



Population	6.4 million
Population growth	2.0 percent
Surface area	462,840 sq. km.
Capital	Port Moresby

Source: World Development Indicators.

Papua New Guinea's strong economic performance continued in 2010, supported by resurgent minerals production and investment in new projects. GDP is expected to have expanded by 7 percent, following 5.5 percent growth in 2009. After contracting 1.8 percent in 2009, minerals output is estimated to have expanded by 5.4 percent in 2010, despite strikes affecting major mines in the first months of the year. Activity in the non-minerals sector also accelerated, expanding overall by 8.2 percent in 2010 following 5.3 percent growth in 2009, according to Treasury's estimates. This upturn was led by sectors most linked to minerals production and the growing income streams they are generating. Construction, manufacturing and retail trade all recorded 20 to 30 percent increases in the nominal value of sales from the first quarter to the second quarter, according to the most recently published Bank of PNG (BPNG) survey. Activity in the transportation and communications sector, which benefited from deregulation earlier in the decade, is estimated to have grown by near 16 percent in 2010—about half the rate in 2009.

The large PNG-liquefied natural gas (PNG-LNG) project moved towards full construction phase, but suffered temporary disruptions due to landowner actions. Construction of the \$15 billion project's first phase is

scheduled to complete by mid-2014, although there are risks of this slipping. Local landowners have slowed or temporarily halted construction work at various sites in recent months. These interventions generally relate to alleged grievances regarding payment of land use compensation and business development grants by the central government to landowner groups. The central government has started distributing funds and has announced spending plans in anticipation of the PNG-LNG revenues. It contributed PGK 89 million in seed capital to 16 landowner companies in late December, as part of the PGK 120 million License-Based Benefit Sharing Agreement, to assist landowners in LNG project areas to participate in associated businesses. Other announcements include a PGK 157 million plan to build a national broadband network, piggybacking on the PNG LNG fiber-optic cable.

The strong growth in construction and investment activity is creating capacity constraints and inflationary pressures. The PNG-LNG is the largest of a range of significant construction projects, but most of its costs will be on imported goods and services, with the government estimating only 4.5 percent or \$675 million will be retained in the local economy, mostly between 2011 and 2013. But the project is generating a greater momentum. Supply limits are being reached in particular sectors, such as property in Port Moresby and Lae, skilled labor, construction equipment and shipping facilities. Businesses with looser budget constraints—generally the minerals investors themselves—are able to secure supplies and skilled labor by bidding up prices. Established firms, including the public sector, face growing difficulty in retaining staff. But not all households are enjoying an increase in wages and find accommodation costs consuming more of their incomes. Increases in demand and prices are generating a lagged supply response, for example significant investments in new hotel rooms and apartments.

Strong price pressures are concentrated in particular sectors, with overall official inflation near historical averages. The CPI increased by 7.2 percent in the year to the December quarter 2010 but the acceleration was

due to a more-than doubling in betel nut prices; other consumer prices increased by a little over 5 percent over the same period, near the average of the past half-decade. Food prices increased by 5.6 percent in the year to quarter four; meat & fish recorded the largest increases. Apart from the rise in oil prices in the first months of 2011, PNG's consumers have thus far remained insulated from the increase in global commodity prices. Underlying inflation has been more persistent, with the trimmed mean measure at 5.7 percent in the year to the September quarter. PNG's inflation has shifted to being domestically-driven, caused by capacity constraints in the face of the large increases in demand, in contrast with the historical pattern of inflation outbreaks being due to rising import prices. Anecdotes suggest that second round impacts of these tighter market conditions are yet to emerge—for example, higher wage demands reflect tightness in skilled labor markets rather than workers requesting higher wages in anticipation of faster price growth—although a lack of survey data makes such assessments difficult. This inflation is particularly challenging to manage. Tightening monetary policy to the extent required to reduce aggregate price pressures could lead to seriously weakening sectors already suffering from increased competition for inputs from the minerals sectors. Reducing prices of imported items by allowing the exchange rate to appreciate would have a similar effect, particularly impacting cash crop exporters and manufacturers focusing on the domestic market as imports become more competitive. This makes prudent management of government expenditure key to addressing aggregate demand pressures.

