in markets that had little to do with the initial crisis. This is having damaging effects on economies around the world.

Mr. Speaker, global output and trade plummeted in the final months of 2008.

The continuation of the financial crisis has caused asset values to fall sharply across advanced and emerging economies, decreasing wealth and putting downward pressure on consumer demand. The associated high level of uncertainty has caused households and business to hold off spending, reducing demand for consumer and capital goods, and curtailing production and trade. The freezing up of credit markets has choked off business access to credit – meaning that otherwise viable companies in many countries are now struggling to meet commitments.

THE WORLD ECONOMIC OUTLOOK

In short, the outlook for the major developed economies is bleak, as shown by:

- The IMF's latest estimate update on the World Economy, which now projects world economic growth falling to ½ per cent in 2009 – the lowest rate since World War II. Advanced economies are now expected to shrink by 2 per cent this year;
- The sharp increase in US unemployment which has shot up to 7.6 per cent in January, compared to 4.9 per cent a year earlier;
- The huge fall in Japanese GDP, which shrunk 3.3 per cent in the December quarter 2008 alone – the biggest drop since 1974; or
- The collapse of consumer and business sentiment to their lowest recorded levels in the US, Australia and the UK.

Just as worrying for PNG is the news that the developing economies have also slowed markedly. The IMF is now projecting that growth in emerging and developing economies will slow sharply from 6½ per cent in 2008 to 3¼ per cent in 2009. This is being driven by falling export demand and financing, lower commodity prices, and much tighter external financial constraints.

In particular, Mr. Speaker, the slowdown in China is significantly worse than previously expected. Chinese industrial production slowed from 16 per cent growth in mid-2008, to 5.7 per cent growth through the year to November 2008 – the smallest increase since 2002.

Chinese exports fell by 17.5 per cent through the year to January – a concrete demonstration of how the slowdown in developed economies is affecting China. This is then being transmitted throughout the region, with Chinese imports falling 43.1 per cent over the same period. These developments are influencing the dramatic declines in commodity prices.

Mr. Speaker, declines of this magnitude are impacting on every other economy in the region.

GLOBAL POLICY RESPONSE

In response to the continued fallout from the financial crisis, sharp contraction in economic activity, and rising rates of unemployment, policymakers around the world have been taking drastic action.

Initially, most policy responses related to the disruption in the financial markets, with large financial support packages directed towards banking and financial institutions announced in the US, Europe and UK. These were primarily aimed at

recapitalizing and propping up bank's balance sheets, which had been decimated by the collapse of asset values.

These measures appear to have had some initial effect, with, for example, the interbank lending market beginning to function again – but they are yet to lead to a widespread revival of credit markets. Nevertheless, there are other problems in the international financial sector and credit markets, and some major financial institutions remain very shaky.

As the financial crisis unfolded, policymakers started to introduce measures in order to boost flagging aggregate demand. Central banks have reduced official interest rates substantially across most of the world – although the freezing of credit markets has limited the impact this has had on business and households across most economies.

There have been major fiscal stimulus packages announced around the world. In the US, President Obama recently announced a US\$787 billion (or 6 per cent of GDP) package. In Australia, a A\$42 billion (or 4 per cent of GDP) package was passed through parliament two weeks ago. And in China, a massive stimulus package, equating to more than 16 per cent of GDP was announced earlier in the year.

However, it will take some time for these packages to have any major impact. The US package is spread out over the years, with 2.4 per cent of GDP expected to be spent in 2009. The Australian package will be spread out over 3 years. And the Chinese package includes a significant amount of spending that was already underway, reducing the size of stimulus in the pipeline.

Nonetheless, according to the IMF, because of continued efforts to ease credit strains and apply expansionary fiscal and monetary policies, the global economy is expected to experience a gradual recovery in 2010, with growth projected to be picking up to 3 per cent.

PAPUA NEW GUINEA ECONOMY

So what does all of this mean for PNG? Mr. Speaker, due to good fiscal and macroeconomic management by the Somare Government over the last years, PNG was in relatively good shape coming into the international financial storm.

Mr. Speaker, on a positive note, our banking sector has been largely unscathed by the international financial crisis. Banks in PNG are largely financed by domestic deposits and are not exposed to some of the instruments that have created havoc on the international scene.

