Papua New Guinea

Consolidating the performance of the previous 2 years, the economy grew by 3% in 2005, given favorable external conditions, political stability, and supportive fiscal, monetary, and trade policies. This level of growth is likely to be maintained, although 2007 is an election year, which generates some uncertainty. Assistance from Australia is facilitating the development and implementation of improved public policies. However, law-and-order problems, governance issues, land-tenure arrangements, limited infrastructure, and basic service delivery are long-standing drags on growth and higher living standards.

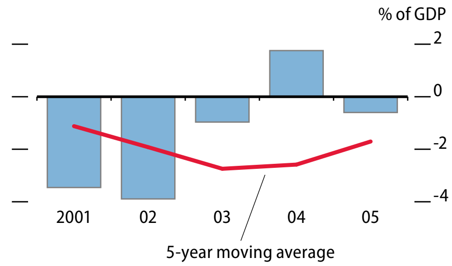
Economic performance

Gross domestic product (GDP) rose by 3.0% in 2005, similar to the outcomes of the previous 2 years. Agriculture performed particularly well, especially coffee, copra, copra oil, and rubber. Export volume percentage increases in the last three of these commodities exceeded their price increases, indicating a strong supply response. The agriculture, forestry, and fisheries sector expanded by 4.1% and supported growth in private consumption. Construction recorded strong growth, a result of low interest rates and solid demand for residential and commercial buildings. However, mining production (which includes oil and natural gas) contracted by 4.5%, primarily on a 6% reduction in gold production due to a landslide at the large Porgera mine. (Gold accounted for 21% of the country's total exports in June 2005.) The oil and gas subsector grew by 11%, as production picked up in response to higher global prices.

Employment in the formal private sector continued to rise, with that in the nonmining sector up by 0.7% in the year to March 2005. Mining employment fell marginally over this 12-month period. However, the share of the labor force employed in the formal sector is still low compared with other countries in the Pacific. Given recent annual population growth of 2.3% (the population grew by more than 1 million to 5.8 million in the 10 years to 2005), employment creation in the formal private sector is unlikely to bring down unemployment and underemployment. Problems of law and order, land tenure, and inadequate physical infrastructure are long-standing impediments to expansion of the formal private sector and are, consequently, constraints to economic development.

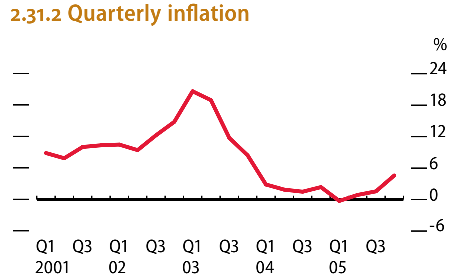
Government revenue and grants overshot the budget projection in 2005 by around 9%. Tax revenues were particularly strong, exceeding the budget projection by an estimated 17%, largely the result of additional tax receipts from mining and petroleum. Total expenditure and net lending exceeded the original budget estimate by 7.8%. This figure includes spending of $140 million allocated for the purchase of an equity share for the Government in a proposed natural-gas pipeline to Australia. The overall budget recorded a small deficit equivalent to 0.6% of GDP (Figure 2.31.1).

2.31.1 Budget balance



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005.

2.31.2 Quarterly inflation



Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005; staff estimates.

Annual inflation averaged just 1.7% in 2005, but accelerated in the fourth quarter driven by higher oil prices and large increases in the price of seasonal produce (Figure 2.31.2). The Bank of Papua New Guinea eased interest rates during the year, in part to stabilize a strengthening currency. The kina exchange rate appreciated on average against major currencies, with its trade-weighted index up by 2.3% in the first 9 months of 2005. The real effective exchange rate against the country's major trading partners appreciated by about 2% in this period. This strengthening resulted from high foreign exchange inflows from exports of minerals and agricultural products as well as improved terms of trade.

On the external side, the trade surplus rose to an estimated $1.5 billion (Figure 2.31.3), the current account surplus is estimated at $78 million (Figure 2.31.4), and gross international reserves increased to $771 million at end-2005 (Figure 2.31.5), sufficient to cover 9 months of nonmineral imports. This is one of the strongest external positions since independence in 1975. External debt as a proportion of GDP has fallen in the past 4 years (Figure 2.31.6).

