Papua New Guinea is not at risk of a Greek-style Crisis

There has been some recent discussion about Papua New Guinea's budgetary situation on the devpolicy blog and in the Australian media. One media commentator has gone as far as to state that PNG could be on the brink of a Greek-style fiscal crisis.

This is clearly not true. Papua New Guinea's budgetary situation is nothing like that of Greece. However a comparison between the two does draw attention to key differences and to some important policy issues and trade-offs of which PNG must be aware of as it adjusts its fiscal and monetary settings.

To begin, the PNG government has two options that are not available to the Greek government: firstly it can devalue the currency to stimulate economic activity, and secondly it can print money to fund the deficit. Given the constraints of Eurozone membership, the Greek government can do neither of these without leaving the euro. While I am not advocating the latter for PNG (although it is a valid short term option in a liquidity crisis) I am certainly suggesting the former, as will be discussed below.

It is certainly true that PNG faces a serious budgetary situation with falling tax revenues as growth in the non-resource sector slows and large increases in spending since 2013, and as a result spending must now be slowed. However some level-headed and nuanced thinking is required in doing so. There are a number trade-offs to consider.

A starting point on PNG's current budgetary situation is that the debt dynamics currently look good. The economy grew by 13.3% in 2014, and is forecast to grow at around 11 percent in 2015. The real interest burden (the interest rate that the PNG government is paying on debt) is about 4 percent.[1] If the primary deficit (the gap between current spending and current revenue) was zero then PNG's debt-to-gdp (gross domestic product) ratio would fall by around 3 % per year.

One way to think about this is that the first 3 percent of PNG's deficit as a proportion of GDP is covered by this "growth dividend". To place this further into context, why is it that Greece's debt-to-gdp ratio of 170% is a big problem, while Japan's at 230% is not? It is because of debt dynamics. The key is the difference between real interest rate on debt, r, and the growth rate of gdp, g. As long as r is less than g, or $(r - g)$ is negative then debt dynamics are stable. So lower r is good, as is higher g, and any contrary movements worsen the debt dynamics (keep this in mind as you read the rest of this analysis). If r rises above g, which is the case for Greece, then the dynamics become unstable and the growth in the debt-to-gdp ratio can become explosive.

[1] The weighted average nominal interest rate on government paper (Treasury bills and inscribed stock) held by the public is 9.4 % (calculated 4 weeks ago – see author for further details) and inflation was 5.2 % in 2014 and is currently running at around 5 – 5.5 %. In addition there is an external debt of K3.5 bn held by international agencies, which presumably has a lower interest rate but carries exchange rate risk. For simplicity in these calculations we assume the interest rate on the external debt to be equivalent to that on remainder of the portfolio.

The *Fiscal Responsibility Act* mandates a debt-to-gdp ratio of 30%, and the Medium Term Fiscal Strategy 2013-17 allows an exemption for 2013-15 where it will not exceed of 35% - this limit was breached by the end of 2014 (37.7%). Given recent GDP growth in the 2015 Mid-year Economic Outlook it was back to 33.5% although it is forecast to rise to 41.3% by year's end. The budget deficit in 2015 is forecast to be 9.4% of GDP, rising from 7.3% in 2014.

If one looks across current debt-to-gdp ratios of developing and developed economies, PNG's mandated target is low. Although one must consider that PNG's gross national income (it's ability to pay) is about 10% below gdp so the current target of 30% is more like a target of 33% for countries where difference between gdp and gni is small. In addition the government has superannuation arrears of around K2 billion, so the current debt-to-gdp ratio is around 38%.

The interest rate the government pays on debt is sensitive to the market's perception of government solvency and risk, and r can rise quickly if demand for government paper falls, turning the debt dynamics bad ($r - g$ positive). Mitigating this possibility in PNG is the fact that the government has a captive market. Where else can the superfunds and the banks park the savings of the nation's workers (without going offshore)? So a key aim for government is to keep debt sales at or below the market's ability to absorb them. This is largely determined by the rate at which savings accumulates. If this can't be done then PNG will have to borrow overseas.

One other significant challenge for PNG after 2015, which is the first full year of LNG production, is that the country's growth will be driven by the non-resource sector where growth rates have averaged around 3-5%. At this point the debt dynamics become more finely balanced (r and g are much closer). This brings added relevance to the next section.

Now to the policy adjustments. As the PNG government cuts back on spending this will be contractionary, and it will lower growth of the economy, g. This worsens the debt dynamics ($r - g$ increases). An awareness of this channel is important, and this is something the Troika has forgotten in their imposition of austerian policies on Greece. While the Troika's lowering of the debt burden through decreasing the interest rate the Greeks pay on their debt has been effective, the severe forced cuts in Greek government spending have driven gdp growth below zero, leading to high growth in debt-to-gdp.

While the cuts in government spending will be contractionary for PNG, this can be offset by a devaluation of the Kina, which makes PNG's exports cheaper to the world, increasing demand for them, and leading to an opposing expansion of activity. This is something the Greeks can't do. So in concert with the cut in spending there should be a devaluation. This expansion has the benefit of stabilizing tax revenues, which decreases as activity falls as is currently happening. One further issue to consider here is the level of PNG government debt that is held in foreign currencies. A devaluation increases the Kina value of this debt, although currently PNG's international exposure is quite small. An additional and offsetting effect of a devaluation is that it leads to a temporary increase in inflation which lowers the real debt burden.

Finally, government spending must be maintained at a level to ensure basic services such as health and education are not cut. People should not suffer in the short run because of the government cut-backs. This may require ring-fencing of this type of spending, and also allowing the debt burden to increase in the short run.

So in summary, an effective policy package must include the following components: firstly, a cut in government spending and the design of a credible path back to a stable debt-to-gdp ratio, a new MTFS. This doesn't have to be 30% and the adjustment to it doesn't have to occur in a short period of time (2 years has been prescribed in recent budget documents which is not realistic given the size of the imbalances) - 5 to 10 years is okay. The "credible" part is important as the market must believe there is a good chance that it will happen. This creates fiscal space by keeping r down. Also 30% is not a magic number, a stable debt-to-gdp above this level is okay. Secondly, protect spending in keys area such as health and education so that these services are maintained. And finally a devaluation is necessary.

A final discussion point is on the possibility of government default in PNG, which also differs from Greece. Again, I am not advocating such a move, rather just comparing PNG with Greece. Since PNG government paper is held entirely by domestic agents (mainly the two large superannuation funds and the major banks) a default or partial default would be contained within PNG and there would not be spillovers into the wider financial system. This would be a major shock to the banks given their large holding of government paper. However given the ongoing high profitability (read that as excess rents) of the banking sector in PNG and the low proportion of government assets in their total portfolios, the international banks would survive somewhat unscathed. Some recapitalization might be necessary for the regional banks. The main losers would be PNG's workers – a default is a transfer from them and also bank shareholders (most of whom are not in PNG) to the government. A haircut could be negotiated with relative ease (in comparison to Greece) given the low number of parties involved and the strong alignment of interests amongst them.

There is much more to discuss here, however that is left to a future paper.

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