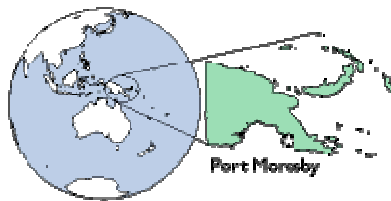


COUNTRY REVIEW

Papua New Guinea



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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Fiscal and current account surpluses with relatively strong external liquidity position
- Low external debt ratios

Weaknesses

- Tendency to political instability, ethnic tensions and weak government as a result of unwieldy coalitions, though the current government has been recently re-elected
- High dependence on primary commodities
- Volatile and low long-term growth
- Weak business environment

Key Risks

- **Growth slowdown**
- **Volatility related to high dependence on commodities and unstable politics**

Country Risk Assessment

Ratings	Papua New Guinea		Median Grade C	Ghana	Peers	
	Latest	Previous			Cameroon	Barbados
Systemic Political Risk:	P3-	P3-	P2-	P2+	P3-	P2+
Systemic Economic Risk:	E5	E5	E5	E5	E5	E5
ME rating:	ME5	ME3	ME5	ME5	ME5	ME5
<i>Structure</i>	6.0	6.0	5.7	6.0	6.0	5.0
<i>Policy</i>	6.0	4.2	5.2	5.6	4.3	3.2
<i>Solvency</i>	1.3	1.9	2.8	3.0	2.0	2.8
<i>External Liquidity</i>	3.6	1.0	4.6	5.6	1.9	6.0
SBE rating:	SBE5	SBE5	SBE4	SBE4	SBE5	SBE3
COUNTRY GRADE:						

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Port Moresby
Population:	6.58 mn (2008)
GDP:	USD 8172 mn (2008)
Currency:	Kina (PGK)
Form of state:	Constitutional parliamentary democracy
Head of government:	Prime Minister Sir Michael Samore
Next elections:	2012

Major Industries (% of GDP at market prices, 2006)		Global Assumptions	2009	2010
Agriculture	35.7%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	45.2%	Inflation (% , av) *	-0.1	1.3
Manufacturing	6.1%	Dated Brent (USD/b)	61	72
Services	19.1%	* Major economies		

Main Exports (% of total, 2008)		Main Imports (% of total)	
Gold	30.3%	Not available	
Copper	23.4%		
Crude oil	22.7%		
Agricultural	19.2%		
Forest products	3.5%		
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
Australia	43.7%	Australia	42.0%
Japan	13.1%	US	22.7%
Philippines	7.7%	Singapore	11.3%
Germany	4.7%	Japan	4.7%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	5,528	6,285	8,172	8,304	8,861
Population (mn)	6.27	6.42	6.58	6.74	6.90
GDP per capita (USD)	882	979	1,242	1,232	1,284
Real GDP growth (% yr/yr)	2.3	6.5	7.2	1.5	3.5
Inflation (% , eop)	-1.0	3.2	11.2	3.5	5.2
Fiscal balance (% of GDP)	2.5	2.6	1.4	-4.0	-1.8
Current account balance (% of GDP)	4.9	0.1	7.2	-4.5	-1.8
External debt/GDP (%)	43	36	30	28	26
External debt/Exports of goods & services (%)	53	44	39	56	49
Interest payments/Exports of goods & services (%)	2	2	2	3	2
Foreign exchange reserves (USD mn)	1,401	2,054	1,953	2,230	2,171
Import cover (months)	2.7	4.1	5.0	5.3	6.2
Exchange rate assumption, PGK:USD (av)	3.06	2.97	2.70	2.79	2.85
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Papua New Guinea (PNG) is a constitutional monarchy (part of the Commonwealth) with a parliamentary democracy. There are generally accepted mechanisms for the transfer of power. However, ethnic tensions boil over into violence intermittently. The 15-year secessionist conflict in Bougainville ended with the introduction of autonomous rule in June 2005, though negotiations continue on the degree of autonomy. Historically, parties are built around personality and party allegiances have been weak with large and unwieldy coalitions, increasing government instability and decreasing the effectiveness of policy implementation. Although PM Sir Michael Somare retained his position after general elections in June-July 2007, becoming the first PM since independence to complete a full term and, overall, stability has improved in this period, these institutional weaknesses and ethnic divisions continue to leave systemic risk relatively high.

There is some doubt over whether Somare will complete his second term, having faced a rising number of calls for him to resign. In July this year, to avoid a no-confidence vote, he adjourned parliament for four months until November and may still face a vote when parliament re-convenes. He also remains under investigation for election irregularities and continues to face allegations over his involvement in the 2006 flight of an Australian lawyer to the Solomon Islands to avoid facing charges in Australia—the so-called “Moti Affair”. There is also a possibility that sometime in 2011 he could hand over to his chosen successor as during the 12 months run-up to the election in 2012 a no-confidence vote is not be permitted under the constitution.

The Somare administration has generally pursued reasonable fiscal and monetary policies to maintain overall economic stability, using high commodity revenues to build-up reserves to cushion a downturn. However, strong structural reforms that would improve the investment environment have not been forthcoming and Somare was re-elected on a more populist platform in 2007.

PNG has strong ties to Australia, which provides financial support under the Enhanced Co-operation Programme. Relations have been strained and are not helped by the allegations against PM Somare, though under Australian PM Rudd, relations have been more constructive than under his predecessor. Although PNG needs Australian funding and Australia needs PNG for security reasons, PNG will continue to extend relations with China. PNG also maintains good relations with the IMF.