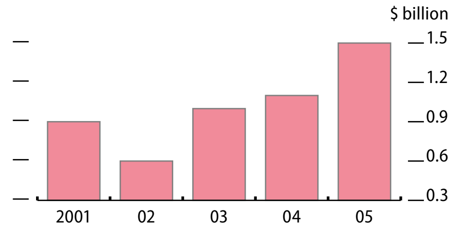
In the policy area, the Government continued to lower taxes and tariffs. It cut income tax rates, gave tax incentives for tourism, and raised infrastructure tax credits for agriculture. (These measures are not expected to lower total tax revenues in 2006.) It also further lowered most tariff rates. Papua New Guinea was rated as one of the "least restrictive" on the trade restrictiveness index of the International Monetary Fund.

The Enhanced Cooperation Program launched with Australia in 2004 is aiding the development and implementation of improved public policies. The original plans were for Australia to provide more than 300 personnel, including police, treasury, justice, customs, and border-control specialists. The program faced a constitutional challenge in May 2005 over a proposal to grant immunity to Australian public servants and police officers, and was scaled down. The policing contingent was withdrawn, but Australian economic, legal, and public administration officers continue to work in the public sector in the areas of capacity building, financial administration, and promotion of good governance.

Key policy strategies of the Government are documented in the Medium-Term Development Strategy 2005–2010 (MTDS) and Medium-Term Fiscal Strategy 2002–2007. The MTDS identifies priority areas for development, while the Fiscal Strategy defines how much the Government can spend. Spending priorities include transport infrastructure, promotion of income-earning opportunities, education, health, and law and justice. The MTDS contains an ambitious list of governance-related programs, including the difficult task of reviewing relations with provincial and local governments. In 2005, the budget provided 48% of total allocations to MTDS priority areas, and the budget deficit was consistent with the Fiscal Strategy guidelines.

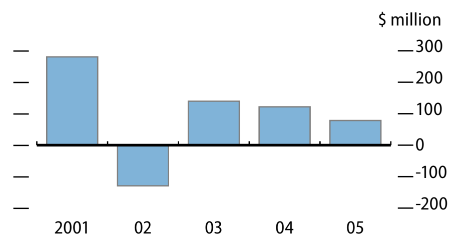
Major public enterprises revealed little sign of improvement in their financial position, with most incurring losses in 2005. In the 2006 budget, the Government has outlined measures to improve budgetary control and accountability of public enterprises including Post PNG, PNG Power, Telikom PNG, the Water Board, and various commodity boards. The authorities are also seeking to construct an appropriate regulatory framework for the telecommunications market.

2.31.3 Trade surplus



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005.

2.31.4 Current account balance



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005.

2.31.5 Gross international reserves

Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005.

Economic outlook

The political stability of the current Government has contributed to economic stability and a more optimistic outlook. The following forecasts assume that economic stability will persist, though some political uncertainty is likely next year because of the election. They also assume that the MTDS and Fiscal Strategy make reasonable progress, and that effective fiscal and monetary policies are maintained in the lead-up to the election. The prospects for Papua New Guinea's major trading partners, particularly Australia, are expected to remain sound.

2.31.1 Selected economic indicators

	2006	2007
GDP growth	3.2	3.0
Inflation	2.4	2.4

Source: Staff estimates.

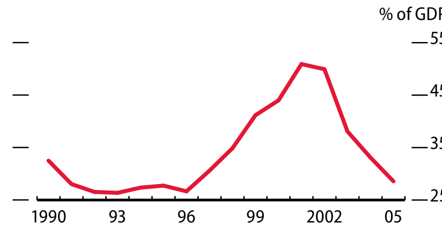
Prospects for 2006 and 2007

GDP growth is projected at 3.2% for 2006 and 3.0% for 2007 (Figure 2.31.7). Industries including construction, manufacturing, and wholesale and retail trade are expected to grow at stronger rates than in 2005. Construction is likely to receive a boost from the planned gas pipeline to Australia and the Ramu nickel mine. However, oil production is expected to decline in 2007 as reserves of existing oil fields are depleted (Figure 2.31.8). Income tax reductions will be implemented this year, continuing the program of tax and tariff cuts, and this should buttress private sector development. Monetary policy is expected to be broadly accommodative. Some cost pressures may accumulate, on account of stronger local demand as the 2007 election draws near, but average inflation next year should be moderate at 2.4% (Figure 2.31.9).

