Papua New Guinea

Lower global commodity prices trimmed economic growth in 2009. The government provided a large fiscal stimulus and ran down public trust fund savings. Inflation decelerated, but remains relatively high. GDP growth is projected to pick up this year and next, lifted by the planned construction of a large resource project. The surge in revenue from this project in the years ahead heightens the need to put in place systems to smooth government expenditure over time and to provide for transparent and well-designed public programs to reduce poverty.

Economic performance

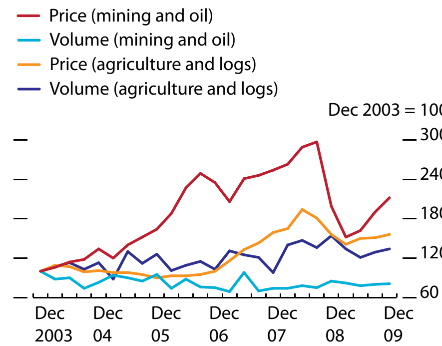
The economy proved fairly resilient to the global recession last year, even though it depends heavily on exports of minerals, crude oil, and agricultural commodities. Several factors cushioned the impact of the global recession: expectations that a $15 billion liquefied natural gas (LNG) project will in fact go ahead, a recovery in commodity prices in the second half of 2009 from a price plunge that started in late 2008, and a strong fiscal stimulus last year. GDP growth was estimated at 4.5%, marking 8 consecutive years of expansion averaging about 3%. Services grew by an estimated 7.0%, mainly reflecting expansion in the communications and construction subsectors; industry grew by 4.6%, and agriculture by 2.3%.

Private investment was bolstered as planning moved forward for the large LNG project, which will generate business opportunities across the economy. Government expenditure increased by 3.0% in real terms (despite a 20% drop in revenue caused by lower export commodity prices), as the government drew down heavily on savings accumulated in trust funds during the commodity boom years. Private consumption, however, likely softened because lower prices for agricultural commodities dented household incomes.

The decline in prices for export commodities (Figure 3.33.1) reduced the value of merchandise exports in United States (US) dollars by 26% in 2009. Mining (mainly copper and gold) and oil exports together fell by about 25% in value (Figure 3.33.2), despite an increase in export volumes of metals. The value of oil exports dropped by over 50%; the price fell by about 37% and volumes by about 13%. Agricultural exports declined in value by an estimated 30%: palm oil by 34%, coffee by 19%, cocoa by 6%, and copra by 66% (from largest to smallest in terms of 2009's export crop value). Most export commodity prices rallied in the second half of the year.

Employment in the private nonmining formal sector increased by 3.7% in the year to September 2009. The services sector saw particularly

3.33.1 Export indexes



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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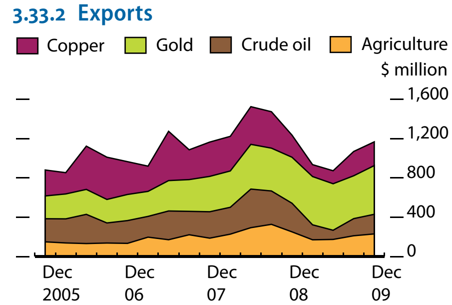
3.33.2 Exports



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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This chapter was written by Dominic Mellor of the Papua New Guinea Resident Mission, ADB, Port Moresby.

strong jobs growth, and employment in mining also rose. However, this formal sector accounts for only one fifth of the labor force. Many people are farmers who produce mainly for their own consumption, with some cash-crop production.

The government adopted a very expansionary fiscal policy stance in 2009, even with the economy continuing to grow moderately. The deficit likely exceeded 10% of GDP, including off-budget items (Figure 3.33.3). (Excluding off-budget spending from the trust funds, the budget showed a near-balanced outcome.) Gross and external public debt levels were little changed from 2008, at about 32% and 14% of GDP, respectively.

Following a sharp rise in private sector credit during the commodity boom years, credit growth pulled back in 2009, from 40% in November 2008 to about 20% a year later (Figure 3.33.4). Inflation eased to average 7.6% over the year, as the impact of lower global commodity prices slightly offset upward domestic pressure on prices.

After raising its monetary policy indicator interest rate in 2008, the central bank kept it steady until December 2009, when, after inflation eased, it lowered the rate by 1 percentage point to 7.0%. The kina exchange rate depreciated by 15% in 2009 against a trade-weighted basket of currencies.

The drop in the value of exports, coupled with a small rise in the value of imports, cut the trade surplus in 2009, and the current account fell into deficit (estimated at about 5% of GDP), the first external deficit since 2002. Gross foreign exchange reserves at year-end totaled $2.4 billion, equivalent to about 10 months of imports of goods and services (Figure 3.33.5).

