

Papua New Guinea

Rising global prices for export commodities and strong supply responses from the agriculture and mineral sectors lifted economic growth in 2006. The outlook is for continued expansion with macroeconomic stability in the context of softer global prices for key commodities and sustained business and consumer confidence. Impediments to faster private sector-led growth are law and order problems, poor infrastructure, and inadequate service delivery by the public service and state-owned utilities.

Economic performance

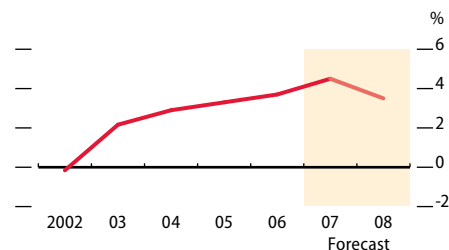
Economic growth accelerated for a fourth year in succession, reaching an estimated 3.7% in 2006 (Figure 2.31.1). A major contribution came from the agriculture, forestry, and fisheries sector, which accounts for about one third of GDP; it expanded by 2.9%. This rise primarily reflected increased production of logs for export and of palm oil. Global prices for both commodities, which were the country's two major agricultural export earners in 2006, trended upward through the year. The world price of coffee, the number three agricultural export, trended down and production declined, with producers continuing to suffer from inadequate transport infrastructure. Copra production is estimated to have risen in response to an improving world price, whereas cocoa production remained stable in the face of price volatility.

Other contributions came from construction, where expansion of 10.0% was stimulated by mining projects and public expenditure on infrastructure, and from oil and gas, where 13.7% growth reflected both the start of production at two new fields and improved extraction rates from existing fields. Climbing oil production was encouraged by the high world oil price. Manufacturing and services also made contributions to growth. However, despite rising world prices for copper and gold and the start of two new mines, mining (excluding oil and gas) contracted by 4.9%. This reflected disruption of production by a landslide at the major Porgera gold mine. On the demand side, net exports were a major driver, supported by increases in private and public investment and in consumption.

A relatively stable political environment facilitated the improved economic performance. The Government entered its fourth year in office under one prime minister and looked set to serve out its full term, with general elections scheduled for June–July 2007.

Higher economic growth fed through to formal private sector employment in agriculture, trade, manufacturing, construction, transportation, and finance and business services, which collectively increased by 4.6% in the 12 months to September 2006. Employment rose particularly fast in construction (13.3%). Over the same period, mineral sector employment (i.e., oil, gas, and mining) registered negligible growth. Only about one in 10 of the total labor force is in paid

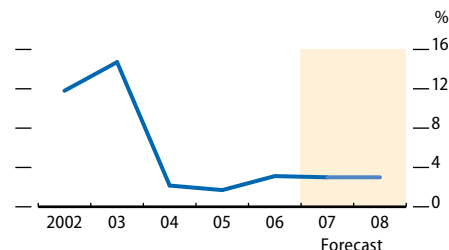
2.31.1 GDP growth



Sources: Department of Treasury, 2007 Budget Volume 1: Economic and Development Policies, 14 November 2006; Bank of Papua New Guinea, Monetary Policy Statement, 31 January 2007.

[Click here for figure data](#)

2.31.2 Inflation



Sources: Bank of Papua New Guinea (BPNG), Quarterly Economic Bulletin September 2006, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; BPNG, Monetary Policy Statement, 31 January 2007; staff estimates.

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employment, so that formal sector employment growth, while important, is not the major determinant of the economic welfare of most Papua New Guineans, who are subsistence farmers and engage in supplementary cash crop production.

