Papua New Guinea

Riding the wave of high world prices for export commodities, growth accelerated in 2007 and government revenues surged. GDP growth is forecast to stay above 6% this year, generated by buoyant public spending and incomes as well as new mineral projects. Inflation is likely to rise sharply. The windfall revenues should provide an opportunity to pay off debt, build infrastructure, and encourage development of the private sector.

Economic performance

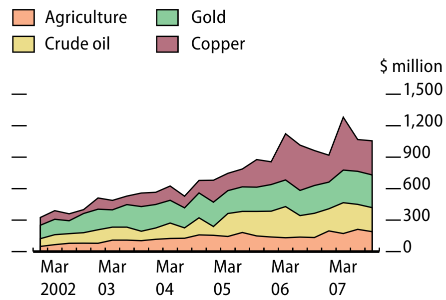
Economic growth accelerated to an estimated 6.2% in 2007, about double the average rate of recent years. The improvement was largely attributable to the flow-through of high prices for export commodities, which allowed for a rise in both government and household spending, and stimulated investment. The United States (US) dollar value of mining and oil exports had jumped by 31.6% in 2005 and 38.8% in 2006, and this continued to stimulate domestic demand in 2007, when the growth of such exports slowed to about 4% as global price rises moderated (Figure 3.32.1). Further, a near 40% increase in the US dollar value of agricultural exports in 2007 boosted rural incomes and spending. (Most Papua New Guineans are farmers who produce for their own use with many also undertaking some cash-crop production.)

Business confidence generally improved, which helped raise private investment. The economy has also realized some benefits from structural reforms, and from extra government revenues earned from the most profitable phase of the nation's largest gold mine, Ok Tedi. A stable domestic political environment last year also played a role: the prime minister was elected to another parliamentary term in a coalition government that holds a large majority.

Export prices in kina for agricultural, forestry, and fishing products rose by about 40%, with copra, copra oil, and palm oil each soaring by more than 50%. Moreover, production of palm oil, the largest agricultural export, continued to expand. However, 2007 was a poor year for coffee, the second-largest agricultural commodity, with production falling to low levels in part owing to rain during the flowering season. In forestry, logging rates rose by about 15% in response to a reduction in log taxes and higher world prices.

The commodity price boom lifted overall spending capacity and business confidence, prompting banks to increase lending to the private sector. Banks were also encouraged along this path by a reduction in borrowing by the Government. Lending to the private sector rose by 31.9% in 2007 (Figure 3.32.2), with the rise concentrated in manufacturing,

3.32.1 Exports



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

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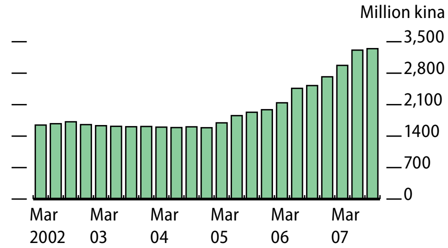
3.32.2 Lending to the private sector



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

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This chapter was written by Craig Sugden of the Pacific Department, ADB, Manila.

wholesale and retail trading, and for personal purposes. Broad money supply (M3) rose by 27.3% over the year and the central bank maintained a neutral monetary policy stance.

High rates of growth in government revenues from mining and oil supported a 19.4% rise in real government spending last year. Even with such a large increase in expenditures, there was an overall budget surplus equivalent to an estimated 1.7% of GDP, although this narrowed from the 2006 surplus. Budgeted expenditures include a large commitment to planned activities termed "additional investment/priority expenditure" (Figure 3.32.3). These funds were largely unspent in 2007 because the intended use was typically only at a conceptual stage and the plans and capacity required for implementation were not in place. Treating these funds as savings, which is the international standard, would raise the estimated budget surplus to 11.4% of GDP (Figure 3.32.4).

Inflation was held to an average 2.5% in 2007, despite the stronger economic growth. Prices of fuel and electricity rose sharply, but those for food and household equipment eased. A slight depreciation in the kina on a trade-weighted basis contributed to a 5.5% rise in the underlying inflation rate, which excludes seasonal effects and price-controlled items. Employment in the relatively small formal private sector rose by 7.4% in the first 9 months of 2007, with the main job generators being retailing, construction, agriculture, forestry, and fishing.

A 30.9% surge in imports in US dollar terms in 2007 reduced the trade surplus, but the current account was still in surplus, equivalent to an estimated 4.3% of GDP for the year. Gross international reserves rose to a historical high of 17.6 months of nonmining and oil imports, or 11.3 months of total imports (Figure 3.32.5).

