INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

Papua New Guinea—Assessment Letter for the Asian Development Bank
August 22, 2019

1. **The Papua New Guinea (PNG) economy has grown sluggishly in recent years, reflecting domestic and external factors.** Low commodity prices and a severe drought in 2015–16 pulled down growth in mining and agriculture, while a massive earthquake in 2018 disrupted production and exports of liquid natural gas and petroleum. Although oil and gas production recovered towards the end of the year, and activity in the rest of the economy remained relatively strong, the outcome for 2018 was still a small contraction. The momentum of fiscal consolidation was reversed in 2018 in reaction to the earthquake and the hosting of the APEC summit. An overvalued exchange rate has led to shortages of foreign exchange and severe import compression in recent years, inhibiting investments and production in the non-resource economy. CPI inflation declined from around 4½ percent in 2017 to 4 percent in 2018, on the back of lower import prices.

2. **The economy is expected to rebound in 2019.** Real GDP is expected to grow at around 5 percent, boosted by higher commodity prices and the easing of the foreign exchange constraint on imports, while the kina has been allowed to depreciate slightly. Business confidence rose on the news of an agreement reached with international energy companies on a major new gas project in April, but the change of government following a vote of no confidence in the prime minister in May, and the pledge of the new government to renegotiate the agreement, has led to some uncertainty about future prospects.

3. **The momentum of fiscal consolidation has stalled.** A number of one-off measures helped bring the fiscal deficit down from 4½ percent of GDP in 2016 to 2½ percent of GDP in 2017, but despite higher revenues in 2018, expenditure pressures could not be contained and the fiscal deficit rose to 2.7 percent of GDP. The main challenge has been to contain spending on the compensation of public employees, which came in roughly 1 percent of GDP higher than budgeted. Based on results for the first six months of 2019, the government is projecting a further widening of the fiscal deficit to around 3 percent of GDP, due again mainly to higher spending on compensation of employees than budgeted. The ratio of gross government debt to GDP has been rising in recent years, reaching 35 percent at end-2018, and is projected to rise to over 36 percent in 2019, above the government's ceiling of 35 percent of GDP in its medium-term fiscal framework, and well above the long-term target of 30 percent. A joint IMF-World Bank Debt Sustainability Analysis (DSA) indicates that at end-2017 Papua New Guinea faced a moderate risk of debt distress based on an assessment of public external debt, with limited space to absorb shocks, and a moderate overall risk of public debt distress. Key risks to public debt arise from the short-maturity of government domestic debt, unfunded superannuation liabilities of the government and the high exposure of the financial system to government debt.

4. **Progress on monetary and FX reforms has been gradual.** In 2018, Bank of PNG (BPNG) began to allow some gradual depreciation of the kina to reduce overvaluation and

restart interbank FX market trading. The BPNG also notified banks that it would no longer provide guidance on the sectoral allocation of FX. Since late 2018, BPNG has also used proceeds of the international bond issue and multilateral loans to clear a portion of the foreign exchange order backlog. High levels of liquidity in the financial system and very limited exchange rate flexibility continue to impair the BPNG's ability to manage domestic monetary conditions.

5. **Policy program going forward.** The government needs to resume the momentum of fiscal consolidation to bring the debt back down to its long-term target floor of 30 percent of GDP. This will require implementation of the Medium-Term Revenue Strategy and containing expenditures, especially personnel emoluments and discretionary grants. Improving the fiscal framework, including through the adoption of an expenditure rule to reconcile the government's non-resource primary balance target with revenue projections in the medium-term, will help reduce the pro-cyclicality of fiscal policy. Restoring exchange rate flexibility and strengthening the monetary framework will require clearing the remaining backlog of FX orders, eliminating exchange rate overvaluation, and strengthening the BPNG's operational framework for managing interbank market liquidity. Developing the non-resource economy will require strengthening the provision of essential public services, improving the business environment and decisively addressing corruption and weaknesses in governance.

6. **Outlook and risks.** The main macroeconomic challenge for the government is to put in place policies that promote economic stability in the face of external shocks, managing natural resource wealth, and strengthening the long-term development framework. The outlook for growth in the near and medium-term remains positive, but there are downside risks from domestic political uncertainty, a deterioration in the external environment, including from rising protectionism and weaker-than-expected global growth, a decline in commodity and energy prices and the higher frequency and severity of natural disasters. On the upside, large investments associated with new energy and mining projects could provide a potentially large stimulus to economic activity, but will need to be managed carefully.

7. **IMF relations**. PNG is an IMF surveillance country. The 2018 Article IV consultation was concluded by the IMF Executive Board on November 26, 2018, and an IMF staff visit took place in April 2019. The next Article IV mission is planned for September 2019. PNG is a substantial contributor to the financing of the Pacific Financial Technical Assistance Center and makes extensive use of IMF technical assistance. The IMF is providing PNG with a resident advisor to assist with implementation of the Medium-Term Revenue Strategy.

