Papua New Guinea

High international commodity prices boosted economic growth in 2011. Restrained expenditure growth allowed the government to accumulate public trust fund savings. GDP growth will remain high in 2012 as construction of a large resource project reaches its peak. The following year, economic pressures will emerge as construction of that project winds down and government revenues from existing mining operations decline A major challenge is to ensure that the poor benefit from the country's higher income.

Economic performance

The economy continued its strong performance in 2011, with GDP growth of 8.9% marking a decade of uninterrupted expansion. Industry made the largest contribution to growth owing to resource investments, including the construction of a $16 billion liquefied natural gas (LNG) project and high government spending that boosted demand in the sector (Figure 3.33.1). Construction was also supported by property developments as investors responded to very high rental demand in urban centers.

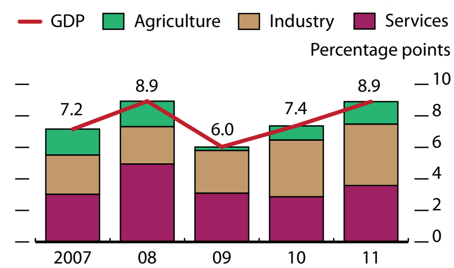
The contribution of industry to overall growth was partly offset by the mining and oil sector, which contracted by 8.7% as a result of declining output from maturing mining and oil operations. Agricultural output rose by 4.5% as producers responded to higher commodity and food prices.

Strong economic growth continued to create income-earning opportunities. The Central Bank Business Liaison Survey showed a 7.1% increase in formal employment in the first half of 2011.

The deficit on the current account of the balance of payments widened to 36.8% of GDP in 2011. Higher commodity prices raised the US dollar value of merchandise exports by 27.8%. Mineral exports climbed by 17%, as rising copper and gold sales more than offset an 11% decline in oil revenue. The value of agricultural exports, which make up roughly a quarter of export revenue, rose by about 51% in 2011, primarily as a result of 63% growth in palm oil exports, an 88% jump in coffee sales, and a 100% surge in marine products.

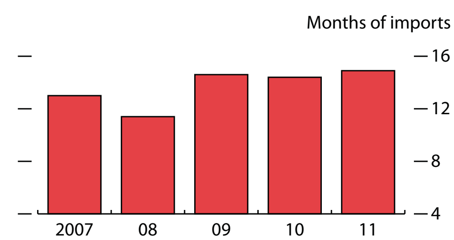
Increased exports were, however, outweighed by a rise in imports, particularly those related to construction of resource projects. Yet because resource-project imports are financed mainly through foreign direct investment, the large current account deficit does not jeopardize external stability. High foreign exchange reserves held by the central bank, which totaled 15 months of nonmineral import cover in 2011 (reaching 18 months in October), also support external stability (Figure 3.33.2).

3.33.1 Contributions to growth (supply)



Sources: Department of Treasury. *2012 National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.2 Gross reserves



Note: Imports exclude mining and oil commodities.

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

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

The 2011 budget recorded a small deficit of $40 million (equivalent to 0.3% of GDP) (Figure 3.33.3). Adjusting official numbers for net trust fund deposits, though, gives an effective budget surplus equal to 2% of GDP. This difference arises owing to the government's classification of trust fund deposits as spending, while international government accounting standards treat them as savings.

Strong growth and high commodity prices took domestic revenue collection 6.6% above projections (Figure 3.33.4). A midyear supplementary budget allocated an extra $359.6 million in expenditure to infrastructure, health centers, and prefunding for a new commitment to achieve universal primary and secondary education.

High levels of government expenditure, large resource investments, and rising international food prices spurred inflation in the first half of 2011, with the consumer price index increasing year on year by 9.6% at end-June 2011. Price increases slowed in the second half, mainly reflecting strong exchange rate appreciation.

Also supporting moderating price growth was monetary intervention: the central bank issued a net $0.6 billion in central bank bills, raised the policy interest rate (the kina facility rate) by 75 basis points to 7.75%, and lifted the capital-adequacy requirement for banks from 4.0% to 6.0%.

A significant policy development in 2011 was the announcement of a new sovereign wealth fund to manage all future mineral revenue. The fund aims to encourage stable and sustainable increases in government expenditure by establishing a maximum drawdown rule and channeling all mineral funds through the budget. The fund also aims to protect local export industries by investing unspent mineral revenue in offshore assets.

One challenge, however, is that the proposed new agencies that will use mineral revenue to finance infrastructure and state-owned enterprise investments have the potential to replicate existing government structures and complicate public financial management.

