Papua New Guinea

Economic growth accelerated in 2010 as construction started on the country's largest resource project and incomes benefited from the recovery in global commodity prices. Growth is forecast to quicken in 2011, underpinned by investment in resources and gains in production of metals and agricultural commodities. Reforms to public financial management and the business environment should be stepped up if the full benefits of a coming surge in revenue from resources are to be realized.

Economic performance

The start of construction on a $15 billion liquefied natural gas (LNG) project and recovery in global commodity prices benefited this resource-rich economy in 2010. GDP growth was estimated at 7.1%, marking almost a decade of uninterrupted expansion averaging about 4.4%.

Industry, including minerals, grew by an estimated 9.3% and was the major contributor to GDP growth (Figure 3.33.1). This mainly reflected a construction boom in Port Moresby and Lae, and an increase in mine production, after several years of contraction in mineral output. Services expanded by an estimated 8.5%, with strong growth in telecommunications and transport. Agricultural output rose by 3.5%.

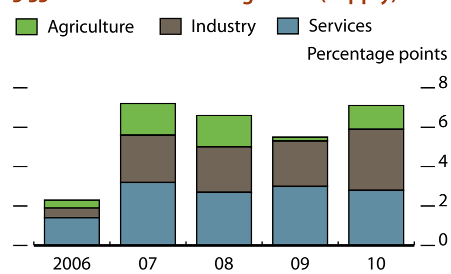
Private consumption was supported by higher incomes, partly attributable to the recovery in commodity prices (most people are farmers who produce primarily for their own consumption plus some cash crops such as cocoa, coffee, and copra).

Progress on securing finance for the LNG plant and starting the construction bolstered private investment and buoyed investor sentiment. The plant is expected to begin production of LNG for export in 2014 or 2015, and full operating capacity will be 6.6 million tons a year. Strong investment helped to offset a decrease in government expenditure of 4.1% in real terms in 2010.

The rebound in commodity prices lifted the value of merchandise exports in US dollars by about 27% in 2010 (Figure 3.33.2). Mining (mainly copper and gold) and crude oil exports together climbed by about 30% in value, despite declines in export volumes of gold (4%) and oil (9%). Agricultural exports shot up in value by about 45%: palm oil 51%, coffee 20%, and copra 87%. (The increase was achieved despite a sharp fall in cocoa exports due to bad weather and disease.) The value of forestry products shipments rose, too, but fisheries and other marine exports fell.

After a highly expansionary fiscal stance in 2009, when the government drew down heavily on savings accumulated in public trust funds during past commodity boom years, the authorities reduced trust-fund drawdowns and spending in 2010. Revenue, including

3.33.1 Contributions to growth (supply)



Source: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies.*

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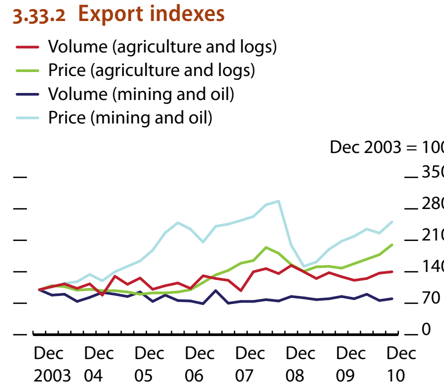
3.33.2 Export indexes



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 Viet Nam Resident Mission, ADB, Ha Noi.

foreign grants, increased in real terms by 17%, mainly due to the higher commodity prices. As a result, the fiscal deficit narrowed significantly to 0.5% of GDP, including off-budget items (Figure 3.33.3). Excluding off-budget spending from trust funds, the budget again showed a near-balanced outcome.

Inflation eased for a second year to average 6.0% in 2010, in large part a result of a pullback in food-price inflation (Figure 3.33.4). However, there are concerns that the consumer price index might understate inflation because its composition is outdated. The index excludes housing costs, thus direct effects of surging rents in urban centers are not captured.

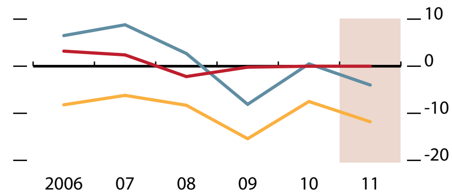
Growth in private sector credit slowed to a still high 17% in 2010 and broad money supply growth subsided to 12.5%. The Bank of Papua New Guinea raised the cash-reserve requirement for commercial banks in October 2010 to 4.0% from 3.0% to reduce excess liquidity, but kept its policy interest rate steady at 7.0% throughout the year. The kina exchange rate depreciated by 8% in 2010 against a trade-weighted basket of currencies, mainly due to the strength of the Australian dollar.