The budget deficit for 2006 is forecast at 0.6% of GDP, similar to last year. Further progress on fiscal consolidation will be required both to ensure that deficits average below 1% of GDP as targeted and to prolong the steady decline in the public debt-to-GDP ratio seen in recent years. In particular, the authorities need to implement the recommendations of an already-conducted review of public spending, address the issue of the Government's rising wage bill, and strengthen fiscal management at the provincial level.

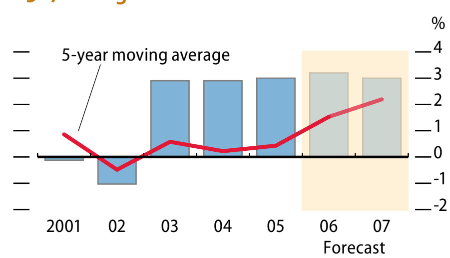
The current account is forecast to turn into deficit in the medium term as merchandise import growth outpaces export growth, and as an increasing deficit on the services and income accounts outweighs a rise in transfers. External debt is expected to remain stable, assuming that commodity prices do not weaken significantly and that there is reasonably strict adherence to the MTDS and Fiscal Strategy. As a result, the country is unlikely to have problems meeting its debt-servicing requirements.

2.31.6 External debt



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005.

2.31.7 GDP growth



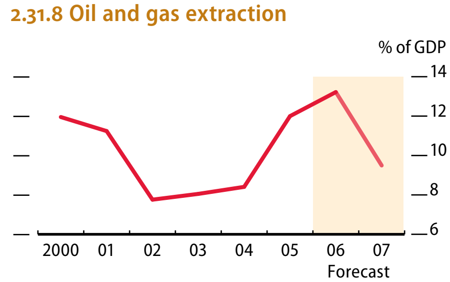
Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005; staff estimates.

Medium-term outlook

Modest economic growth averaging around 3% is forecast over the period to 2010, a little higher than the projected population growth of just over 2% a year. Moreover, much of the GDP growth is likely to be in export-oriented sectors; the majority of people, who have subsistence livelihoods, have limited prospects of a meaningful increase in per capita incomes. Expansion of the private sector will be constrained until the problems of law and order and of corruption are resolved, and the high transport and telecoms costs are brought down. Current levels of education and standards of health also crimp economic growth potential.

Uncertainties center on the vagaries of the weather, possible volatility

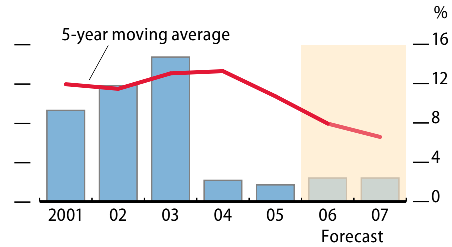
2.31.8 Oil and gas extraction



Sources: Ministry of Finance and Treasury, *National Budget Volume I—Economic and Development Policies*, various years; staff estimates.

in commodity prices, and progress in implementing large mineral projects, including the gas pipeline. The main risk to the growth forecasts is that high oil and commodity prices could weaken significantly. Business confidence has improved but it is fragile. If the Government fails to convince the private sector and overseas investors that it is capable of addressing the country's economic and social issues in the medium term, then even the projected modest economic growth may not be sustained. The election may engender risks to political and economic stability, including less focus on the MTDS. But, if the Government follows through on its public sector reforms and its other policies, this will help ensure macroeconomic stability and provide a solid platform for growth.

2.31.9 Annual inflation



Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, available: http://www.bankpng.gov.pg/publications/qeb/index.htm, downloaded 5 December 2005; Bank of Papua New Guinea, *Monetary Policy Statement*, 31 January 2006; staff estimates.