

Papua New Guinea Economic Briefing

Enjoying the opportunities—and facing the challenges—of resurgent commodity prices



WBPNG 2011-01

1. Overview

Resurgent commodity prices are benefiting Papua New Guinea's economy. The economy expanded at its fastest pace since the early 1990s, as investors built the infrastructure to access the country's rich store of natural resources, and these investments supported business conditions across the economy. This performance appears to be on a more sustainable track than the growth spurt of the early 1990s. But significant challenges remain – from avoiding current capacity constraints leading to an inflation outbreak, to ensuring that the economy is protected from the volatility in resources revenues and that all citizens are able to access the new opportunities these revenues are creating.

2. PNG's economy is benefiting from the resurgence in commodity prices

PNG's economy expanded strongly in 2010, consolidating its recovery from the crises at the start of the decade

Papua New Guinea's strong economic performance continued in 2010, supported by resurgent minerals production and investment in new projects. GDP expanded by 8.0 percent, following 5.5 percent growth in 2009 (one-half to one percentage point faster than earlier estimates), according to Bank of Papua New Guinea (BPNG). This makes 2010 the economy's strongest since the short-lived boom between 1990 and 1993, and the economic consolidation since the mid-2000s contrasts with PNG's volatile economic fortunes over the previous three decades. (Figure 1 and Box 1) 2010's momentum appears to have continued into the first months of 2011.

Surging investment in future mining and energy extraction led the expansion...

The upturn in 2010 was led by sectors most linked to future energy and minerals production and the growing investment and income streams they are generating. This occurred even as current mining and extraction sites neared the end of their lives, and strikes impacted production at some sites in the first months of the year. After contracting by 1¾ percent in 2009, Treasury estimates overall minerals and oil & gas output to have expanded by about 4½ percent in 2010. The opening of the delayed Ramu Nickel/Cobalt mine expected later in 2011 will provide some offset from further declines in production from older mines.

Activity in the transportation and communications sector, which benefited from some deregulation earlier in the decade, is estimated to have expanded by nearly 16 percent in 2010 – itself about half the growth rate of 2009. Manufacturing and retail trade recorded 20 to 30 percent increases in the value of sales from the first quarter to the second quarter of 2010, according to BPNG's survey, and strong growth appears to have continued through the rest of the year particularly for retail sales.¹

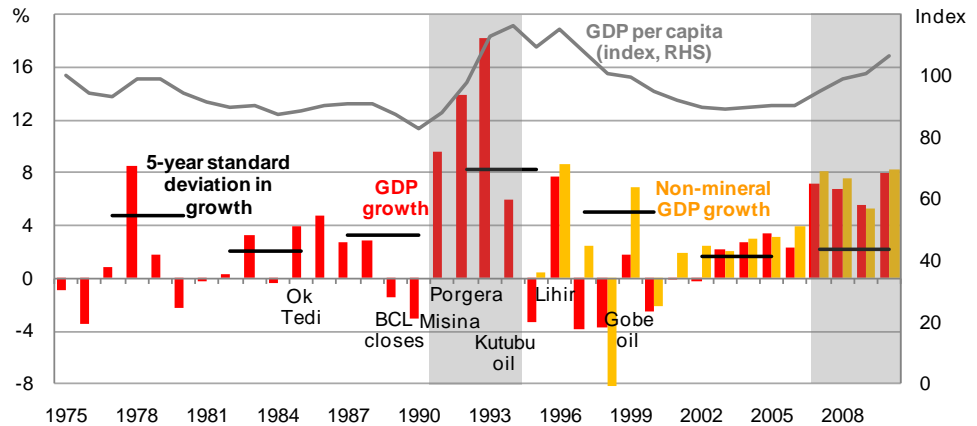
Construction provided the largest contribution to overall output growth. Treasury estimates that construction activity expanded by 14 percent in 2010, slower than in the preceding three years but still contributing more-than one-quarter of the overall increase in economy's output. Much of this surge is due to the PNG-liquefied natural gas (PNG-LNG) project moving towards its full construction phase. The large increase was recorded despite bulk of the construction

¹ Survey results need to be treated with extra caution during periods of rapid structural change in the economy, such as PNG is currently experiencing. New entrants to markets, not included on the register of surveyed firms, may quickly become important participants, meaning that survey results may omit an increasing share of new activity.

materials and much of the labor for the project being imported. Treasury estimates that only 4.5 percent or USD 0.7 billion of the construction investment will be retained in the local economy, although some anecdotal reports suggest that these figures may be conservative.