A surge in imports of equipment for the LNG plant, mainly funded by foreign direct investment, more than offset higher export receipts in 2010. The merchandise trade deficit widened to about 11% of GDP and the current account deficit to an estimated 27% of GDP. An increase in gross foreign exchange reserves to $2.6 billion (equivalent to 15.3 months of nonmineral imports of goods and services) was attributable to inflows of foreign direct investment.

The government in 2010 decided to move new public trust accounts to the central bank, a move that should give the monetary authorities better control over banking sector liquidity. Existing trust fund balances, however, remain in the commercial banking system.

In another important policy development, the government established a working group, chaired by the Treasury, to oversee establishment of a sovereign wealth fund. The plan is to manage revenue from resources through the offshore fund, with drawdowns to be channeled through the budget. This should help to shield the economy and the budget from the impact of swings in global commodity prices.

3.33.3 Budget balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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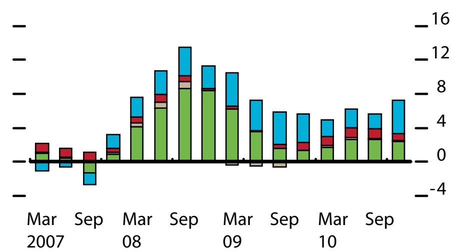
3.33.4 Contributions to inflation



Source: National Statistical Office.

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Economic prospects

Plans have been disclosed for a second LNG project, to cost $4 billion, and its developers have said construction could start late this year. Given uncertainty about the construction timetable, the outlook does not factor in any direct impact from this proposal.

Construction of the first LNG plant will accelerate this year (it faced some delays in 2010 owing to land access and compensation issues), thereby increasing activity in the construction and transport industries in particular. Still, the government estimates that only 4.5% of project investment will be retained in the domestic economy because most of the outlays are for imported goods and services.

The $1.4 billion Ramu nickel–cobalt mine, delayed last year over environmental concerns, is assumed to start production in 2011. Output from some operating mines is projected to rise, too. However, crude oil extraction rates will continue to fall as fields mature.

3.33.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	6.5
Inflation	8.0	7.5
Current account balance (share of GDP)	-35.9	-34.2

Source: ADB estimates.

High global prices for agricultural commodities will likely stimulate their production in 2011. Cocoa output is expected to rebound after it suffered from disease in 2010, and coffee production will rise, weather permitting.

On the balance of these factors, GDP growth is forecast to step up to 8.5% in 2011 (Figure 3.33.5), then ease to about 6.5% in 2012 when construction of the first LNG plant starts to taper off.

Price pressures will intensify this year in view of the demands on labor and resources from the first LNG plant. Supply-side constraints are apparent in construction and transport, the property markets in Port Moresby and Lae, and in skilled labor.

Higher global food and oil prices, coupled with last year's depreciation of the kina (against the Australian dollar especially) will fuel inflation, which is projected to accelerate to average about 8.0% this year and be near this rate in 2012. The central bank is expected to tighten monetary policy as inflation pressure builds.

The 2011 budget targets a balanced position, excluding trust fund expenditure. Nevertheless, there may be pressures on the government to spend more from trust funds ahead of elections expected in 2012. Further, a large portion of previous years' trust fund withdrawals may yet be spent. Such expenditure would result in a fiscal deficit and add to inflation pressures.

A buildup in net foreign assets has partially offset the impact of a reduction in net domestic assets on growth in money supply (Figure 3.33.6). This could add to inflation if the trend continues in 2011.

In the external accounts, higher levels of imports for resource projects will continue to widen the current account deficit, to around 35% of GDP in 2011 and 2012 (Figure 3.33.7). This gap will be largely financed by foreign direct investment. Foreign reserves are expected to remain adequate in terms of import cover.

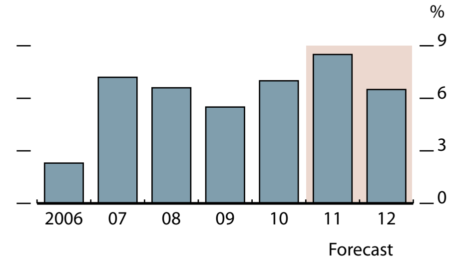
Risks to the forecasts on the upside would come from an early start to work on the second LNG plant or from higher than expected prices for export commodities. The main downside risk is seen in further delays to large resource projects from disputes over land and compensation for landowners.