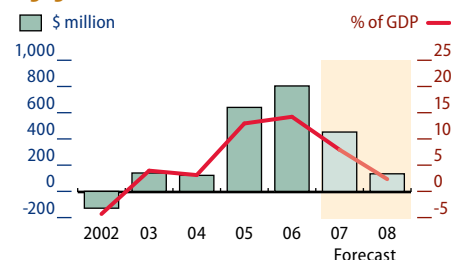
Inflation edged up to an estimated 3.1% (Figure 2.31.2). This good outcome was underpinned by exchange rate stability, which in turn reflected a strong external sector performance and the maintenance of sound macroeconomic management. In 2006, the kina appreciated by 2.1% against the US dollar and depreciated by 5.5% against the Australian dollar. In the first 9 months of 2006, exports (in nominal US dollars) shot up by 33.2% on the year-earlier period, imports rose by 16.0%, and the trade surplus widened by 8.3%. Copper, gold, and oil were the main boosts to export earnings, supplemented by palm oil and logs. The transfers account also improved, but deficits on the net services and income accounts widened. The current account surplus picked up to an estimated 14.2% of GDP (Figure 2.31.3). Gross foreign exchange reserves jumped by 90% to \$1.45 billion, sufficient to cover 9.2 months of total imports (Figure 2.31.4).

The Bank of Papua New Guinea maintained a neutral monetary policy in 2006 on the basis that the macroeconomic environment was stable and that short-term, mostly imported, inflationary shocks could most effectively be dealt with through foreign exchange market interventions aimed at reducing exchange rate volatility, rather than through interest rate adjustments. The kina facility rate—the official interest rate—was left at the 6.0% set in September 2005. Credit to the private sector grew by 36.8% and, along with the 58.2% rise in net foreign assets, accounted for a 39.0% rise in the broad money supply (Figure 2.31.5). The high level of liquidity in the banking system posed a potential inflationary threat that the monetary authorities monitored closely.

The Government's fiscal position strengthened because of mineral tax revenue windfalls attributable to the high global prices for oil, copper, and gold. Total revenue collections were 60% above the level required to meet original budget estimates and permitted the passage of a supplementary budget in August approving the early retirement of some external debt, payment of outstanding state obligations, and the allocation of more resources to the priority expenditure program identified in the Medium-Term Development Strategy 2005–2010. The spending priorities include transportation infrastructure, promotion of income-earning opportunities in agriculture, basic education, HIV/AIDS prevention (Box 2.31.1), and law and justice. The Government's revised estimate was for a balanced budget in 2006 (Figure 2.31.6), instead of an earlier expected deficit of 0.6% of GDP, with a primary surplus run for the fourth year in a row. Public debt was reduced in line with the medium-term debt strategy, which provides for replacement of external debt by domestic debt and the restructuring of domestic debt from short-term treasury bills to longer-term government bonds. Total public debt is estimated to have fallen in 2006 by almost 1% in absolute terms, to 42.4% of GDP. External debt was 21.4% of GDP and was mostly on concessional terms (Figure 2.31.7).

In policy areas, the Government pursued implementation of a public sector reform program. Senior ministers endorsed the objectives of a

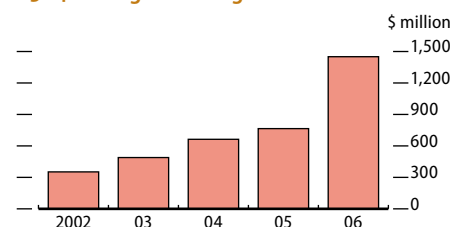
2.31.3 Current account balance



Sources: Bank of Papua New Guinea, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; Department of Treasury, 2007 Budget Volume 1: Economic and Development Policies, 14 November 2006.

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2.31.4 Foreign exchange reserves



Sources: Bank of Papua New Guinea (BPNG), *Quarterly Economic Bulletin September 2006*, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; BPNG, *Monetary Policy Statement*, 31 January 2007; staff estimates.

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2.31.1 HIV/AIDS prevention and the economy

An immediate challenge in health policy that has long-term economic implications is the rising incidence of HIV/AIDS, since about 2% of the population is HIV positive. A 2002 report by the Australia-based Center for International Economics concluded that the country faced a serious epidemic, that the working-age population could be smaller than it otherwise would be in 2020 by 13–34%, and that GDP could be 2.6–7.5% lower. Although GDP per capita would increase as (largely foreign) capital substituted for labor, national per capita income could fall by 6–16%. Understanding the threat, the Government has made HIV/AIDS prevention a priority area of expenditure under the Medium-Term Development Strategy.

report on restructuring the public service, but deferred consideration of its recommendations for abolishing or merging departments and functions until after the 2007 general elections. Law and order and corruption remained priority issues. Unrest in the energy-rich Southern Highlands province led to a declaration of a state of emergency in August 2006.