Figure 1: The strengthening in PNG's economy over the past decade contrasts with the volatility of previous years

(real annual GDP growth, 5-year standard deviation in GDP growth, real per capita incomes indexed to 100 in 1975, and opening dates of major mines; PNG's two growth surges shaded)



Sources: BPNG, Treasury, IMF Selected Issues (2003), World Development Indicators, and World Bank staff

...which is straining productive capacity....

But the project is generating a greater momentum, and its impact extends beyond the work being carried out between the Southern Highlands, the adjacent coastline, and the refinery and port near Port Moresby. The boost in demand it has created has supported investments in hotels, apartments, and retail space, particularly in Port Moresby, and in the productive capacity of businesses located there and in the manufacturing center of Lae. As a result, supply limits are being reached in certain areas, such as property in Port Moresby and Lae, and for skilled labor, construction equipment and shipping facilities. Businesses with less constrained budgets – generally the minerals investors themselves – are able to secure supplies and skilled labor by bidding up prices. Established firms face growing logistical challenges, be it trucking firms to carry their goods, space at the port to ship them, or access to customs officers to process their transaction. In the face of higher living costs, skilled staff are tempted by more lucrative positions with the minerals investors – which particularly affects the public sector with its stricter compensation rules.

...and raising prices

So far the rise in prices has been concentrated in the sectors most affected by the increase in activity and demand, and is yet to spill over into the larger economy, with overall official inflation near recent historical averages. The CPI increased by 7.2 percent in the year to the December quarter of 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 level of the past half-decade. Food prices rose by 5.6 percent in the year to quarter four with meat & fish recording 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. (Box 2) Underlying inflation has been more persistent – for example, the trimmed mean rose by 5.8 percent in the year to the December quarter 2010, near previous quarters' rates.

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 (Figure 12). Issues with survey methodology suggest

that the official CPI is understating price growth. For example, the published CPI reports that ‘rents, council charges, fuel & power’ prices were lower in the December quarter than mid-year. Meanwhile firms involved in the property industry reported that the increase in housing rental prices had accelerated to 15-20 percent per annum from around 5 percent in 2008. Other 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 there are also reports of requests to employers to provide greater housing support, a lack of survey data makes such assessments difficult. In early April the government announced that it will increase public servants’ pay by 7.5 percent on average in each of the following three years, but would not raise direct housing allowances.

Box 1: Recent years’ growth differs in important ways from the short boom of the early 1990s

Papua New Guinea has previously enjoyed sequential years of growth even stronger than in the second half of the 2000s. Between 1990 and 1994 GDP expanded by more than half, raising per capita incomes by 40 percent. In comparison, GDP increased by one-third in the second half of the 2000s, or almost 20 percent per capita, but growth was much less volatile and more broadly-based (Figure 1, 2 and 3) The opening of several mines explained much of the early 1990s’ growth, but a rapid expansion in government spending was supportive too.

Figure 2: Mining output played a stronger role in the earlier surge...

(annual percentage change in real mining activity)

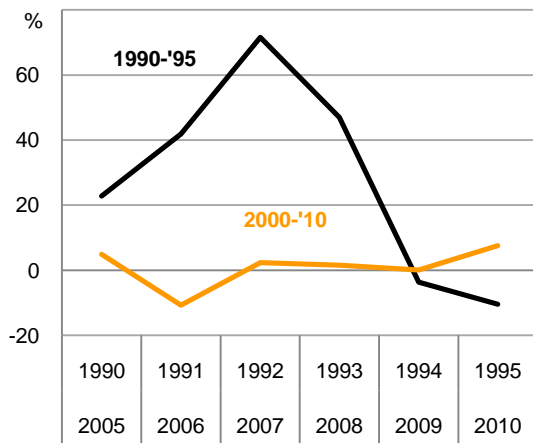
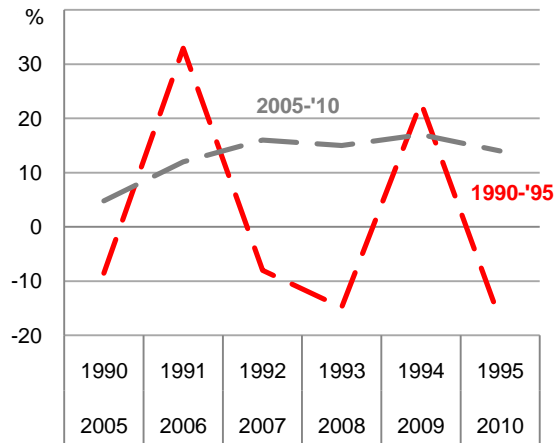