In the medium term, production from the first LNG plant will underpin growth in GDP, but the likelihood of more such plants is uncertain. There are also uncertainties over mineral production: several large mines are forecast to close sometime in 2012–2015. It will be important that the authorities are cautious about committing to any substantial increases in expenditure, given that they will not receive significant revenue from the first LNG plant until 2018 and that receipts from mining depend on global prices and the life of the mines.

Development challenges

Although the economy has experienced sustained economic growth, driven primarily by development of minerals, the direct contribution of minerals to reducing poverty is limited. Few of the poor depend directly on mining and the links between mining and the rest of the economy are weak. There is currently no official measure of poverty but social

3.33.5 GDP growth



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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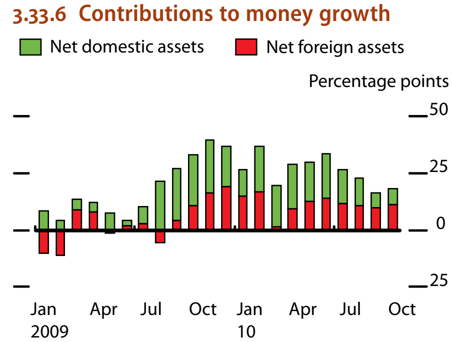
3.33.6 Contributions to money growth



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

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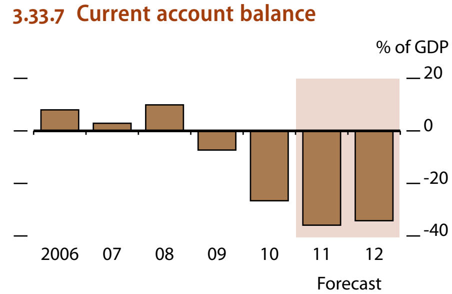
3.33.7 Current account balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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indicators are below those of other countries with similar per capita incomes. Indeed, Papua New Guinea is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 137 out of 169 countries in the 2010 human development index compiled by the United Nations Development Programme.

The government will have an opportunity to improve living standards by rehabilitating infrastructure and upgrading basic services when substantial revenue starts to flow to the budget from LNG projects. It will also have funds to meet adjustment costs of structural reforms to open business sectors controlled by state-owned enterprises, such as ports and electricity, to private competition.

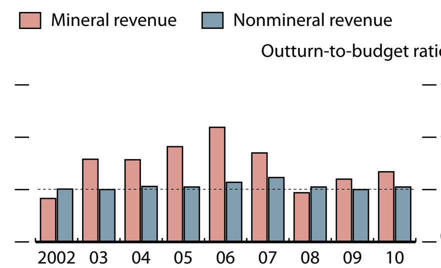
The government's medium-term development plan for 2011–2015 recognizes these challenges and paves the way for a stronger effort to address them. It puts more emphasis on policy achievements and results-based monitoring of the public service. Government commitment to the plan will be critical if agencies are to be held accountable for underperformance. Further, realizing the plan's goals will require marked improvements in the public service and public financial management.

Managing volatile flows of revenue from resources is a continuing challenge. The government has usually erred on the side of caution, under-forecasting commodity prices so that mineral revenue has tended to exceed budget targets (Figure 3.33.8). This generates large windfall revenue that has been directed to discretionary capital spending in supplementary budgets.

It would, though, be helpful if the supplementary budget process was more flexible, to allow some of these funds to be spent on rehabilitation and maintenance of public infrastructure. The plan to manage resource revenue through a sovereign wealth fund should help to smooth revenue flows to the budget.

Improvements to the business environment, including reforms of state-owned enterprises, are required to generate sustainable growth and employment in nonmineral sectors. The World Bank's *Doing Business 2011* report ranks Papua New Guinea 103 out of 183 countries, up from 108 in 2010. The improvement in the overall ranking stemmed from easier availability of credit (though its ranking dropped for other sub-indicators). The lack of enforcement of contracts is, in particular, a deterrent to investment.

3.33.8 Budget revenue forecasts



Note: If the ratio is greater than 1, the outturn is larger than the budget target.

Source: ADB estimates using Papua New Guinea budget documents, 2002–2010.

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