

PAPUA NEW GUINEA

A prudent macroeconomic policy mix together with favorable terms of trade trends has helped Papua New Guinea maintain macroeconomic stability, strong external balances and solid economic growth over the past five years. Formal employment, although very low as a share of the labor force, has also expanded. The country, however, faces difficult development challenges, including weaknesses in governance, infrastructure, human development, the business climate, public financial management, security, and service delivery.

The political situation in PNG has stabilized in recent years. The coalition government headed by Prime Minister Somare between 2002 and 2007 was the first since independence to serve a full term. The mid-2007 national elections returned PM Somare's coalition to power. Political stability and the resulting greater consistency of policies have contributed to the recent strong macroeconomic performance.

In the past five years, PNG has seen the longest period of uninterrupted growth since independence in 1975. Real GDP growth in 2007 climbed to around 6 percent, the highest in a decade. Growth was led by construction, telecommunications and export-oriented agriculture (coffee, copra and palm oil) and mining. Formal employment across most sectors has grown by around 10 percent annually since 2005. Growth is expected to continue although structural constraints are likely to slow its pace over the medium term.

The fiscal position remains strong. Budget revenue is booming as world market prices for PNG's key exports (oil, copper and gold) reach new highs. The government has prudently restrained expenditures, directing part of the windfall mineral revenues to public debt repayments and saving a part in trust accounts for one-off investment spending in the future. As a result the central budget had a strong fiscal surplus (around 6 percent of GDP) in both 2006 and 2007. The non-mineral budget deficit, meanwhile, remained relatively steady over the past two years at around 7-8 percent of GDP, indicating that the injection of windfall revenues into the economy remains under control. By end-2007 the windfall revenues in trust accounts designated for future investment reached about 17 percent of GDP. The 2008 budget and the newly prepared medium-term fiscal framework envision continued fiscal restraint and expenditure smoothing over the commodity price cycle.

The public sector debt burden has been substantially reduced in the past five years. Healthy growth, an appreciation of the real exchange rate, tighter external borrowing policy and prepayment of public debt using a portion of windfall revenues, have led to a fall in the public debt-to-GDP ratio from over 60 percent in 2003 to around 35 percent in 2007, and the declining trend is expected to continue in coming years.

Inflation appears to remain subdued: consumer prices rose by an average of 0.9 percent in 2007 compared to 2.3 percent in 2006.¹ But average consumer price inflation excluding seasonal products, goods subject to price controls, and changing excises, was close to 7 percent in 2007, an acceleration compared to the previous year. In the medium term inflation is expected to pick-up as the economy will have to cope with continued monetary expansion

¹ This is based on official figures. The quality of price data (as well as other statistics) in PNG needs substantial strengthening.

coming from accumulation of foreign exchange reserves, strong growth of credit to the private sector, and record low interest rates.

The current account surplus rose to over 4 percent of GDP in 2007, thanks to high commodity prices. In the medium term it is expected to decline as import growth rises in line with per capita income, investment, and output. International reserves increased from US\$1.4 billion at end-2006 to US\$2.1 billion at end-2007, equivalent to about 4.5 months of imports of goods and services or about a year of non-mineral project-related imports. Reserves have stabilized in early 2008 as imports have been increasing. The kina has been fairly stable in recent years, appreciating against the US dollar in 2007 by around 2 percent. Given the expected continued strong commodity export inflows, some appreciation pressure on the kina will remain in the coming year or two.

Notwithstanding Papua New Guinea's comfortable macro-fiscal position, significant structural and policy challenges limit its long-term growth potential. Most notable among these is the institutional and policy framework for public financial management. Critical areas for improvement are the integrity of budget processes, intergovernmental financial arrangements, efficiency of sectoral expenditure and service delivery, performance of the civil service and parastatals, and transparency and accountability in budget management. To stimulate private sector investment, particularly outside mining, the critical priority is improvement in the business climate, especially by opening more markets to competition, reducing the regulatory and licensing burden, clarifying property rights (especially for land), and maintaining law and order.