The government has returned fiscal policy to a neutral stance, after the significant slippages from the medium-term fiscal strategy (MTFS) in 2009. The 2011 Budget is near balance, following an estimated deficit of 2.7 percent of GDP in 2010 and 8 percent in 2009 (adjusting for trust fund transactions). The 2010 and 2011 budget positions are consistent with the MTFS. In the first eleven months of 2010 the central government recorded a higher-than-expected overall surplus, of PGK 1,574 million, which it used to reduce debt. Total government debt fell to PGK 6.5 billion or

26 percent of GDP at the end of Q3. The budget for 2011 (33.4 percent of GDP) allocates a large share of funds to education, health and infrastructure. The government has also re-engaged in the tax and tariff reform agenda. This year's budget adjusts housing benefits tax exemption rates to better target those with greatest needs. It also sets out a modest tariff reform program, building on the 2007 Tariff Review, that will reduce 'prohibitive' and 'protective' tariff rates towards the intermediate rate of 15 percent by the second half of this decade. The Budget extinguishes some superannuation liabilities and other arrears, following several years when these liabilities were allowed to mount. But the composition of government spending is as important as the overall fiscal stance, as the budget papers discuss. The Development Budget continues its trend increase relative to recurrent spending, with the latter again falling in real terms. Development spending needs to address current capacity constraints, without adding unduly to demand pressures. This may mean sequencing construction-heavy activity later in the medium-term development plan, when it could potentially offset waning demand from the private sector. Financing may be more challenging than envisaged when the development plan was drafted: the Budget projects a small decline in real revenues by 2015 as current minerals production is set to decline before the LNG project becomes active; in comparison the medium-term plan projects an increase in revenue.

The 2011 Budget takes important steps to ensuring that PNG can continue its recent macroeconomic stability even as the importance of volatile minerals revenues grows. Natural resource projects monetize a country's existing natural wealth, and the scale of the PNG-LNG project places a premium on ensuring that future generations benefit from this wealth. This can be done through saving part of the revenue for future generations, and through investing in the country's productive physical and human capacity. The 2011 Budget proposes creating three funds, two of which are to be for these purposes. Natural resource revenues are especially volatile and unpredictable, as the wide swings in oil prices over recent years demonstrate. The third fund seeks to protect PNG's public finances and

economy from these fluctuations by saving revenues when prices are high for supporting public spending when prices are weak. The Budget proposes placing the three funds offshore. This will reduce the pressure on the Kina to appreciate, protecting the competitiveness of PNG's cash crop farmers and nascent manufacturing sector. It will also limit the impact on the already excessive liquidity in the banking system, and improve the effectiveness of monetary policy at smoothing fluctuations in the economy. But achieving these goals requires getting the details of the funds' design right. This will be a politically and technically challenging task and has been assigned to a high-level working group through 2011.

BPNG slightly tightened the stance of monetary policy, to address high liquidity in the banking system. BPNG maintained the Kina facility rate at 7.0 percent through January, for the thirteenth month. It did, however, increase the cash reserve ratio from 3.0 percent to 4.0 percent in October, to absorb ongoing high liquidity in the banking system. The move led to a modest immediate rise in bank bill rates from the 2.4 percent for one-month and 2.9 percent for 3-month tenors in September to rates tens of basis points higher by November, although by January yields had fallen below even these levels; 10-year government bond yields remained near 9 percent. Foreign reserves continued to rise, exceeding \$3 billion by December 2010, approaching 10 months of imports. The Kina appreciated by 2.7 percent to 2.65 per U.S. dollar from end August to late January 2011, although it depreciated by 1.3 percent between August and November 2010 in real effective terms.