Figure 3: ...in contrast to construction’s role in the recent acceleration

(annual percentage change in real construction activity)



Sources: World Development Indicators and Treasury

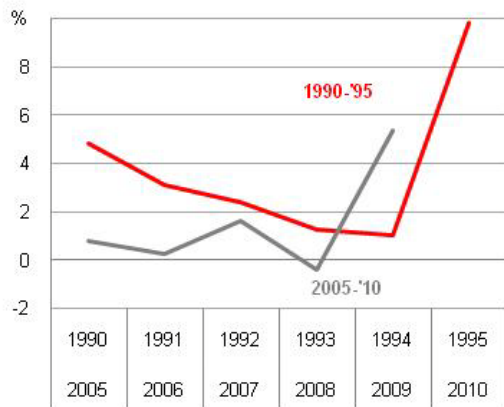
Sources: World Development Indicators and BPNG

The early 1990s’ growth surge coincided with important gains in human development, but these stagnated over the following decade. Maternal mortality rates fell from 340 to 300 per 100,000 live births, and the primary school enrollment rate rose from 65 percent to 72 percent, with greater gains for female enrollment (fewer data are available for recent years). In contrast, in the late 2000s, maternal mortality rates appear to have continued to have fallen, but less rapidly, from 270 per 100,000 births in 2005 to 250 in 2007 (reliable indicators of other are not available).

But the early 1990s growth episode was partially reversed over the following decade. Real GDP per capita fell almost one-quarter, when public finances were often on a weak footing, impacting on delivery of services and maintenance of PNG’s public infrastructure. External imbalances led to the Kina being floated at sharply lower exchange rates in 1994, which precipitated a sharp rise in consumer prices.

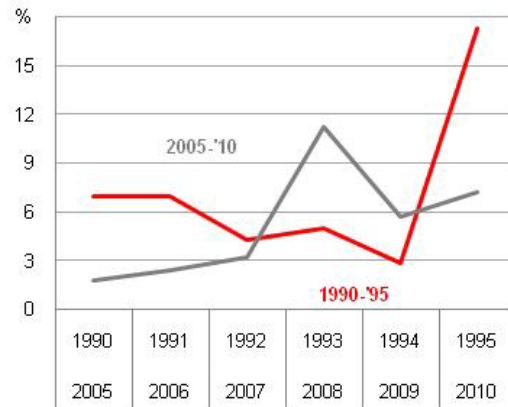
So it is worth comparing the two experiences, towards ensuring that this time PNG is able to sustain strong growth into the long-term and achieve its development objectives of middle-income status. The following graphs illustrate some of the differences. Overall, these indicators suggest that the most recent growth acceleration appears to have been more sustainable than the early 1990s’ experience. The key differences have been the more prudent approach to managing public finances and, at least up to up to 2010, the exchange rate moving with market forces. The result has been less volatile growth. Holding policy to this prudent position will help ensure that it is sustainable through the coming years.

Figure 4: Foreign direct investment accelerated over the course of both growth episodes
(net foreign direct investment as a percent of GDP)



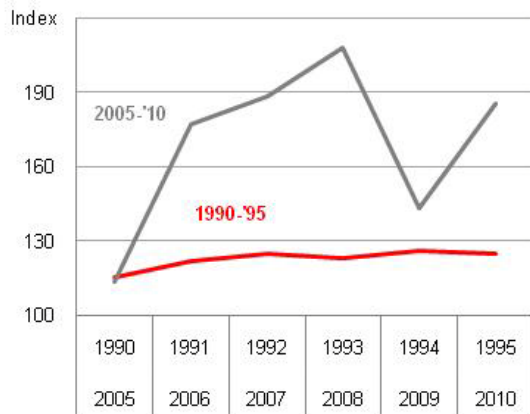
Sources: World Development Indicators and BPNG