The banking sector in PNG is relatively well capitalized, and has maintained strong liquid asset ratios, which puts our banks in a relatively good position. Banks have continued to lend strongly over the last year which is continuing to support private sector expansion. Mr. Speaker, having a financial sector which represents the backbone of the economy being in relatively good shape in the current international environment is a major bonus for PNG.

Mr. Speaker, the Government took prudent fiscal action during the boom years. Most observers would have expected the PNG economy to be hit very hard by the global slowdown, mainly because PNG's export prices have fallen dramatically. Indeed, this is having a major effect on PNG, through a sharp reduction in export values and Government revenues.

However, by restraining Government expenditure, and saving a large portion of the proceeds of the commodity boom during the past four years, the Government has prevented the need for a sharp adjustment in Government expenditure now that the boom is over.

Now that the boom has ended and the global economy is in recession, we can use the saved funds held in trust over the next few years to help build up infrastructure and shore up the economy.

Government debt has fallen from over 70 per cent of GDP earlier this decade to around 30 per cent today, and more than 15 per cent of GDP has been saved in the form of trust funds. These savings and the lower level of debt allow increased flexibility to deal with the fallout from the international financial crisis on PNG.

Mr. Speaker, I am happy to report that we are now in a position where Government spending can be maintained at a moderately high level, in order to support the economy. However, we need to be careful and ensure that fiscal policy is conducted within the Medium Term Fiscal Strategy (2008-2012) framework that has served us so well. The Somare Government plans to maintain its fiscal and macroeconomic credibility that has been built up over recent years – this will be a crucial aspect in maintaining domestic business confidence about the outlook.

The slump in global demand has led to a collapse in prices of PNG's key export commodities which, as foreshadowed in the 2009 Budget, will impact on Government revenues and on the balance of payments.

The price of oil continues to be volatile and has fallen to around US\$35 per barrel – a 75 per cent fall from the high of US\$147 per barrel in July 2008. This is well below the oil price assumption in the 2009 Budget of US\$55, while the copper price is hovering around the Budget assumption of US\$3250 per tonne – down from almost US\$9000 in July last year.

On the other hand, because of its status as a safe haven asset, the price of gold has strengthened to nearly US\$990 per ounce. This is significantly higher than the US\$600 assumption contained in the Budget. While it is unlikely that this will be enough to fully offset the revenue impacts of other commodity price falls below that expected at Budget time, it will partly mitigate the impact on revenue.

Mr. Speaker, while the dramatic fall in oil prices has had a large negative impact on the value of PNG's exports and Government revenue, it has led to a substantial fall in fuel prices paid by ordinary Papua New Guineans at the petrol pump. This is assisting to ease inflationary pressures in the wider economy.

World agricultural prices have also dropped, due to a sharp reduction in demand. The prices of PNG's major cash crops have fallen significantly, with the price of palm oil and copra oil down more than 50 per cent from their peak in mid 2008, and the price of cocoa and coffee down by around 15 per cent. Most cash crop prices are now below the 2009 Budget assumptions.

Falling agricultural prices could have a pronounced effect on domestic demand, as agricultural producers have less income to spend. Furthermore, falling commodity prices are likely to reduce the profitability of some mining projects and reduce the expansion of marginal mines.

These developments are increasing the downside risks to the economic growth forecasts outlined in the 2009 Budget, which projected GDP growth for 2009 of 6.2 per cent, and non-mining GDP growth of 5.6 per cent. I will be updating these forecasts in a few months time when further information comes to hand.

However, Mr. Speaker, despite all of the bad news coming in from overseas, and notwithstanding the vulnerabilities to the PNG economy that I have just described, the picture in PNG has remained relatively robust to date.

Early indications are that the non-mining sectors will continue to grow in 2009. Initial consultations with the business community indicate that while businesses are nervous about the outlook, economic activity is robust and continuing to expand. Banks are still lending strongly, investment projects are progressing, there is a lot of construction in progress that we can all see, and jobs are continuing to be created.

The Government increased expenditure in the 2009 Budget, and is increasing the utilization of trust accounts, all of which should support economic growth.