Optimism continues to surround PNG's medium-term economic outlook, but the risks are significant, as the government recognizes. Growth is expected to slow only modestly from recent strong rates, towards 5 percent in 2011 and 2012. Consumer prices risk accelerating in 2011 and 2012. The completion of the Household Income and Expenditure Survey and recalibration of the CPI expected later in 2011 and 2012 will give a better indication of Papua New Guineans' cost of living and real spending power. The 25 percent boost to GDP

generated by the LNG project by 2015 is contingent on construction being able to proceed on schedule. And before it comes on-stream, public finances will be pressured by declining revenues as existing mines age and oil wells are depleted. Ensuring that the LNG project is translated into sustained improvements in Papua New Guineans' quality of life requires a robust set of mechanisms such as the Sovereign Wealth Funds currently being contemplated to manage revenues, as well as reforms to improve the effectiveness with which government spending translates into public services. Progress on these fronts could be challenged by intensive factional bargaining within the governing coalition, and the demands of campaigning for the national elections scheduled for 2012.

Papua New Guinea Key Economic Indicators

	2007	2008	2009	2010e	2011f	2012f
	Year	Year	Year	Year	Year	Year
Output, Employment and Prices						
Real GDP (% change y-y)	7.2	6.7	5.5	7.5	5.5	5.5
Tourist arrivals (thousands)	104.1	115.0	123.0	..	..	..
(% change y-y)	34.0	10.4	7.0	..	..	..
Consumer price index (% change y-y)	0.9	10.7	6.9	6.0	8.0	5.0
Public Sector						
Government revenues (% GDP)	36.9	30.5	19.3	29.7	33.4	31.6
Government expenditures (% GDP)	28.4	30.0	27.3	32.4	33.4	30.6
Government balance (% GDP)	8.8	2.7	-8.0	-2.7	0.0	1.0
Domestic public sector debt (% GDP)	18.4	18.9	19.6	17.2	14.5	14.7
Foreign Trade, BOP and External Debt						
Trade balance (millions US\$)	2,193	2,675	1,187	83	-2,098	-1,441
Exports of goods (millions US\$)	4,822	5,823	4,617	5,742	6,391	6,199
(% change y-y)	11.5	20.8	-20.7	24.4	11.0	-3.0
Key export (% change y-y) 1/	4.8	16.0	-17.5	30.4	13.5	0.0
Imports of goods (millions US\$)	2,629	3,148	3,430	5,660	8,489	7,640
(% change y-y)	32.0	19.7	9.0	65.0	50.0	-10.0
Current account balance (millions US\$)	208	805	-541	-2,202	-3,123	-2,457
(% GDP)	3.3	10.0	-6.8	-25.0	-35	-20
Foreign direct investment (millions US\$)	462.7	-31.0	764.0	1,137.0	1,322.0	1,322.0
External debt (millions US\$)	1,978	2,042	2,127	2,273	2,382	3,562
(% GDP)	31.2	25.5	26.9	25.8	26.7	29
Short-term debt (millions of US\$) 2/	48	44	72	93	..	..
Debt service ratio (% exports of g&s)	8.3	5.1	7.0	5.7	5.2	5
Foreign exchange reserves, gross (millions US\$)	2,087	1,988	2,571	3,000	3,300	3,500
(months of imports of g&s)	4.2	4.4	5.6	3.8	4.7	5.5
Financial Markets						
Domestic credit (% change y-y)	5.5	31.3	30.2	25.2	17.0	15.0
Short-term interest rate (% p.a.)	4.4	5.9	7.2	..	..	..
Exchange rate (Kina/US\$, eop)	2.8	2.7	2.7	2.5	2.5	2.5
Real effective exchange rate (2000=100)	96.5	109.4	118.0	113.0	..	..
(% change y-y)	-4.4	13.4	7.8	-4.2	..	..
Memo: Nominal GDP (millions US\$)	6,339	8,009	7,907	8,809	8,922	12,284

Sources: National data sources, IMF, and World Bank staff estimates.

e = estimate

f = forecast

1/ Gold

2/ Banking system short-term external debt only