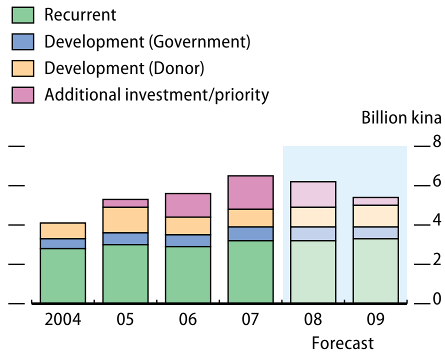
Economic prospects

Strong economic momentum will be maintained in 2008, supported by a projected increase in government spending, the continuing boost to incomes from buoyant export prices, and the improved level of business confidence. Furthermore, new mining projects are scheduled to start production, notably the Sinivit and Simberi gold mines and the Ramu nickel-cobalt project. Subsequently, GDP growth is projected to rise to 6.6% in 2008, before easing to 4.6% in 2009 (Figure 3.32.6). The surge in export prices has so far elicited little supply response in production of minerals, hydrocarbons and agricultural commodities (Figure 3.32.7).

Almost all the expansion in export income and in government revenues stems from higher prices, or from the realization of production plans in place before the recent rise in export prices. This suggests that a tapering off in world prices for oil and possibly other commodities over the medium term will slow economic growth after this year. Similarly, trade and current account surpluses are expected to decline over the medium term.

Inflation is forecast to rise to 5.2% in 2008 (Figure 3.32.8) as the effect of higher fuel prices and rising public expenditures feed though the economy and as inflation rises in Australia and other major sources of imports. There is a risk that any rapid spending of the "additional" expenditures that have been saved would put additional upward pressure

3.32.3 Government expenditure, 2004 prices



Source: Department of Treasury, *2008 Budget*, Volume 1.
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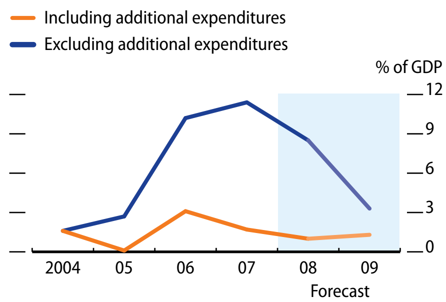
3.32.4 Budget surplus



Source: Department of Treasury, *2008 Budget*, Volume 1.
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3.32.1 Selected economic indicators

	2008	2009
GDP growth	6.6	4.6
Inflation	5.2	4.0
Current account balance (% of GDP)	4.1	1.9

Source: Staff estimates.

on local prices, as well as downward pressure on the kina through high import demand. However, substantial reserve holdings, which are projected by the central bank to rise to 21.2 months of nonmineral imports by 2010, provide a capacity to manage the risk.

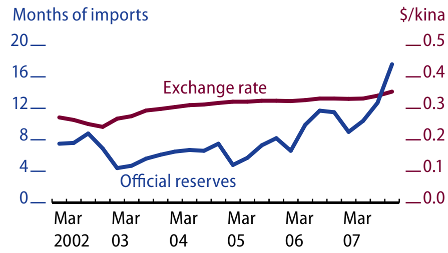
The commodity price boom and subsequent boost to public revenues have allowed for a rapid reduction in public debt. This debt fell to an estimated 35% of GDP by end-2007, from more than double that level in 2002, and is expected to decline further to about 27% by 2010. The ratio of external debt to GDP declined to 18.0% in 2007 and is projected to fall to 11.4% by 2010. The net public debt position (gross debt less savings) is even more favorable because of the large savings of unspent "additional" expenditures. Despite the moderate level of debt, weakness in governance and the vulnerability of the economy to commodity price swings mean that the risk of debt distress is significant.

The boom has the potential to push up the currency, which would hurt nonresource activities and hence their growth prospects. So far, the Bank of Papua New Guinea has largely controlled this effect by allowing foreign reserves to rise instead of the exchange rate. The boost to government revenues also brings the danger of an erosion of fiscal discipline that can undermine governance and institutions over time. Signs of such a problem have become evident. District-level governments were allocated the equivalent of about $300 million last year in "additional" expenditures for basic services delivery. This is equivalent to 20% of a normal year's total public expenditures. In contrast to provincial-level governments that have key responsibilities for delivery of basic services, districts have had little responsibility for service delivery. Their capacity for planning and implementing such large increases in funding is weak and their levels of transparency and accountability are low. The large allocation to districts is at odds with lessons from provincial government reforms of the mid-1990s, that decentralization needs to be preceded by a major capacity development effort that takes into account the prominent role of political representatives in rural areas.

Furthermore, the "additional" expenditures are held in trust funds. Such accounts have been difficult to monitor and safeguard in the past, and their extensive use has the potential to undermine accountability. It would be to the economy's advantage to use the revenue windfall from resources to rapidly pay off public debt, thereby reducing interest costs on the budget and easing the inflation effect of a further acceleration in government expenditures.