Figure 5: ...and Inflation was moderate, at least initially.
(annual percentage change in CPI)



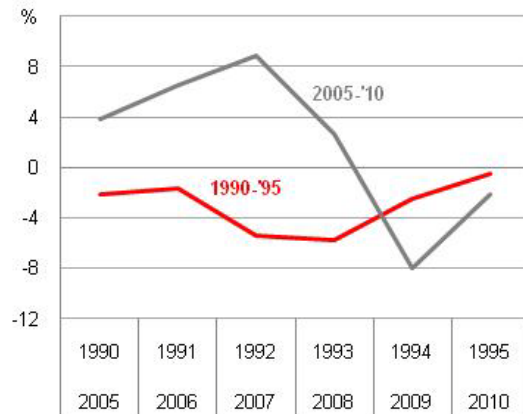
Sources: World Development Indicators and NSO

Figure 6: In contrast with the early 1990s, the late 2000s growth acceleration saw much stronger growth in PNG's export prices
(weighted average export prices, indexed to 100 in 2000)



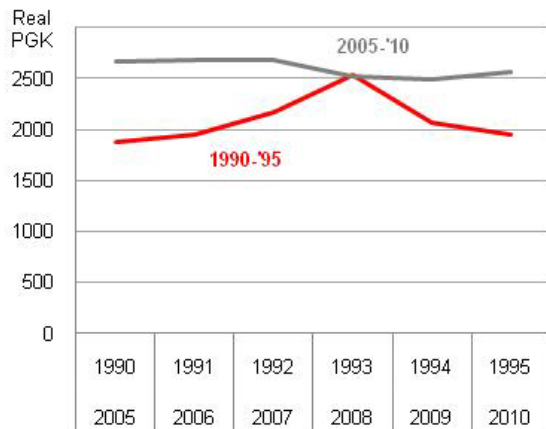
Sources: World Development Indicators, BPNG and World Bank staff calculations

Figure 7: ...helping maintain the budget near balance (despite slippages around the global financial crisis)...
(percent of GDP)



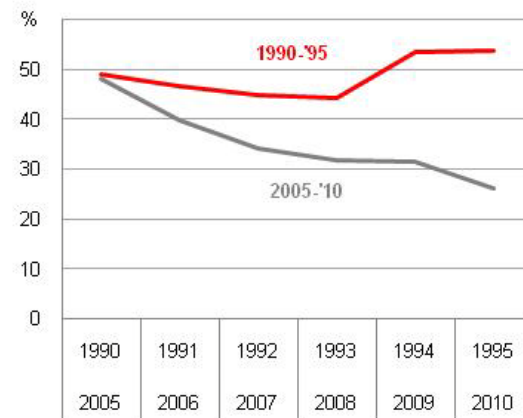
Notes: Budget balances in late 2000s adjusted for financing through Trust Account transactions. Sources: World Development Indicators, IMF and Treasury

Figure 8: ...with stable real government consumption...
(final government consumption expenditure, in constant 2010 PGK, deflated by the CPI)



Sources: World Development Indicators, NSO and World Bank staff

Figure 9: ...allowing the government to cut public debt
(public and publically-guaranteed debt as a percent of GDP)



Source: World Development Indicators and IMF

Figure 10: Meanwhile, in contrast to the early 1990s, reserves have been built... (millions of USD)