Credit growth is continuing to increase strongly, indicating that the private sector is still confident in the future of PNG. Commercial bank lending continues to grow at the fastest pace on record, indicating continued investment activity in the year ahead.

In addition, the LNG project is already beginning the early stages of construction, and, if it goes ahead as planned, can be expected to provide further stimulus to the PNG economy over coming years.

Nonetheless, the sharp slowdowns in other countries illustrate the speed at which investment and GDP can turn around. We will continue to monitor the situation closely as the year progresses, and Treasury will be stepping up liaison with the private sector in order to put together more informed assessments. As 2009 progresses, I will provide Parliament with updated assessments on the State of the PNG economy, to keep you and the nation informed of how events are playing out.

The Government will need to be very careful how we spend our revenues and funds in trust, making sure that we keep to our budget and spend only on our highest priorities, to extract the most value for money. To do otherwise would represent a failure on our part to those who elected us to manage their tax revenues – the ordinary people of PNG.

The Government remains focused on maintaining the long and medium term sustainability of our nation's finances. By holding to the Medium Term Fiscal Strategy (2008-2012), we will utilize the flexibility made available by our fiscal prudence over the boom years, without creating fiscal and economic problems further down the road.

Mr. Speaker, we also need to be very mindful of the significant emerging risks to our balance of payments. The value of PNG's exports has fallen sharply – in the range of 30 per cent, while imports continue to grow in line with the broader economy.

In the absence of a large reduction in PNG's imports, the current account is in the process of moving into a large deficit position. While PNG has built up large foreign reserves which provide a buffer against such swings, there will need to be adjustments within the economy in order to prevent this becoming a major issue

in the period ahead. In formulating fiscal policy over the coming year, the Government will be focusing on balancing supporting economic growth with the need to reign in strong demand for imports and keeping inflation in check.

Mr. Speaker, I will now turn to discuss how the Government is responding to the sharp downturn in the international economy.

GOVERNMENT'S RESPONSE TO THE INTERNATIONAL RECESSION TO SUPPORT PNG'S ECONOMIC GROWTH

2009 Budget Expenditure Allocations

Mr. Speaker, the Government is committed to shielding PNG's economy from the worst of the Global Financial Crisis and world recession as best we can. At a time of unparalleled international uncertainty, the Government will not leave PNG's continued economic growth and development to chance.

The Government has and will put in place a number of measures to shore up PNG's economic growth and development through this challenging period. There are two key phases of the Government's plan.

Phase 1 provides a substantial short-term injection and fiscal stimulus to the PNG economy. Phase 1 will be implemented in 2009 and will include public investments funded from vastly increased budget appropriations, including the substantially larger 2009 Development Budget, as well as from funds available in trust accounts.

Phase 2, which is expected to be implemented over the medium term in 2010 and beyond, involves significant investment in public projects and infrastructure,

which is expected to be funded by the PNG Government, the Australian Government and possibly other aid partners. Phase 2 will not only provide an economic stimulus, but, crucially, will ensure the continued economic and social development of PNG.

Phase 1 - Economic Stimulus from the Development Budget and Trust Funds

Mr. Speaker, under Phase 1 of the Government's response to the global recession, the Government will provide a fiscal stimulus to the PNG economy in 2009 that will rank among the largest in the world.

The 2009 fiscal stimulus has two key elements. First, measures included the 2009 Budget, which were framed against the backdrop of the global financial crisis only a few months ago. The pre-emptive measures and fiscal stimulus contained in the 2009 Budget made PNG one of the first countries in the world to respond to the slowing international economy.

Mr. Speaker, the Government used the 2009 Budget to shield the economy and support its citizens by promoting sustained economic growth and to further empower and transform the rural economy.

