Papua New Guinea

An earthquake disrupted production from major resource projects in 2018, slowing growth. However, economic circumstances improved with higher commodity prices, easier access to foreign exchange, and the government's continued commitment to fiscal consolidation. Inflation eased, and the current account posted another large surplus. Sustained adoption of market-orientated policies and ongoing structural reform are needed to attract foreign capital.

Economic performance

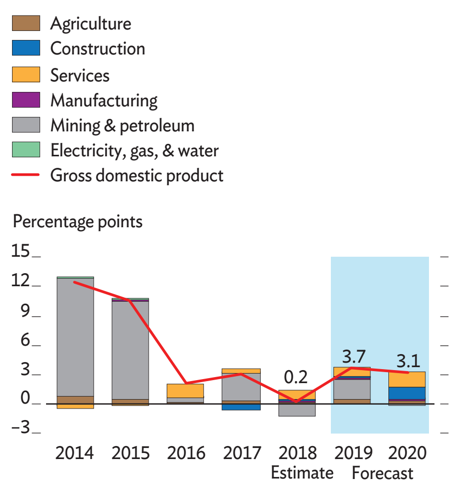
A large earthquake in February 2018 undermined growth, estimated at 0.2%, but the impact was somewhat mitigated by higher commodity prices, activity associated with the Asia-Pacific Economic Cooperation (APEC) summit in Port Moresby in November 2018, and reconstruction in the earthquake-affected zone. Credit to the private sector picked up by about 7% in 2018, and employment ceased to decline. The availability of foreign currency improved with greater inflows, though private businesses continued to be stymied by delays in accessing it.

The oil and gas industry, which constitutes 20.2% of GDP, contracted in 2018 primarily because of damaged facilities and lost output caused by the earthquake. Output of liquefied natural gas (LNG), which provides an estimated 14.9% of GDP, fell by 8.8% in 2018. Production of oil and condensate, which together account for more than 4% of GDP, were also lower (Figure 3.33.1).

Gold production from Porgera, a large mine in the highlands, was hit by the earthquake, but this loss was largely offset by increased production from the country's largest gold mine on the island of Lihir, New Ireland. Production from the Lihir mine, which has the third-largest reserves of gold in the world, grew by 6.2% in 2018, with total output equal to 5.0% of GDP. Production from some medium-sized mines, including the Kainantu gold mine, was also higher in 2018. An estimated 80,000 small-scale alluvial miners increased production by over 7% in 2018, earning combined revenues of about $120 million.

The economy apart from mining and petroleum is estimated to have grown by 3.1% in 2018. The APEC summit in 2018 boosted growth to some extent, channeling business

3.33.1 Contributions to growth



Sources: Papua New Guinea national budget documents, various years; ADB estimates.

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to hotels, restaurants, and transportation providers, and accelerating growth in construction. Higher government spending and the improved availability of foreign exchange also supported growth.

The agriculture, forestry, and fisheries sector, which makes up about 17.0% of GDP, had mixed results in 2018. Farm production, including vegetables and fruit for the domestic market, continued to expand steadily on increased demand from population growth and with improved access to markets thanks to new infrastructure such as roads and bridges. Palm oil is the largest agricultural export, providing 1.3% of GDP, but export volume in 2018 fell below that of 2017 because of a carryover effect from the 2016 El Niño event. Cocoa production was lower in 2018, but coffee production was higher. Forest products, largely logs for export, increased in 2018.

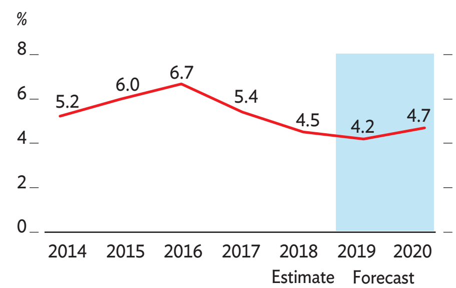
Inflation eased to 4.5% in 2018 as foreign exchange became more readily available and the money supply contracted (Figure 3.33.2). Prices for food, betel nut, and beverages, which had earlier spiked under drought, increased only slightly in 2018. However, higher oil prices pushed up transportation costs. Prices for health care increased by 9.0% in 2018, and for clothing and footwear by 8.3%. Hotel and restaurant prices rose by 8.2%, largely because of the APEC summit.