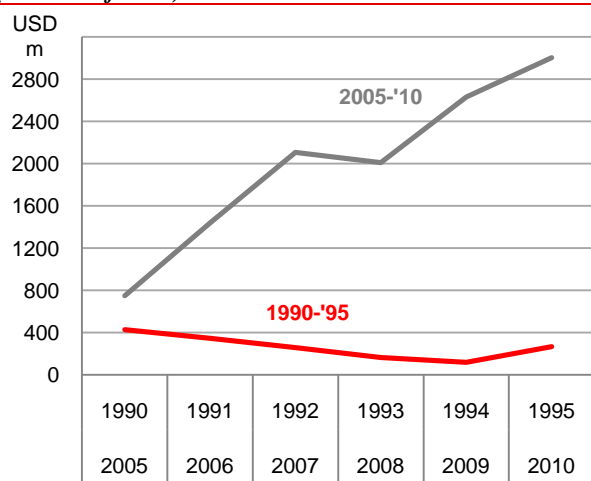
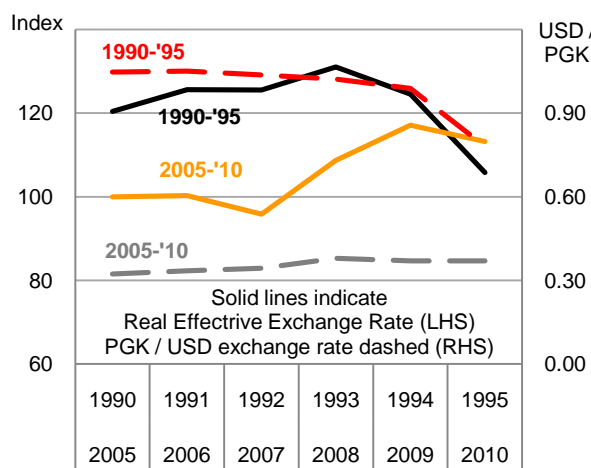


Figure 11: ...and, until 2010, the exchange rate has been allowed to appreciate with the rise in export prices and FDI (PGK per USD, and real effective exchange rate indexed to 100 in 2005)



Sources: World Development Indicators and BPNG

Source: World Development Indicators

Sources: World Development Indicators, PNG Treasury 2011 Budget documents, and World Bank staff

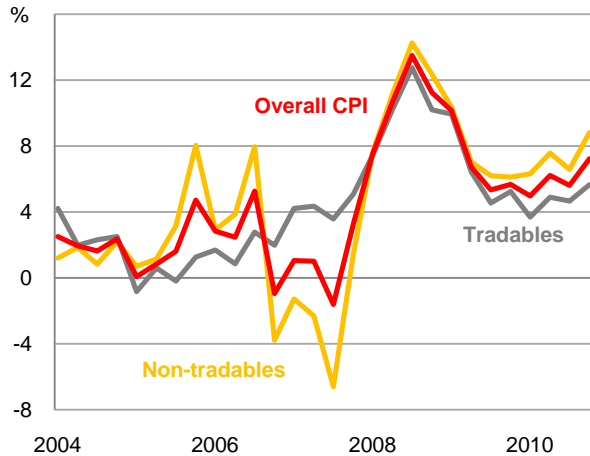
Rising global cash crop prices may be having a net positive impact on rural households

Rising commodity prices may be yet to significantly appear in PNG’s official consumer prices, even if they are impacting consumers with a sweet tooth or cars to fuel. (Box 2) At the same time, higher prices for cash crops are lifting many rural households’ incomes. Non-energy global commodity prices are near historic highs, despite some decline in prices in March, 2011. Palm Oil prices were almost double the levels of twelve months earlier, coffee prices two-thirds higher and copra prices one-third higher in Kina terms. Cocoa prices were stable over 2010, but these levels are at historic highs. Importantly, much (but not all) of these increases in global cash crop prices appears to be passed on to the growers – for example, cocoa exporters’ margins are historically high but stable. (Figure 13)

The rise in international coffee prices has been more recent, with both Arabica and Robusta prices rising by about two-thirds in the twelve months to March in Kina terms, to PGK 16.50 and PGK 6.70 per kilogram respectively. Prices received by growers have almost doubled, with local exporters reporting that growers in the Goroka area receiving PGK 7.50 to PGK 8.00 per kilogram, compared with around PGK 4 per kilogram in early 2010. Industry participants report that this is leading to greater focus on improving yields, through better cultivation of the plants for example. Indeed, this may lead to coffee growing being perceived as a viable profession rather than simply as a source of funds when cash needs are high. But it is also pressuring the informal ‘middlemen’ who connect the growers to exporters, as their working capital needs rise while they continue to face restricted access to finance.