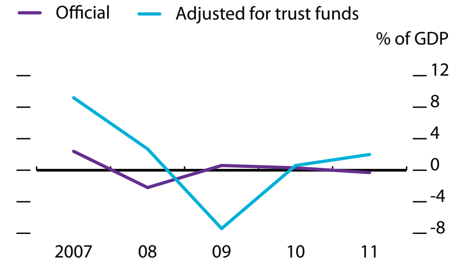
Economic prospects

Growth is seen moderating to 7.5% in 2012 and more sharply to 4.5% in 2013 (Figure 3.33.5). This year growth will be supported by higher prices for the country's key export commodities, heavy government spending, and rising domestic employment, at the same time as the LNG project's construction phase reaches its peak. Growth will also be supported by a 20% expansion of the mineral sector as production starts at the Ramu nickel and cobalt mine, although this will be partly offset by a 9.9% reduction in oil production.

The slowdown in 2013 will stem from the winding down of LNG project construction, which will hit demand in a range of sectors, including construction itself, transport, and aviation. This effect will spill over into the wholesale and retail sectors. Adding to this shock will be further declines in oil production, which is predicted to contract by 17% in 2013.

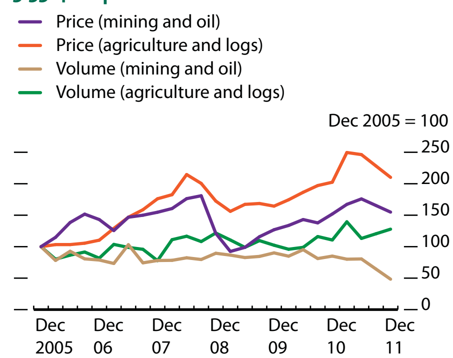
Inflation is expected to remain high in 2012 (Figure 3.33.6). Record public and private investment will leave many areas of the economy, including construction, shipping, and port facilities, operating at close to full capacity. Offsetting these pressures is the kina exchange rate,

3.33.3 Budget balance



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

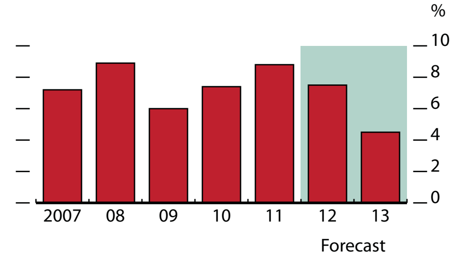
3.33.4 Export indexes



Note: Index rebased to December 2005 = 100.

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

3.33.5 GDP growth



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

which is likely to remain high against those of major trading partners in 2012, after appreciating by 21% against the US dollar and 18% against the Australian dollar in 2011. On balance, price growth in 2012 is expected to ease slightly to 7.0% and to 6.0% in 2013 as the economy slows further and LNG-related construction activity declines.

In the external accounts, resource-project imports will maintain a large current account deficit, of around 33.2% of GDP in 2012 and 29.7% in 2013 (Figure 3.33.7). Foreign direct investment will continue to finance this gap. Foreign reserves are expected to remain adequate in terms of import cover over the forecast period.

The 2012 budget targets a balanced position, with an expected 9.5% increase in domestic revenue collection. As in previous years, the budget excludes net trust fund expenditure. Pressure to draw on these accumulated savings will be raised in the lead-up to national elections in mid-2012. Given existing capacity constraints, any large trust-fund drawdowns would add to inflationary pressures and crowd out private sector activity.

Fiscal stress will mount in 2013 as revenues from maturing mining and oil operations continue to decline. Combined with slowing growth, this is expected to begin a 2-year period of stagnant revenue collection, until LNG revenue begins in 2015.

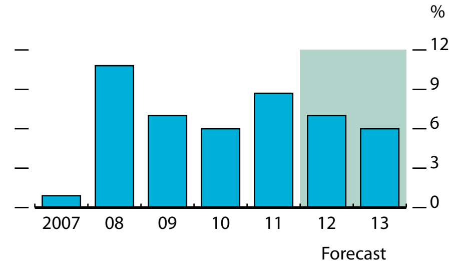
Low public debt—about 24% of GDP in 2011—will enable measured government borrowing to maintain expenditure without compromising macroeconomic stability, although public finances face some risks, and a decline in international commodity prices would be painful. Revenue projections in the 2012 budget are predicated on an optimistic outlook for commodities: cocoa, coffee, palm oil, rubber, and tea prices are expected to moderate only slightly but remain near record highs, while prices of copra, copra oil, and copper are all expected to rise. The price of gold in particular, which makes up almost half of export earnings, is forecast to be 20% higher in 2012 than in 2011.