Table 1. Papua New Guinea: Selected Economic and Financial Indicators, 2016–2024

Nominal GDP (2016):	US$21.1 billion 1/
Population (2016):	7.9 million
GDP per capita (2016):	US$2,568
Quota:	SDR 131.6 million (14th Review: SDR 263.2 million)

	2016	2017	2018	2019	2020	2021	2022	2023	2024
	Est.	Est.				Proj.			
					(Percentage change)				
Real sector									
Real GDP growth	4.1	2.7	-1.4	5.1	3.3	3.5	3.7	3.6	3.7
Resource 2/	9.8	4.4	-9.9	11.9	5.0	5.0	5.0	5.0	5.0
Non-resource	1.5	1.8	2.8	2.2	2.5	2.8	3.0	2.9	3.1
Agriculture, forestry and fishing (share)	17.9	17.6	18.3	17.9	17.9	17.7	17.6	17.4	17.4
Mining and quarrying (share)	9.0	9.1	9.0	9.4	9.6	9.7	9.8	10.0	10.2
Oil and gas extraction (share)	14.8	15.2	13.1	14.2	14.4	14.6	14.8	15.0	15.3
CPI (annual average)	6.7	5.4	5.2	4.0	4.1	4.3	4.4	4.1	3.7
CPI (end-period)	6.6	4.7	4.8	3.6	4.4	4.5	4.5	4.1	3.8
					(In percent of GDP)				
Central government operations									
Revenue and grants	16.1	16.1	18.3	17.5	17.1	16.9	17.7	18.4	18.3
Of which: Resource revenue	0.6	0.9	1.7	1.8	1.1	1.0	1.0	1.0	1.0
Expenditure and net lending	20.9	18.7	21.0	20.8	19.6	19.0	19.4	19.8	19.5
Net lending(+)/borrowing(-)	-4.7	-2.5	-2.7	-3.3	-2.6	-2.1	-1.7	-1.4	-1.2
Non-resource net lending(+)/borrowing(-)	-5.4	-3.5	-4.4	-5.1	-3.7	-3.1	-2.7	-2.4	-2.2
					(Percentage change)				
Money and credit									
Domestic credit	24.6	-0.1	-7.9	8.7	5.2	4.8	4.3	5.4	5.2
Credit to the private sector	7.2	-3.8	7.4	8.2	4.6	3.7	5.1	4.9	4.2
Broad money	10.9	-0.9	-3.8	5.7	5.2	5.5	6.1	7.4	7.0
Interest rate (182-day T-bills; period average)	7.4	7.1	7.0	7.1	7.1	7.8	8.0	7.8	7.4
					(In billions of U.S. dollars)				
Balance of payments									
Exports, f.o.b.	8.9	9.7	9.5	9.4	9.6	9.6	9.6	9.7	9.8
Of which: Resource sector	7.3	8.1	8.3	8.2	8.2	8.2	8.2	8.3	8.4
Imports, c.i.f.	-2.1	-3.1	-2.6	-2.7	-2.9	-3.0	-3.1	-3.2	-3.2
Current account (including grants)	4.6	4.2	5.2	4.7	4.4	4.2	4.1	4.0	3.8
(In percent of GDP)	22.1	18.8	22.4	19.6	17.8	16.7	15.7	14.9	13.9
Gross official international reserves	1.7	1.7	2.2	2.0	1.9	1.9	2.0	2.1	2.2
(In months of goods and services imports)	3.8	4.9	6.3	5.4	5.1	4.9	4.9	4.9	5.0
					(In percent of GDP)				
Government debt									
Government gross debt	33.7	33.0	35.1	36.4	37.2	37.5	37.2	36.7	36.2
External debt-to-GDP ratio (in percent) 3/	8.5	8.9	13.0	14.6	15.0	14.8	14.9	14.1	13.1
External debt-service ratio (percent of exports) 3/	1.3	1.3	2.1	2.5	4.9	5.0	2.8	3.2	3.1
Exchange rates									
US$/kina (end-period)	0.3150	0.3060	0.2977	...	...	...	...	...	...
NEER (2005=100, end-period)	104.2	101.0	98.3	...	...	...	...	...	...
REER (2005=100, end-period)	123.5	124.0	124.1	...	...	...	...	...	...
Terms of trade (2010=100, end-period)	90.4	81.5	85.3	72.3	78.3	79.9	80.9	81.6	0.0
Nominal GDP (in billions of kina)	65.0	71.4	77.0	81.6	85.8	90.2	95.2	100.4	105.2
Non-resource nominal GDP (in billions of kina)	49.5	54.0	59.9	62.3	65.2	68.2	71.7	75.3	78.4

Sources: Department of Treasury; Bank of Papua New Guinea; and IMF staff estimates and projections.

1/ Based on period average exchange rate.

2/ Resource sector includes production of mineral, petroleum, and gas and directly-related activities such as mining and quarrying, but excludes indirectly-related activities such as transportation and construction.

3/ Public external debt includes external debt of the central government, the central bank, and statutory authorities.