Economic prospects

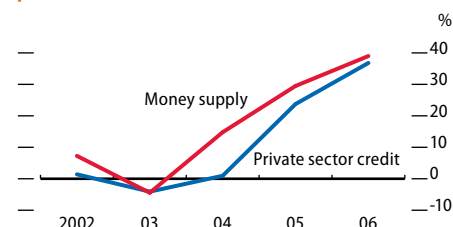
Economic growth is expected to accelerate further in 2007 before slowing in 2008 (Figure 2.31.1 above). Global prices for key commodities are projected to soften from the high levels of 2006, but mining production will recover from the contraction of 2006 as a result of earlier investments and the exploitation of higher-grade ore bodies. This recovery will offset an expected decline in oil and gas output resulting from depletion of fields. Mineral production overall is likely to grow by about 7% in 2007 before easing a little in 2008. The forecast is not affected by the cancellation in early 2007 of a planned gas pipeline from the Southern Highlands to Australia, since this facility would not have had an impact on output for several years. Energy companies involved in the project have indicated willingness instead to consider developing the gas fields for liquefied natural gas exports and petrochemical production.

Mining investment will stimulate construction, notably in the first year of building the Ramu nickel mine. The sector will also benefit from public expenditure on infrastructure and strong private demand in a low interest rate environment. Construction is forecast to grow by 10.0% in 2007 and 7.0% in 2008. Manufacturing, such as food and beverage processing, is expected to grow at a modest rate on the back of growth in consumer demand, which will also underpin growth in areas like transport and communications. The agriculture, forestry, and fisheries sector is expected to grow by 3.6% in both 2007 and 2008 as cash crop production rises in response to new investments and transport infrastructure improvements, as forestry output expands when new project areas are developed, and as fisheries production maintains a steady rate of increase. Palm oil and log production will be the major contributors to growth in the sector. Nonmineral GDP is forecast to grow by 4.2% in 2007 and 4.0% in 2008.

Growth at these rates will mean a continued increase in per capita GDP, given population growth of 1.8%. More important, growth in nonmineral GDP implies that the benefits will be more widely distributed, since mineral sector production is not labor intensive. Sustained and faster agricultural growth in particular will be the foundation for reducing poverty, since 85% of the population live in rural areas. An estimated 41.3% of the rural population live below the national poverty line, compared with 16.1% for the urban population.

Inflation is forecast to remain at 3.0% (Figure 2.31.2). Continued fiscal prudence and sound monetary management should maintain exchange rate stability, and a move to a productivity-based wages policy will be more effective in containing supply-side pressures, because inflationary expectations have fallen in 3 years of relatively low inflation. The 2007 budget targets a deficit of 0.2% of GDP (Figure 2.31.6), in accordance with objectives established in the Medium-Term Fiscal Strategy 2002–2007.

2.31.5 Growth in money supply and private sector credit



Sources: Bank of Papua New Guinea (BPNG), *Quarterly Economic Bulletin* September 2006, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; BPNG, *Monetary Policy Statement*, 31 January 2007; staff estimates.

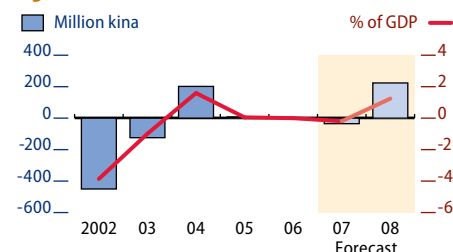
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2.31.1 Selected economic indicators

	2007	2008
GDP growth	4.5	3.5
Inflation	3.0	3.0
Current account balance (% of GDP)	7.9	2.3

Source: Staff estimates.

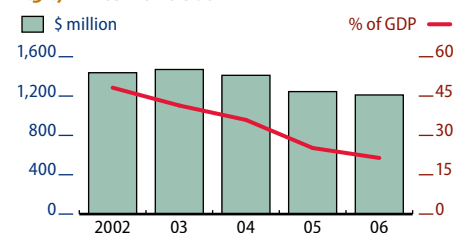
2.31.6 Fiscal balance



Sources: Bank of Papua New Guinea, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.