If commodity prices decline significantly this year, the government will face pressures to meet expenditure commitments without undermining the fiscal discipline that has underpinned the last decade of macroeconomic stability.

Another risk to the economic outlook is the government's growing off-balance sheet contingent liabilities related to resource-project guarantees and unfunded superannuation liabilities, now totaling 32% of GDP. Of particular concern is the potential for unresolved landowner compensation issues to delay LNG project construction, which may result in the government being obliged to meet its project-completion guarantees.

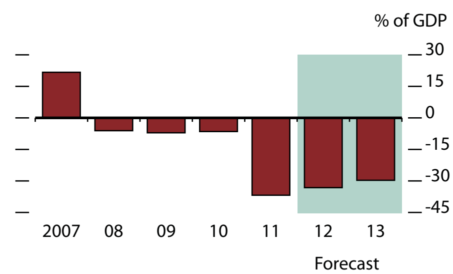
On the upside, medium-term projections do not incorporate some potential new mining investments, including extending the lifespan of the Ok Tedi mine and a second LNG project.

3.33.6 Inflation



Sources: Department of Treasury. *2012 National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.7 Current account balance



Sources: Department of Treasury. 2012 *National Budget. Volume 1. Economic and Development Policies*. http://www.treasury.gov.pg; ADB estimates.

3.33.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.5	4.5
Inflation	7.0	6.0
Current account balance (share of GDP)	-33.2	-29.7

Source: ADB estimates.

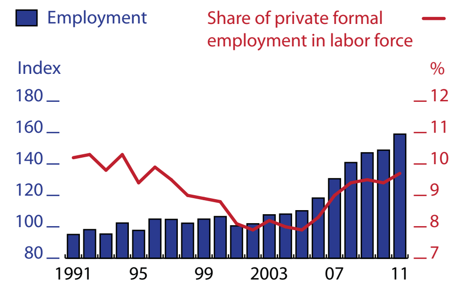
Policy challenge—tackling inequalities

The last decade of economic growth has led to rising inequalities. Mineral exports and resource-project construction have underpinned a 30% increase in real per capita incomes from $1,398 in 2002 to $1,850 in 2011. But the link between economic growth and the welfare of the poor is weak—the country is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 153 out of 187 countries in the 2011 human development index compiled by the United Nations Development Programme.

A major challenge is the limited ability of the public sector to translate higher revenue into improved public services. A lack of socioeconomic data makes tracking performance difficult, but anecdotal evidence suggests that, despite a 120% increase in government expenditure since 2002, the quality of service delivery has remained stagnant and in some cases even declined, particularly in rural areas.

The effects of growth on employment creation are also restricted by the business environment. The country ranked 101 out of 183 countries on the World Bank's 2012 *Doing Business* survey, the lowest in the South Pacific and well behind regional partners in Southeast Asia. So, despite some growth in recent years, the formal private sector remains small, employing less than 10% of the economically active population (Figure 3.33.8) and concentrated in just a few industries such as mining and agriculture.

3.33.8 Employment



Sources: Bank of Papua New Guinea. Quarterly Economic Bulletin. Various issues. http://www.bankpng.gov.pg; PNG National Census 1990; World Bank. World Development Indicators online database (accessed 15 March 2012); ADB estimates.

High inflation has also undermined the inclusiveness of growth. Although wage earners can negotiate higher wages when costs rise, the roughly 85% of the population reliant on cash crops for their semi-subsistence livelihoods have seen their purchasing power deteriorate rapidly in recent years. Further, structural constraints in land and housing markets have restricted the supply response to rising property demand, and contributed to rising rental prices. As a result, an increasing portion of urban residents are now forced to live in informal urban settlements, which have poor access to power and sanitation facilities and which pose significant personal security risks.

Inequality is also growing in villages, reflecting rising compensation payments to incorporated landowner groups made by mining companies for use of land. With low educational and financial literacy levels, members of these groups can rarely hold leaders to account for the equitable distribution of royalty payments.

The government will have a major opportunity to improve living standards when revenue starts to flow to the budget from LNG exports. Inclusive growth will, however, require substantial reforms to public financial management to ensure that higher expenditure improves service delivery. A rejuvenated public sector is also needed to create a more diversified private sector able to create jobs on a broad base, by rehabilitating infrastructure and by pursuing an aggressive structural reform agenda that addresses the pervasively high cost of doing business.