The newly elected administration has adopted an investment strategy that signals a shift in some expenditures away from core areas of government. In early 2008, it bought the mid-size Tolukuma gold mine through a new state-owned investment company, Petromin PNG Holdings. Given that mining usually maximizes its economic contribution when it is privately owned, and that private ownership puts mining at arm's length to regulators, it is not clear if this is the optimum use of such public funds.

3.32.5 Exchange rate and reserves



Note: imports refer to nonmineral products.

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

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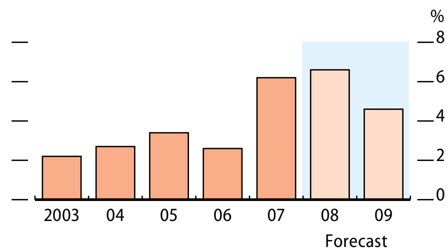
3.32.6 GDP growth



Source: Department of Treasury, *2008 Budget*, Volume 1.

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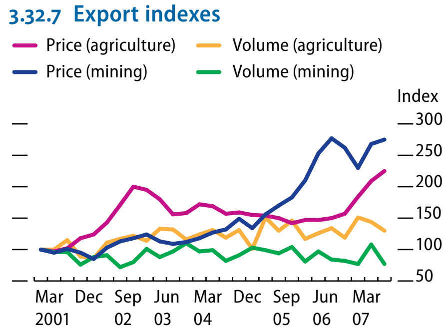
3.32.7 Export indexes



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

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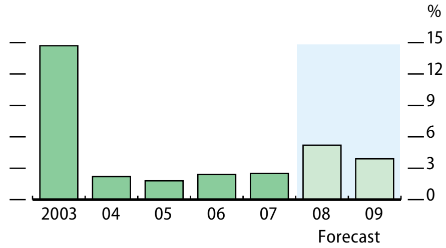
Development challenges

Economic growth is likely to subside when global commodity prices steady and possibly turn down. An earlier resources boom in the 1990s is officially recognized as a lost opportunity, with the rate of development generally slowing over that decade despite large inflows of mining and oil revenues. A key issue is to use the current favorable market conditions to secure sustainable development through upgraded infrastructure and basic services.

This period of strong growth in public revenues also provides an opportunity to adopt much needed structural reforms to open sectors controlled by state-owned enterprises, such as ports and electricity, to competition and to fund a rehabilitation of infrastructure and basic facilities, such as schools and health clinics. The Government has funds to meet adjustment costs (such as those that would arise from privatizing state entities or outsourcing public activities). Potential gains from such reforms have been highlighted by the entry of a new firm into the mobile-telephone market, which has resulted in a noticeable improvement in phone services in rural areas.

Placing greater reliance on private sector development, however, would require further improvements in the business environment. The still-deficient investment climate is evident in the lack of growth in export volumes, and an apparent overall decline in the ratio of private investment to GDP. This weakness is also shown in survey-based indicators of the quality of the investment environment (Box 3.32.1).

3.32.8 Inflation



Sources: Bank of Papua New Guinea, available: http://www.bankpng.gov.pg, downloaded 13 February 2008; staff estimates.

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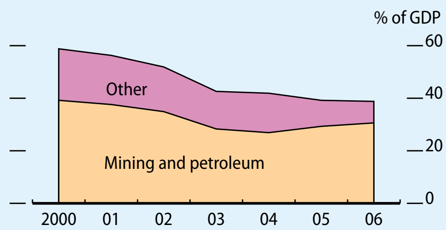
3.32.1 The climate for private investment

The World Bank's *Doing Business* indicators ranked Papua New Guinea 84 out of 178 economies in 2007, placing it in the middle range of this international measure of business regulations and property protection rights. The country's rank is as high as 31 in terms of the ease of employing and laying-off labor, but as low as 162 in terms of the ability for companies to enforce contracts. The World Bank's most recent governance indicators place Papua New Guinea in the weakest 25% in relation to regulatory quality, rule of law, and control of corruption. Further on this latter issue, Transparency International's measure of corruption put the country at 162 out of 179 in 2007, a notable deterioration from the ranking of 102 out of 145 in 2004.

Papua New Guinea's total investment ratio, which averaged 25% in the 1980s, fell in the 1990s to about half that level. Investment subsequently rebuilt as major projects expanded and was estimated at close to 1980s levels from 2000 to 2002. But partial data suggest that the investment ratio has subsequently weakened. As a ratio to GDP, the stock of foreign investment (debt and equity) has declined. This decline has outweighed an encouraging rise in locally funded investment illustrated by the rise in domestic borrowing.

Private foreign debt and equity



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, June 2007.

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