The Bank of Papua New Guinea, the central bank, maintained a neutral monetary policy in 2018, with the main policy rate, called the kina facility rate, maintained at 6.25%, a slight premium over the rate of inflation. There is no transmission of the policy rate to banks' lending or deposit rates because commercial banks can source cheap local currency deposits. This largely reflects excess liquidity arising in part from a tough lending environment. Although there is ample liquidity in the system, broad money contracted by 8% in 2018 as statutory authorities transferred their deposits from banks into government coffers in accordance with revenue reform measures.

The current account posted a large surplus in 2018 equal to 26.7% of GDP (Figure 3.33.3). Oil and gas prices lifted the surplus and helped to overcome the effects of the earthquake. LNG exports were the largest contributor to the surplus. Foreign currency reserves increased by 33.6% to $2.3 billion at the end of 2018, providing cover for 11.6 months of imports. The main source was $940 million in new external sovereign borrowing.

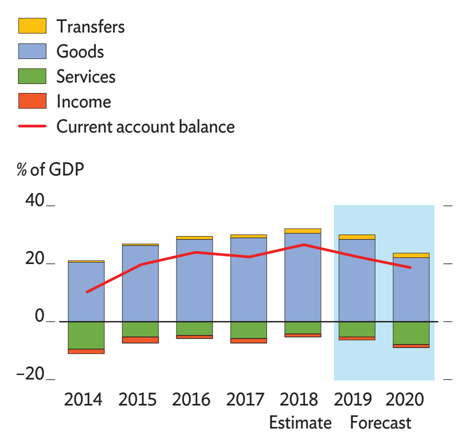
Government revenue increased by 16.3% in 2018, benefiting from improved tax compliance and higher collections of mining and petroleum taxes and dividends with the rise in commodity prices (Figure 3.33.4). Taxes and dividends from the Papua New Guinea (PNG) LNG project were $267 million, according to the Department of Treasury, equal to 1.1% of GDP.

3.33.2 Inflation



Sources: Bank of Papua New Guinea Quarterly Statistical Tables; ADB estimates.

3.33.3 Current account balance



GDP = gross domestic product.

Sources: Bank of Papua New Guinea Quarterly Statistical Tables; ADB estimates.

Expenditure almost kept pace with revenue growth, however, increasing by about 15% in 2018 as it was brought higher by arrears carried over from 2017 and a steeper public sector wage bill. In its supplementary budget, the Department of Treasury projected the 2018 fiscal deficit at the equivalent of 2.3% of GDP, in line with the government's strategy to reduce the fiscal deficit, but the final outcome is expected to be slightly higher.

Economic prospects

Growth is projected to rebound in 2019 with a return to a full year of production of gold, LNG, oil, and condensate. LNG production is forecast to expand by 9%–16% in 2019. If production reaches the higher end of this range, the growth forecast may need to be revised upward. Condensate and oil production are similarly expected to rebound in 2019, though oil production is on a declining trend and condensate production is forecast to start falling by 2020. Gold output should expand in 2019 as the Porgera mine enjoys a full year of uninterrupted production.

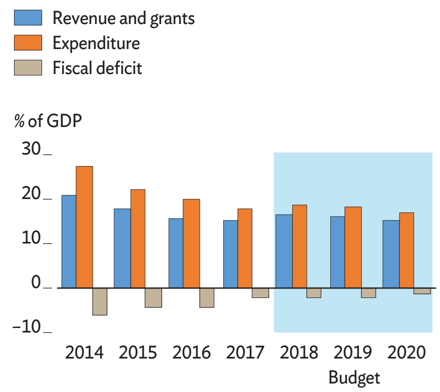
Agriculture should also expand in 2019 assuming oil palm rebounds to the kind of output achieved in 2017. Fisheries are expected to grow steadily, and forestry may also expand, though a proposed ban on log exports may be introduced in 2020, causing production to fall. Coffee, cocoa, and copra will continue to experience volatility in production year on year because of weather variation and changes in global commodity prices.