As a result, total recurrent expenditure in the 2009 Budget increased by K265.2 million to K3904.5 in 2009. This represents an increase of 7.3 per cent over the previous year. The 2009 Budget saw extremely large increases in the Development expenditures which increased by K720.6 million to K2595.2 million in 2009. This represents a substantial increase of 38.4 percent. This included reprioritization of the funds held in the gas equity trust fund to other spending programs, including the large boost to the District Services Improvement

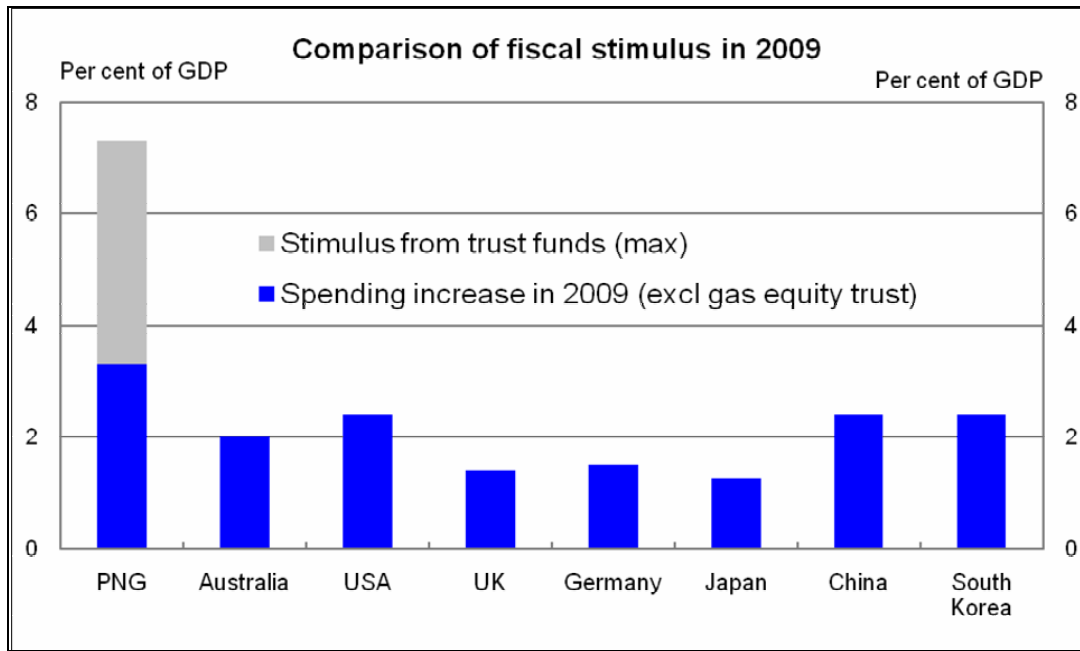
Program and to undertake substantial investments in agriculture, infrastructure maintenance, improvement and development.

Mr. Speaker, the increases in the 2009 recurrent and development Budgets spending amounts to almost an additional K1 billion being injected into the economy, or almost 5 per cent of GDP.

As the second element of Phase 1 in 2009, the Government will make available monies currently held in trust of up to 4 per cent of GDP, equivalent to about K844 million, for spending on public investments. This is the maximum allowed under the Medium Term Fiscal Strategy (2008-2012). This will provide a further fiscal stimulus as well as promoting sustained economic growth and development across PNG. Spending from trust funds will complement the level of development expenditures already allocated in the 2009 Budget for public investments. However, the final level of investment spending will need to be responsive to changing economic circumstances and capacity constraints.

Together, this brings the expected fiscal stimulus in PNG in 2009 to in excess of 7 per cent of GDP. This additional stimulus would certainly rank among the largest in the world, and is more than double the very large economic stimulus packages announced by Australia, the USA, the United Kingdom and other countries. This is despite the PNG economy being in a relatively robust position compared to most of the major developed and other developing countries.

Chart 1: Comparison of Economic Stimulus (as % of GDP) in 2009



Source: Reserve Bank of Australia, February 2009

The 2009 fiscal stimulus in PNG is substantially larger than the stimulus for Australia and the US, even before additional expenditures from trust funds are considered. Additional spending from trust accounts, over and above the reprioritisation of the gas equity trust fund announced in the 2009 Budget, brings the total fiscal stimulus in 2009 to more than double the fiscal stimulus (even triple the fiscal stimulus) in the comparison countries of Australia, the USA, the UK, Germany, Japan and China.