Economic Stability

PNG is a lower middle income country (World Bank classification) with an estimated per capita GDP of USD1,242 in 2008. Mining—principally gold, oil and copper—accounts for 25% of GDP (current prices, 2008, ADB), 77% of exports and 35% of government revenues (excluding grants). As a result the economy is highly vulnerable to external shocks. Until the end of 2008, these were positive in the form of high commodity prices, but the converse has been the case since Q4 2008. Over the past ten years growth of GDP has been volatile and real GDP per capita growth has been negative (-0.5% annual average) a reflection of political instability and weak economic management over the longer-term, overlain on commodity price fluctuations. As the IMF noted in the latest article IV consultation (Feb. 2009) “an unattractive business environment, due primarily to weak infrastructure, problems with governance and high crime, constrains more rapid growth of the non-mineral sector”.

Annual average growth of real GDP was 5% in 2005-08, with particularly strong growth in 2007 and 2008 as commodity prices soared and new projects were developed in the minerals sector came on stream. The sharp drop in demand for and prices of commodities (minerals, except gold, and agricultural products) during the global downturn, however, will slow growth to 1.5% in 2009 and 3.5% in 2010, as private sector consumption is squeezed, though unlike most economies, recession should be avoided, as investment in mineral projects should be relatively robust. Government spending will also underpin growth. Medium-term growth prospects depend on further development of the minerals sector and strengthening of the economic infrastructure. LNG projects are expected to provide momentum as crude oil production declines.

The fiscal balance (central government) was in surplus in 2004-08. However, as revenues from the mineral sector account for 35% of the total, the fall in commodity prices is likely to result in a deficit of around 4% of GDP in 2009 (excluding trust fund withdrawals). This should narrow to less than 2% in 2010 as commodity prices have stabilised. These deficits should be manageable as the public debt-GDP ratio was a low 30% in 2008 and trust funds have been established, into which surplus (“windfall”) revenues from recent high commodity prices were deposited, that can now be utilised to cushion the worst effects of the global downturn. The deficit estimates exclude the drawdown from

these funds which the government includes as non-tax revenues.

The government also operates a Medium-Term Fiscal Strategy—introduced in 2008—which limits the non-mineral fiscal deficit to 4-8% of GDP. This reflects the underlying assumption that ongoing spending should be maintained in line with normal revenues (i.e. stripping out a commodity price boom) of about 4% of GDP, which will be re-assessed every two years. Any surplus revenues will go into the trust funds or be used for one-off expenditure.

Inflation accelerated sharply in 2008 to a peak of 13.5% yr/yr in September (up from 3.2% at end-2007) but has since declined rapidly and was down to 6.7% yr/yr in June 2009. With inflationary pressure limited in the near term and the high base in 2008, the end-2009 rate could fall to 3.5%, before picking up to 5.5% at end-2010. The central bank tightened monetary policy during 2008 and has kept policy tight in 2009, with the policy interest rate unchanged at 8% since December 2008. Moreover, in his policy statement at the end of September the central bank governor said that the current tight stance will be maintained in the coming six months, citing concerns over the fiscal deficit. However, inflation and growth may undershoot the bank's projections putting pressure on the policy stance. The real effective exchange rate has appreciated strongly in 2008-09 and there is some risk of a nominal depreciation, though the central bank has resources to maintain a managed float.

The IMF article IV consultation noted that the financial sector was insulated from the direct effects of the global financial crisis as banks are funded primarily from domestic deposits and liquidity was not seriously impacted. Nonetheless, lending to the private sector has grown rapidly in recent years and remains relatively strong.

The external current account balance was in surplus in 2005-08, as increased commodity earnings ensured a large trade surplus, but this will give way to a deficit around 4.5% of GDP in 2009, as export earnings fall sharply on lower prices of and demand for the main commodities (except gold exports the value of which has risen). Assuming that commodity prices do not fall back in 2010, the deficit should narrow to less than 2% of GDP. The deficit is more than covered by net FDI inflows already in 2009, but in 2010 could fall back to 65%. Other external liquidity indicators are adequate, as FX reserves provide more than 5 months import cover and more than six times external debt falling due in 2010 (eight times 2009). Total FX reserves also amount to 400% of the sum of our projected current account deficit for 2010 plus principal repayments on medium-term plus projected short term debt outstanding at end-2009.

External debt ratios are relatively low. External debt was 30% of GDP at end-2008, down from 78% in 2001 (recent peak), and 39% of exports of goods and services (129% in 2002, recent peak). Interest payments are 2% of exports of goods and services.

Overall, the economic structure leaves PNG highly vulnerable to movements in world commodity prices and potential political instability adds to the inherent volatility of GDP growth. Strong mineral exports in recent years have left external liquidity and debt ratios sufficiently robust to cope with the global downturn in the short term, provided the current fiscal framework and political stability are maintained and commodity prices do not fall back.

Structural Business Environment

The Structural Business Environment is well below average in our assessment.

Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed Starting a Business, Dealing with Construction Permits, Getting Credit, Paying Taxes, and Closing a Business were weaker areas, ranking below average, while Enforcing Contracts was particularly weak and well below average. The World Bank Institute's Governance Research Indicator puts regulatory quality just below and rule of law below and control of corruption well below average for the East Asia region. Transparency International's Corruption Perception Index, 2008, assigns PNG a score of 2.0—on a scale of 1 (bad) to 10 (good)—and a ranking of 151= out of 180 (the same as, among others, Laos, Ecuador, Tajikistan). As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks PNG 121 out of 179.

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Charts