[Click here for figure data](#)

2.31.7 External debt



Sources: Bank of Papua New Guinea, available: <http://www.bankpng.gov.pg>, downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.

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Pressures on the budget are expected in the lead-up to the elections, but responsible fiscal management is likely to be maintained. In 2008, a budget surplus of 1.2% is projected on the basis that revenues from the mineral sector will decline and that expenditures will be reduced accordingly. Public debt is expected to fall to 39.7% in 2008 as both domestic and external debt stocks come down from 2006 levels. Continued fiscal prudence and exchange rate stability will permit the central bank to maintain a neutral monetary policy stance, and interest rates are expected to be steady.

Softer prices for mineral exports and declining oil production are projected to reduce the current account surplus in 2007 and 2008. Moreover, imports for major mining projects will rise (Figure 2.31.8). The cancellation of the gas pipeline points to a smaller drop in the external surplus than earlier penciled in, since the pipeline-associated high level of imports will no longer be required. The decline in the current account surplus does not reflect excess demand pressures or structural imbalance. Imports arising from mining projects are fully funded by capital inflows related to private sector decisions to launch financially viable projects. Foreign reserves are forecast to provide over 9 months of import cover.

General elections scheduled for this year will be the first based on a limited preferential voting system, rather than a first-past-the-post system. This change is expected to reduce, to some degree, the large number of political parties in the parliament, but coalition governments still seem likely.

The major downside risks in the medium-term economic outlook are a sharper than expected weakening in global commodity prices, disruptions to mining and petroleum projects from civil unrest or natural disasters, political instability, and the abandonment of sound macroeconomic policies by the incoming government.

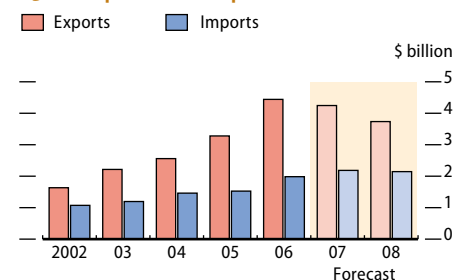
Development challenges

The Government acknowledges that much remains to be done to remove obstacles to greater domestic and foreign private investment, particularly in nonmineral sectors. The main concern is the longstanding problem of lawlessness and disorder (Box 2.31.2).

Other impediments to private sector development include corruption, weak service delivery from the public sector including state-owned power and water utilities, poor road maintenance, high transport costs, and inefficient telecommunications. In 2005, the country ranked 130 out of 158 surveyed for the Corruption Perceptions Index for degrees of corruption, scoring 2.3 out of 10, where zero is highly corrupt. Yet successes have been notched up in dealing with corrupt practices, notably in the pension fund industry. However, the challenge remains to ensure compliance with policies, laws, and regulations. In the forestry sector, for example, sustainable production is at risk from illegal logging, even though the necessary regulations are in place to prevent it.

The private sector also raises concerns that land tenure, access, and utilization issues impede business investment, and the Government has stated that it will at some stage review land legislation. However, this is a complex and sensitive area that is unlikely to be tackled in an election year.

2.31.8 Exports and imports



Sources: Bank of Papua New Guinea, available: <http://www.bankpng.gov.pg> downloaded 7 February 2007; Department of Treasury, 2007 Budget Volume 1: Economic and Development Policies, 14 November 2006.

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2.31.2 Installing law and order

Issues of lawlessness and disorder damage the country's image as a desirable destination both for foreign investors and for tourists. In 2005, net foreign direct investment was only \$27 million and about 18,000 tourists visited (less than 2% of total holiday visitors to the South Pacific and 10,000 below a 1999 peak).

The Enhanced Cooperation Program with Australia originally had a policing component intended to assist in dealing with law and order, but this was removed in 2005 following a dispute over whether or not Australian Federal Police would be subject to domestic law. (The 2007 budget papers indicate that future discussions with Australia will examine reintroducing the policing component of the program.)

In the long run, much faster economic growth that generates employment for young labor market entrants would contribute to curbing the law and order problem, but successful short- and medium-term interventions are needed, precisely in order to encourage the investment that generates faster growth.