Mr. Speaker, despite the world economic downturn, the level of economic stimulus that will be made available from the trust accounts each year is very significant. The Government will allocate up to the maximum spending from the trust expenditures permitted under the Medium Term Fiscal Strategy (2008-2012)

to add further stimulus if there is evidence that the PNG economy is slowing significantly. But the usage of the trust funds will be subject to capacity constraints, the ability of the private sector to deliver value for money, and inflationary and balance of payment pressures.

Phase 2 - Further Economic Stimulus from Partnership Development Program

Mr. Speaker, the second phase of the Government's plan applies in 2010 and beyond. The Government is actively exploring a significant investment in the development of PNG that would provide a further economic stimulus through the PNG-Australia Partnership for Development program. The Partnership for Development program is currently being developed between the Governments of PNG and Australia, following the agreement of Prime Minister Somare and Prime Minister Rudd in August 2008.

It is expected that the program will deliver significant increases in public investment from the Governments of PNG and Australia and possibly other aid partners from 2010 to 2015. Investments are being considered in the critical sectors of:

- elementary and primary education;
- transport, especially the national road network, airports and ports;
- basic health;
- the public sector; and
- statistics

While the details will be firmed up over coming months and in the lead-up to the 2010 Budget, I can confirm that the program is expected to provide a significant

injection and fiscal stimulus to the economy in support of a range of critical public investments. A significant portion of funding is expected to come from funds held in trust accounts in addition to increased contributions from aid partners. The Government will provide further details after the Ministerial forum between PNG and Australia, which is expected to be held in late April 2009.

Because the Partnership for Development program and trust fund spending will be carried out over the medium term, it will give certainty to the private sector that there will be an ongoing stream of projects and public investment for many years ahead. This will enable the private sector to invest to increase their capacity and plan for the future, with the confidence that a significant amount of public investment is in the pipeline.

Finally, in announcing these different components that represent a substantial fiscal stimulus, the Government is mindful of the need to be prudent and fiscally responsible, and not to repeat the mistakes of the past. The Government is committed to the implementation of these measures without additional borrowings or increasing the level of public debt. The Government also recognizes that Government expenditure must remain on a sustainable path following the end of the commodity boom and the need to continue to adhere to the Medium Term Fiscal Strategy (2008-2012) that has been serving us so well. The Government will continue to monitor economic and fiscal developments and adjust its response as necessary.

CONCLUSION

Mr. Speaker, the PNG economy has remained robust to date despite the international financial crisis. While there are many reasons to be optimistic about PNG's growth prospects, dark international storm clouds are all around us and

the international economic outlook has never been so uncertain and bleak – there is no room for complacency. We have already seen a substantial decline in Government revenue and PNG's export values as a result of the substantial falls in commodity prices. In addition, the emerging balance of payments pressures will require careful management by the Bank of PNG and the Government.

Given these challenges and the world recession, the Government will not leave PNG's growth and development prospects to chance. The Government has already responded, and will continue to respond, to shield the economy from external shocks as best we can.

The Government will provide a significant fiscal stimulus in 2009 that is more than double the rescue packages announced by Australia, the US, the United Kingdom, and others. Spending from trust funds will also support the economy over the medium term.

The Government will support the PNG economy over the short and medium term in a manner that improves PNG's economic development. The PNG-Australia Partnership for Development program, which is expected to come into force in 2010 and over the medium term, should involve significant additional public investment in areas that are critical to PNG's economic and social development. This program, together with investment spending from trusts will also provide certainty for the private sector to expand and invest, knowing there is a continuity of development programs in train over the medium term.

Mr. Speaker, the Government is committed to the development of PNG and to measured, prudent steps to navigate through these turbulent economic times. While the end of the commodity boom affects PNG more than all but a few other countries in the world, PNG stands well placed to tackle these challenges in the

years ahead. This is because of a vibrant domestic economy and the fiscally responsible policies of the Government to accumulate part of the proceeds from the commodity boom in trust accounts and to reduce debt. These trust funds and lower debt will help to cushion PNG in avoiding the full effects of international recession and the sharp economic contraction that has followed past commodity booms.

Finally Mr. Speaker, let me assure this Parliament and the people of Papua New Guinea that this Government continues to monitor international developments closely and we are doing what we can to secure our economic future.

Thank you.



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