

Papua New Guinea

Booming commodity prices underpinned growth in the economy and in government revenue in recent years. GDP growth accelerated a little in 2008, and inflation shot up. The plunge in global commodity prices is expected to pull down growth this year, and inflation is likely to moderate. The Government can draw on savings made in the boom years to support its spending, but also needs to put a higher priority on infrastructure investment and extending basic services.

Economic performance

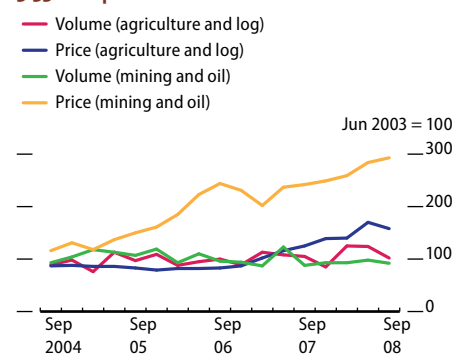
A country with crude oil, metals, and agricultural commodities, Papua New Guinea continued the trend of earlier years to perform strongly in the first half of 2008 on the back of high world commodity prices. GDP growth for the year accelerated to an estimated 7.2%, the highest for over a decade. It was fairly broad-based: services grew by an estimated 9.2%, industry by 7.8%, and agriculture by about 5.0%. This outturn was achieved despite a slowdown in crude oil production, which reflected the gradual depletion of established oil fields.

Strong gains in government revenue during the global commodities boom allowed for a 3% increase in real public expenditure in 2008. Private spending also continued to rise as incomes moved higher, along with commodity prices. Improved business confidence, supported by political and fiscal stability, helped sustain private investment. Expansion of mobile communications (after deregulation of the industry), of construction, and of new mining projects all made solid contributions to GDP growth.

Merchandise exports in nominal US dollar terms rose by 22.9% in 2008, largely driven by higher prices for export commodities (Figure 3.33.1). Mining (mainly copper and gold) and crude oil exports together rose by an estimated 21% in United States (US) dollars (Figure 3.33.2), despite a contraction of about 4% in volumes. The value of oil exports jumped by about 26%, with price increases outweighing a 20% volume contraction. Agricultural exports climbed by almost 30% in 2008. Strong performances were recorded in shipments of palm oil (44%), coffee (37%), cocoa (139%) and copra oil (98%). Export growth is estimated to have more than offset a 13.7% rise in imports, and the trade surplus increased to \$2.8 billion. The current account recorded a surplus of about \$700 million, equivalent to 8.7% of GDP.

Employment in the private formal sector increased by around 10% in the 12 months to June 2008. However, this accounts for only a small share of the labor force. The cash economy employs no more than one fifth of the population. Many people are farmers who produce mainly for their

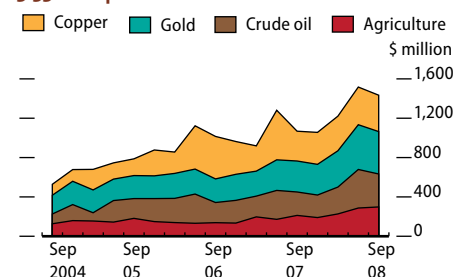
3.33.1 Export indexes



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

[Click here for figure data](#)

3.33.2 Exports



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

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own consumption, with some cash-crop production of products such as cocoa, copra, and coffee.

Since 2005, the Government has set aside some of its windfall revenue generated during the commodity price boom in “additional investment/priority expenditure” trust funds. The aim is to avoid unsustainable and inflationary increases in recurrent spending and to smooth outlays on social and infrastructure projects during the commodity cycle. By end-2008, trust fund accounts were valued at the equivalent of about 22% of GDP. Contrary to international standards, which treat such new deposits as saving, the budget records them as off budget items, an approach that led to a budget that was roughly in balance last year. Using international norms would have resulted in a budget surplus of almost 12% of GDP (Figures 3.33.3 and 3.33.4). The Government has raised repayments on its debt, lowering gross government debt to an estimated 29% of GDP by end-2008, or less than half the 2002 ratio. The ratio of external public debt to GDP declined to 13.0% in 2008.