Economic prospects

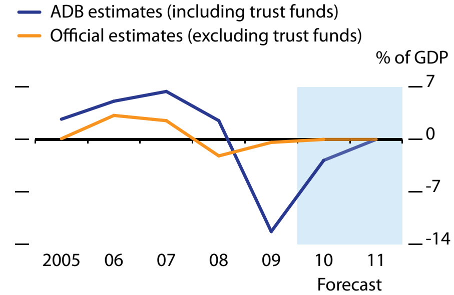
Financing for the LNG project was secured in March 2010. Tapping natural gas from the Highlands region, the project will have the capacity to produce 6.6 million tons of LNG a year for export, contributing as much as 20% of annual GDP when it starts operation, which could be as early as 2013.

Construction is expected to start this year. During this construction phase, up to 1,500 local workers will be employed, and when the plant starts operating it will directly employ about 850 people, mostly locals. However, given that the project could yet be delayed by landowner compensation issues, the LNG project's contribution to growth this year might well be less than the officially forecast 3.0 percentage points of GDP.

In the construction sector, other projects associated with the LNG project are scheduled to start this year, keeping overall construction activity high, although growth of construction could be limited by the fact that many firms are already operating at full capacity.

Oil production will continue to decline owing to lower extraction rates from maturing oil fields, but mining output will be boosted midyear by production from a new Ramu nickel–cobalt mine. The Hidden Valley gold mine started operating last year and is expected to increase production, while the existing gold mines of Ok Tedi, Porgera, and Lihir are all expected to raise production this year.

3.33.3 Budget balance



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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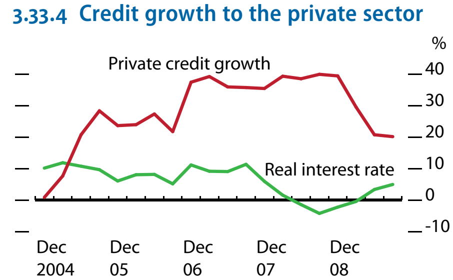
3.33.4 Credit growth to the private sector



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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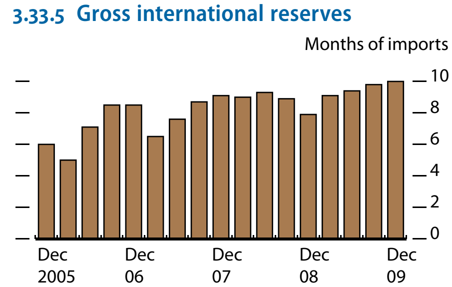
3.33.5 Gross international reserves



Note: Imports excluding mining and oil commodities.

Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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Higher prices for agricultural commodities should stimulate their production, particularly as last year's cocoa crop was damaged by pod borer and coffee was hit by floods in the Highlands early in 2009.

Business confidence is underpinned by high levels of government expenditure and expectations that the LNG project will generate spillover benefits. In addition, two competing mobile telephone service providers plan further investments to increase network coverage.

Fiscal policy will likely be less stimulatory in 2010. The government is expected to moderate its drawdowns from the trust funds, so that the fiscal deficit, including off-budget spending, is forecast to narrow sharply to just under 3% of GDP. (The government targets a balanced budget, excluding off-budget items.)

On the balance of these factors, GDP growth is forecast to accelerate to 5.5% in 2010 and to 7.7% in 2011, when construction of the LNG project is stepped up (Figure 3.33.6).

Merchandise exports will increase in value terms, as will imports, given high levels of public expenditure and imports of machinery and equipment needed for the LNG project. The current account deficit is projected to widen to 15.0% of GDP in 2010 and then to 30.0% in 2011 (Figure 3.33.7). This gap will be largely financed by foreign direct investment.

Inflation is projected to remain relatively high at 7.1% and 7.7% over the next 2 years (Figure 3.33.8) in the context of higher global commodity prices and rising domestic demand. Shortages of residential and commercial properties in the main urban centers are also causing upward pressure on inflation through significant rent increases. Inflation pressures will constrain further easing of interest rates.

Domestic risks to the 2010 forecasts are largely on the upside: GDP growth could be higher than forecast if landowner compensation disputes for the LNG project are settled quickly and the equipment, materials, and skilled labor are available to ramp up plant construction. There are risks, too, for the 2010 inflation forecast if the momentum from last year's high fiscal expenditures is greater than anticipated.

Development challenges

Even with 8 consecutive years of economic growth, poverty incidence remains high (at about 50%), much public infrastructure is in poor condition, and human development indicators are low: Papua New Guinea is ranked 148 out of 182 countries in the human development index compiled in 2009 by the United Nations Development Programme.

When substantial revenue from the LNG project starts to flow, the government will have an opportunity to fund development projects that improve living standards. Managing the revenue flows prudently and sharing the benefits widely through well-designed public programs will be critical to avoiding the "resource curse" that mining- and energy-exporting countries often bear. This will require a fiscal framework that saves part of the resource revenue so that it can be spent over time, transparently and accountably.