A number of major resource projects are set to drive growth in the medium term. The Papua LNG project and the PNG LNG expansion project together are forecast to attract foreign direct investment in excess of $10 billion, with construction expected to commence in 2020. The forecast period should also see construction start on the $2.8 billion Wafi-Golpu gold and copper mine project. A telecommunication fiber optics cable connecting Port Moresby with Sydney is scheduled for completion toward the end of 2019 and has the potential to significantly increase internet speed and reduce costs, which should facilitate business growth.

Inflation is expected to ease slightly in 2019 as foreign exchange becomes more available and following the recent contraction in the money supply. In 2020, inflation is expected to pick up again with the commencement of new resource projects.

The current account surplus is expected to shrink somewhat as oil and gas prices sink below those of 2018. Imports should pick up with the greater availability of foreign exchange. In 2020, imports should rise even more rapidly as construction begins on new projects, further shrinking the current account surplus. The new resource projects will attract

3.33.4 Fiscal performance



GDP = gross domestic product.

Sources: Papua New Guinea national budget documents, various years.

3.33.1 Selected economic indicators (%)

	2019	2020
GDP growth	3.7	3.1
Inflation	4.2	4.7
Current account balance (share of GDP)	22.5	18.5

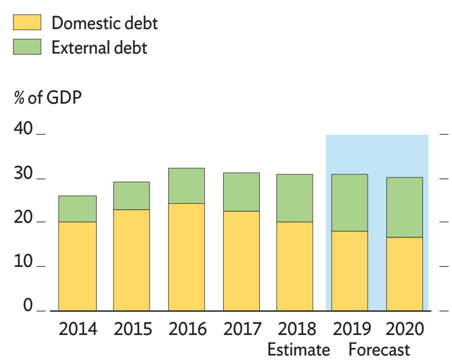
Source: ADB estimates.

significant inflows of foreign exchange, finally ending the era of foreign currency shortages.

The 2019 budget targets a fiscal deficit equal to 2.1% of GDP, which aligns with the government's fiscal consolidation strategy. Targets become progressively lower, with the 2022 deficit intended to equal 1.0% of GDP. Revenue including grants is forecast at 16.1% of GDP in the 2019 budget and is seen to increase by 6.5% largely through ongoing reform, including the recent establishment of an office dedicated to handling large tax payers. Mining and petroleum taxes and dividends, which are forecast to equal 2.1% of GDP, assume an oil price of $68 per barrel, meaning that a lower average oil price would cause revenue to fall below expectations, possibly widening the fiscal deficit or forcing cuts to expenditure, which is forecast to equal 18.2% of GDP. The government's expenditure strategy would reallocate spending from current to capital expenditure, which aligns with the government's Medium Term Development Plan 3, 2018–2022 to increase spending on infrastructure. The 2019 budget seeks to reduce current expenditure, including the public sector wage bill, but this may prove to be challenging.

The deficit will be financed by external borrowing, including budget support loans from multilateral institutions and proceeds from a 2018 sovereign bond. External debt has been on the rise in recent years, projected by the Department of Treasury to reach the equivalent of 13.6% of GDP by 2020, when it will be 44.8% of total central government debt (Figure 3.33.5).

3.33.5 Public debt outstanding



Sources: Papua New Guinea national budget documents, various years.

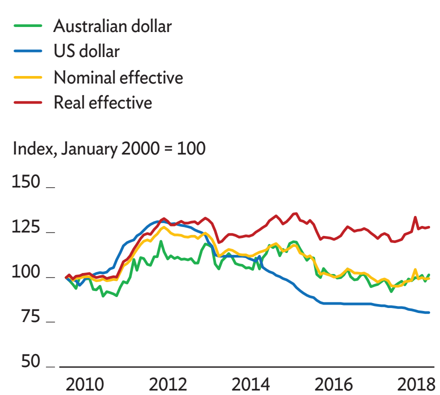
Policy challenge—resolving foreign currency shortages

Shortages of foreign currency have been a key constraint on the private sector in recent years, with importers having to queue to receive foreign currency, sometimes for several weeks until it becomes available. These circumstances have dragged on the economy. Business surveys found foreign currency shortages to be among the worst impediments to doing business.