Inflation accelerated last year to peak at 13.5% in the third quarter (year on year). The causes were strong growth in money supply and credit; higher costs of fuel, transport, and food staples; increased government spending; and shortages of rental properties and skilled labor. Average inflation was 10.8%, compared with just 0.9% in 2007.

The Bank of Papua New Guinea raised its monetary policy indicator rate in response to rising inflation. Still, lending to the private sector in 2008 rose by an estimated 40% and the money supply by 11.2%. The annual average kina exchange rate appreciated by 10.0% against the US dollar and by 11.4% against the Australian dollar.

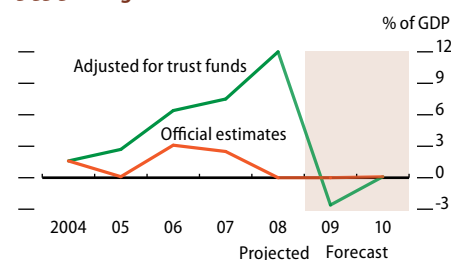
The global slump deepened in the fourth quarter and checked the growth of both export income and government revenue, though to what extent is not yet clear. Gross foreign exchange reserves fell from a historical high of about \$2.7 billion in August 2008 to just over \$2.0 billion by year-end (equal to about 11 months of imports of goods and services) as foreign exchange inflows from exports declined.

Economic prospects

GDP growth is expected to moderate to about 4.0% in 2009 and 3.5% in 2010 (Figure 3.33.5), as the global economic downturn erodes exports and government revenue, leading to reductions in commodity production, weaker growth in incomes, and generally softer domestic demand. Crude oil production is seen declining further, but mining output should be supported by the Hidden Valley gold mine, which is scheduled to start production in the middle of this year, and the Ramu nickel mine, which is expected to reach full capacity next year.

A large liquefied natural gas export project to cost about \$12 billion is in the engineering and design stage. If the Government and energy companies involved make final decisions to proceed with the project, it could start production in 2013, and increase GDP by about 20% over its lifetime. Business confidence is likely to be underpinned by expectations that the project will go ahead. Nevertheless, construction activity overall is expected to slow this year and next, in part because many construction firms are operating at near full capacity.

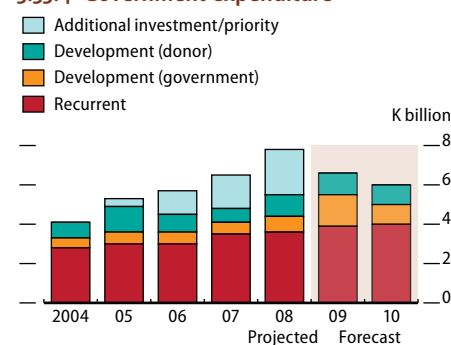
3.33.3 Budget balance



Sources: Department of Treasury, 2009 Budget, Volume 1; staff estimates.

[Click here for figure data](#)

3.33.4 Government expenditure



Note: Data refer to 2004 prices.

Source: Department of Treasury, 2009 Budget, Volume 1.

[Click here for figure data](#)

3.33.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.0	3.5
Inflation	7.0	6.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

The plunge in international prices of copper, crude oil, and many agricultural commodities, and the expected reduction in their production, will cause the value of exports to fall from 2008. Furthermore, severe flooding in the Highlands region in February and March 2009 will damage coffee and tea production, which usually peaks between March and June.

Merchandise imports will also decline as domestic demand softens. The trade surplus is expected to narrow and the current account to tip into deficit, equivalent to 7.0% of GDP this year and 6.0% in 2010 (Figure 3.33.6).

Commodity prices for most of the country's main exports have fallen further since the Government approved its 2009 budget in November 2008, further suppressing revenues. At the same time, expenditures are to remain elevated, with support from withdrawals from trust funds. The budget deficit is expected to be at least 3% of GDP this year.

Bank lending to the private sector ramped up during the commodity boom (Figure 3.33.7), and the quality of these loans could deteriorate as the economy slows. With this in mind, the banks will likely take a more cautious stance on lending, tightening credit and making it more expensive. Given the drop in mining and energy profitability, major projects that depend on foreign investment also face higher borrowing costs in global markets, as well as a more difficult environment for equity investment.

