



Papua New Guinea

Economic Assessment

Preliminary estimates suggest that GDP growth for 2004 will reach the *ADO 2004* forecast of 2.8%, thus continuing the modest upward trend of 2003. Growth, while broad based, remains heavily dependent on exports of primary commodities: gold accounts for approximately 37% of total exports, copper for 20%, agriculture for 19%, and crude oil for 18%. Supported by high global commodity prices, the total value of exports of most mineral and nonmineral commodities has risen. However, the volume of gold exports declined by 12.2% from 18.8 tons in the last quarter of 2003 to 16.5 tons in the first quarter of 2004, while copper production fell by 33% from 69,100 to 46,300 tons in the same period.

The agriculture, forestry, and fishery sector benefited from favorable weather conditions, resulting in higher export volumes for most commodities compared with the first quarter of 2003. The volume of crude oil exports in the first quarter of 2004 increased to 3.3 million barrels, from 2.9 million barrels in the last quarter of 2003, though this was still 12.8% lower than in the equivalent period in 2003 due to natural decline in the older fields. New capacity in the Moran field is expected to come on stream toward the end of 2004.

Further consolidation of the budgetary situation was achieved through the Government's efforts at expenditure control and improved revenue collection. As of May 2004, higher than expected revenues resulting from increased collections from personal, corporate, and mineral taxes, together with lower expenditures, had led to an overall budget surplus of K258.5 million, equivalent to 2.0% of GDP, compared with K16.2 million a year earlier. The decrease in expenditures was primarily due to lower interest payments and slow disbursement of the devel-

opment budget. In the first 5 months of 2004, the Government retired K61.6 million of its domestic and K161.8 million of its external debt.

Prudent monetary policy and better fiscal management helped further reduce inflation in the first quarter of 2004. In the quarter to March 2004, year-on-year inflation fell to 2.9%, the lowest rate since 1997. The kina strengthened against the US dollar and to a lesser extent against the Australian currency. The stronger kina offset somewhat the effects of higher international fuel prices and the 2% import levy introduced in the 2004 budget. The easing of inflationary pressures led to further cuts in the official Kina Facility Rate from 14.0% in December 2003 to 9.0% in September 2004. Interest rates on 28-day treasury bills declined from 16.1% in December 2003 to 6.5% at end-July 2004.

Broad money supply increased by 5.4% in the first 6 months of 2004 after an overall drop of 1.0% in 2003. Liquidity levels in the banking system increased but did not translate into an expansion of commercial bank credit to the private sector. With private sector demand for credit remaining weak, commercial lending rates continued their downward trend to 13.3% in June 2004. Lower interest rates are expected to boost private consumption and investment levels.

Official government forecasts show a balance-of-payments deficit of K44.8 million in 2004 as the deficit on the capital and financial accounts more than offsets the gains in trade. The latter deficit is expected to reach K678.3 million in 2004, resulting from higher external loan repayments by the Government, lower loan drawdowns, and higher balances held in offshore accounts by mineral companies. However, preliminary estimates for the first 5 months point to a slightly better outturn. Gross foreign reserves are expected to build up to \$491.9 million by year-end, equivalent to approximately 6.5 months of nonmineral import cover.

Table 2.21 Selected Economic Indicators, Papua New Guinea, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	2.8	2.8	1.7	1.7
Inflation (CPI)	8.7	7.4	9.6	6.0
Current account/GDP	5.0	5.0	3.2	3.2

Source: Staff estimates.

Policy Developments

While higher commodity prices and improvements in fiscal management led to a reversal of the 3-year contraction from 2003, political instability and frequent government reshuffles are still hampering the Government's ability to implement structural reforms, such as reducing government payroll numbers. Fearing a motion of "no confidence," the Government has several times tried to adjourn Parliament since the beginning of the year. The prime minister has also resorted to frequent reshuffles in his coalition, which has harmed continuity.

The governments of Australia and Papua New Guinea agreed, at end-June 2004, on an Enhanced Cooperation Program. This provides for additional assistance to the Government of K2 billion as well as senior in-line advisors in the public sector to strengthen law and order, customs, transport and border security, governance, and economic and public sector administration. Additionally, Australian police officers will assist with the improvement of the law and order situation, which is likely to lift business confidence in the medium term.

The Government has made progress toward implementing the recommendations of the Public Expenditure Review and Rationalization (PERR), finalized in mid-2003. The PERR outlined recommendations for four core areas: a road map to fiscal sustainability, reduction in civil service size, restoration of the integrity of budget institutions and systems, and expenditure adjustment and prioritization. It also provides recommendations for improving health and education spending.

While progress to date has been particularly noticeable in terms of restoring the integrity of the budget process, the focus is still on

improving processes and technical solutions. The Government is also aiming for a 10% reduction in public sector staffing by end-2007. Current plans are to achieve this through a 1% reduction in the workforce in 2004 and 3% in each of the remaining 3 years. Progress has already been made in implementing the integrated payroll and human resource records management system as well as in identifying ghost workers and eliminating overpayment of allowances.

Financial controllers have been positioned in key spending departments, leading to improvements in reducing arrears and budget overruns. The first phase of data cleansing of trust accounts has been completed and efforts to close irregular trust accounts are currently under way. Despite these efforts, the Government is aware that further attention is needed to directly improve fiscal sustainability and strengthen accountability mechanisms and oversight institutions. Another formidable challenge is to strengthen the effectiveness of provincial expenditures and to improve monitoring and reporting systems of subnational accounts.

Since end-2003, the Medium Term Development Strategy (MTDS) covering 2003-2007 has undergone substantial changes and is yet to be finalized and endorsed by the National Executive Council. Based on the Government's agenda for Recovery and Development, the MTDS emphasizes good governance, export-driven growth, rural development, human resource development, and poverty reduction as the main priorities. However, the resources required to implement the MTDS have not been clearly mapped out and its link to the annual budgets is unclear. The PERR provides a framework for identifying sources of saving, for revenue-raising initiatives that would permit a reprioritization of government spending while maintaining aggregate fiscal discipline, and for improving accountability. However, much remains to be done to integrate and move forward the implementation of the various initiatives.

Privatization of the state-owned telecommunications company, Telikom PNG, is currently awaiting cabinet approval. Efforts are also under way to improve performance standards and corporate governance of other SOEs with a view to privatization or corporatization in the medium term.

Outlook for 2004–2005

Economic growth projections are expected to remain at the forecast level of 2.8% for 2004 and at slightly lower levels for the following 2 years. However, the economic growth seen since mid-2003, while relatively broad based, remains fragile and highly dependent on favorable commodity prices and weather conditions.

Most commodity prices are likely to remain high in 2005, particularly for crude oil and gold, while the start of operations of the Wewak tuna loining facility and the Napa Napa oil refinery in June 2004 is expected to boost manufacturing output. As a result, the merchandise trade account is projected to maintain its surplus in 2005.

The Government is committed to limiting

the budget deficit to 1.0% of GDP in 2005 and to lowering it thereafter. Provided that these fiscal targets are met, the IMF estimates that central government debt could be reduced from 63% of GDP at end-2003 to 46% at end-2009. However, 2005 budget savings, initially targeted at K240 million, have been scaled down to K80 million on account of anticipated lower interest payments and improved revenues from commodity exports. To reach its targets, the Government will have to vigorously pursue the steps initiated for generating savings, particularly in continuing to reduce the public sector wage bill.

Annual inflation is forecast to reach 7.4% in 2004, somewhat lower than earlier projected, and to continue to fall to 6.0% in 2005.