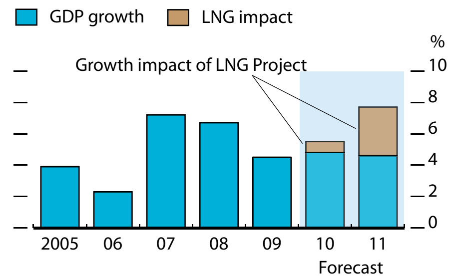
Although elements of such a framework are spelled out in existing

3.33.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	7.7
Inflation	7.1	7.7
Current account balance (share of GDP)	-15.0	-30.0

Source: ADB estimates.

3.33.6 GDP growth



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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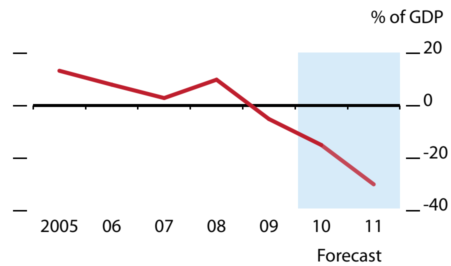
3.33.7 Current account balance



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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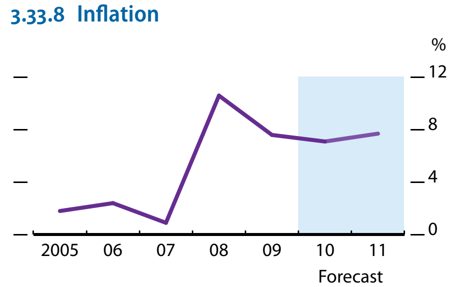
3.33.8 Inflation



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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policy statements and were previously followed, the system broke down in 2009 when large drawdowns were made from trust funds. Stronger governance arrangements and enhanced public financial management systems are now needed (Box 3.33.1).

3.33.1 Managing revenue volatility

The 1990s are often referred to as the "lost decade" in Papua New Guinea because the country did not translate significant public mineral revenue into improved living standards for the majority of people. In an effort to manage volatile resource revenue, the government set up a Mineral Revenue Stabilization Fund. But a lack of transparency and accountability caused those savings to be largely wasted.

During the recent commodity boom, disciplined fiscal policies enabled the government to accumulate windfall revenue, which was saved in trust funds earmarked for development purposes and public debt repayment. In 2009, though, this discipline weakened. Drawdowns from trust funds were far above a limit set in the medium-term fiscal strategy and did not appear justified given that the economy was maintaining solid growth.

Net expenditure from trust funds in 2009 equaled about 10% of GDP, and represented almost two-thirds of total trust fund expenditure since 2005. Moreover, spending was channeled outside the national budget and not integrated into the macroeconomic framework. A significant amount of trust fund monies is currently channeled through local administrations, which have limited capacity to implement development projects. It is unlikely that all the spending went to development priority projects, given the rapid pace of drawdowns and lack of transparency in the spending.

Public revenue to flow from the liquefied natural gas (LNG) project will provide the country with another chance to increase the productive capacity of the economy and raise living standards. This time, development objectives are more likely be achieved, and macroeconomic stability maintained, if the rules of the medium-term fiscal strategy are followed strictly, monetary and fiscal policies are closely coordinated, and a sovereign wealth fund is established and then integrated into the policy framework.

The government plans to channel LNG project revenue into three funds: a stabilization fund, an infrastructure fund, and a future fund. These funds should be saved offshore, to help minimize currency appreciation that would hurt domestic producers, including farmers. It is vital for drawdowns from all funds to be channeled through the national budget, strengthening stabilization efforts and helping ensure higher-quality spending aligned with development priorities. The rate of drawdown should also be calibrated on the capacity of the public and private sectors to efficiently and effectively utilize funds.

Improvements to the business climate are required to pave the way for developing the private sector. They include a more secure legal environment for doing business and encouragement of competition throughout the economy. The World Bank's *Doing Business 2010* ranks Papua New Guinea overall at 102 of 183 countries, down from 89 in 2008.

Inefficient state-owned enterprises hold dominant market positions in many sectors and are a drag on economic growth. Competition in the telecommunications and aviation sectors shows what can be achieved: a new firm in the mobile telephone market led to notable improvements in phone services in rural areas, while a new airline servicing the route between Papua New Guinea and Australia has cut airfares.

However, more needs to be done, particularly with those state-owned enterprises that will see considerable increases in demand from the LNG project. Still, the government's commitment to implementing a public–private partnership policy is encouraging and could potentially facilitate significant private investment in infrastructure. There is scope for such partnership investments in the utility and transport sectors, both critical to reducing the costs of doing business.