Inflation is projected to slow to around 7.0% in the forecast period (Figure 3.33.8). Falls in import prices of fuel, flour, and other commodities will trim inflation, but this will be somewhat offset by upward pressures generated by continued high levels of public spending, capacity constraints in construction, and short supply of rental housing. The central bank is unlikely to ease its monetary stance until it is sure inflation is coming down.

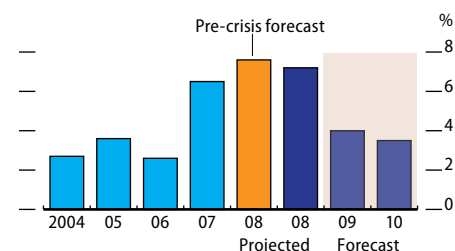
Foreign exchange reserves are expected to decline but are sufficient to enable the central bank to smooth any excess volatility in the exchange rates.

Development challenges

Public infrastructure continues to deteriorate in many parts of the country. The Government faces a critical need to manage fiscal savings from recent years and to use them to improve infrastructure and basic service delivery, as outlined in its medium-term development strategy. A related challenge for the Government is to manage public expectations that overall public expenditure can continue to rise quickly. Public financial management systems will be severely tested during the adjustment to more austere fiscal conditions.

Efforts to increase the level of real development expenditure have been hampered by a lack of skilled staff to plan and implement projects, especially at local level. The Government has sharply raised its grants for development spending to K14 million (\$4.8 million) for each of the country's 89 districts. The capacity of local government to administer and effectively implement projects will need to be significantly enhanced if increased expenditure is to be translated to improved public service

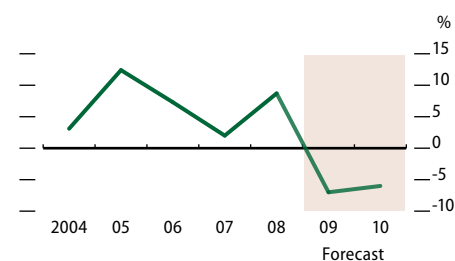
3.33.5 GDP growth



Sources: Department of Treasury, 2009 Budget, Volume 1; staff estimates.

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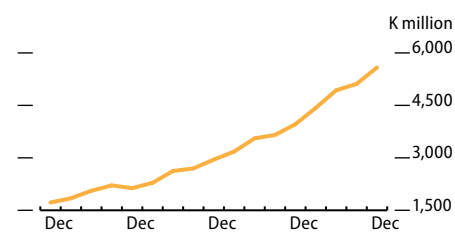
3.33.6 Current account balance



Source: Department of Treasury, 2009 Budget, Volume 1.

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3.33.7 Lending to the private sector



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

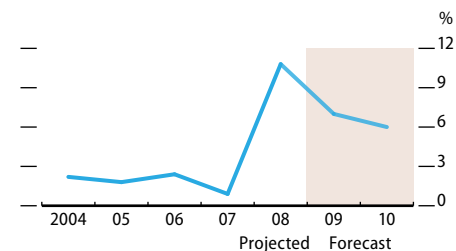
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delivery. More broadly, increased investment in human and physical capital is needed to equip people with skills, provide basic services, and reduce the very high poverty incidence.

It will be important for the Government to pursue reforms to state-owned enterprises by increasing accountability, strengthening governance, and opening to competition those facilities dominated by the public sector, such as air and sea ports and electricity. Potential gains have been highlighted by the opening of the formerly government-owned mobile telephone sector. This resulted in notable improvements in phone services in rural areas. There are also promising signs in aviation, where consumers now benefit from lower international airfares offered on some routes by a competitor to the national carrier.

The Government last November approved a policy framework that paves the way for increased private sector participation in the economy through a greater role in public service delivery, such as physical infrastructure and health services. It will now draft laws and regulations and prepare a list of projects for public-private partnerships. Placing greater reliance on private sector development will require complementary efforts to improve the business environment. The World Bank's *Doing Business 2009* report ranks Papua New Guinea 95 overall in a list of 181 countries, but much lower on issues including enforcement of contracts and access to credit.

3.33.8 Inflation



Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues; staff estimates.

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