From January 2010 to June 2012, during the construction of PNG LNG and a period of buoyant commodity prices, large inflows of foreign currency caused significant appreciation of the kina, by 33% in real terms (Figure 3.33.6). Central bank reserves grew accordingly, from $2 billion in 2007 to over $4 billion in 2012.

This trend reversed in 2012 as PNG LNG construction ended and commodity prices began to slide. This put significant downward pressure on the kina and on international currency reserves. The central bank intervened to stem the pace of depreciation by introducing in July 2014 a trading band and

3.33.6 Real and nominal kina exchange rates



Sources: Bank of Papua New Guinea; International Monetary Fund.

a policy of rationing foreign exchange. These interventions prevented the exchange rate and currency trading from adjusting to market conditions, finally appearing as shortages of foreign exchange.

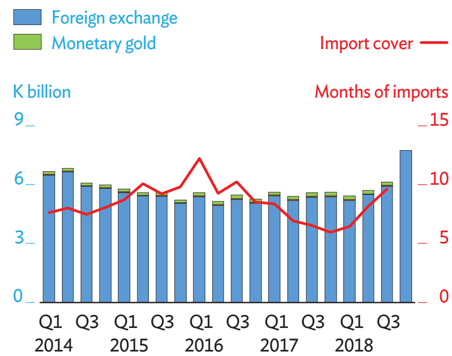
Managing the foreign exchange imbalance has been a challenge for the authorities, who fear that significant inflation could result if the market determined the exchange rate.

The foreign currency environment improved in 2018. Whereas there was only minimal kina depreciation in 2017, in 2018 the kina depreciated about 4% against the US dollar, which is seen as having helped to ameliorate the foreign exchange imbalance. The central bank intervened further in 2018, supplying $695.2 million to the market, more than three times the $227.0 million it supplied in 2017. This was enabled by higher commodity prices that improved earnings in the form of taxes, dividends, and royalties from resource projects, including from PNG LNG. In addition, a portion of foreign currency was released from the $940 million of new sovereign borrowing in 2018. The central bank reported that the waiting time to clear foreign exchange orders was shortened in 2018 as pending foreign exchange orders fell by 48% from K2.5 billion in January 2018 to K1.3 billion in January 2019.

In 2019, the foreign currency backlog should continue to shrink as the central bank injects more foreign exchange into the system at the same rate as in 2018 or higher thanks to proceeds from its 2018 sovereign borrowing and up to $450 million of new sovereign borrowing planned for 2019 (Figure 3.33.7). The central bank has increased its monthly allocations to up to $60 million in recent months. Continued allocations will allow the rolling up of another backlog, this one composed of undeclared dividends estimated by market participants at about $500 million. These are retained profits held by foreign companies operating in PNG and heretofore unable to remit currency overseas. In the longer term, observers predict, new plans for large resource projects expected to begin in 2020 will bring significant inflows of foreign exchange, helping to restore the market to equilibrium.

While a market-determined exchange rate allows equilibrium that puts an end to foreign exchange shortages and removes distortions that can hurt exporters and industries that compete with imports, ongoing structural reform is just as critical for attracting foreign capital and helping to build an economy that is more diversified and shock resilient. Many such reforms are outlined in the Medium Term Development Plan 3, 2018–2022, recently released by the government. They include increasing investment in infrastructure to facilitate business and trade, expanding access to investable land, continuing revenue-raising reform, and improving the management of public finances.

3.33.7 Gross international reserves



SDR = special drawing rights.

Note: Data on monetary gold, SDR holdings, and imports in the December 2018 quarter are not yet available. Imports are free-on-board values.

Source: Bank of Papua New Guinea. *Quarterly Statistical Bulletins.*