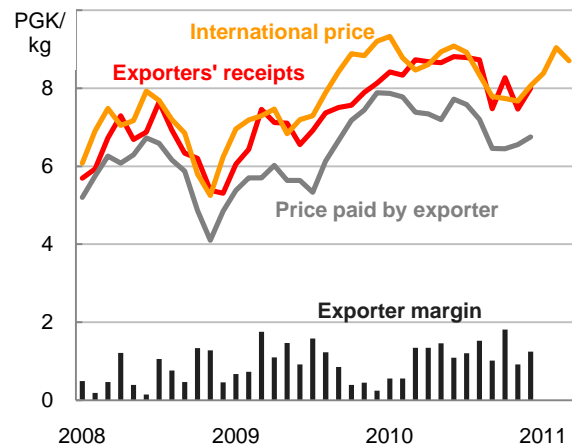
Input costs have also risen, but by less than prices received. Producers generally bear the cost of transporting their produce to the main market centers, and diesel fuel prices have risen by around one-quarter in the past year. Global fertilizer prices have also risen with higher gas prices (international urea prices have risen about one-fifth in Kina terms in the twelve months to March), although cash crop producers in PNG tend to use fertilizers less intensely than in other major producing countries. Industry participants report that the most significant input price shock in recent years was the increase in the national minimum wage from PGK 37.20 per week in mid-2009 to PGK 101.8 per week 40 weeks later. However, the low level of most prices and wages in rural areas relative to this minimum wage means that compliance is patchy.

Figure 12: Local price growth has become a more important driver of inflation
(year-on-year percentage change)



Sources: NSO and World Bank staff calculations

Figure 13: Much of the increase in international cash crop prices is being passed on to growers
(PGK per kilogram, cocoa)



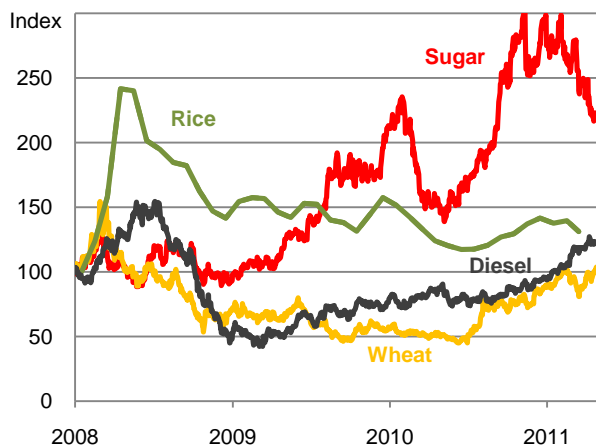
Sources: Cocoa Board of PNG and World Bank international price data

Box 2: Global food and energy prices have risen back to historical highs, but the impact on PNG has been limited...so far

Food prices throughout developing East Asia & Pacific (EAP) rose significantly from the middle of 2010 through to the first quarter of 2011, contributing to the increase in headline inflation in some countries. (Figure 14) The pace of increases in food prices quickened in most countries around the turn of 2011. The rise in prices this time has been slower and smaller than in 2008 – but prices are starting from a higher level, meaning that in March 2011 they were near historical highs again. The situation bears close watch. The 25 percent increase in international grain prices during 2010 did not match the 96 percent increase between the start of 2007 and the mid-2008 peak, while prices for rice - the key regional staple and the main food imported to Papua New Guinea – fell 12 percent over 2010 to be 40 percent below its 2008 peak.

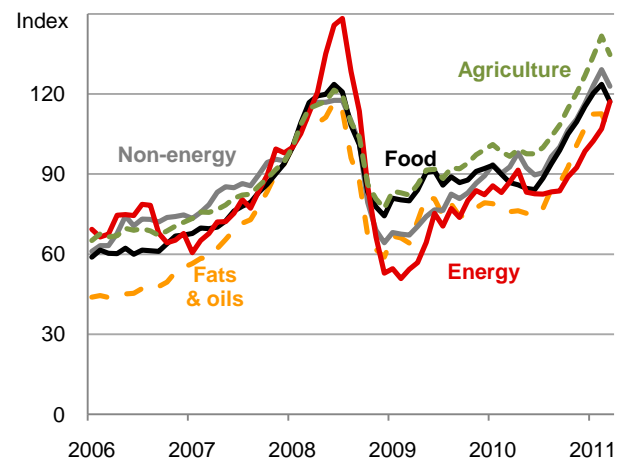
The increase in prices is driven by declining or disrupted supply and growing demand due to rapid growth in the developing countries. Supply has been slow to respond to the growing demand. In food, the supply side impacts of bad weather, as well as preemptive purchases due to the generally unstable global situation, combined with stronger demand, depleted stocks and resulted in higher prices. Similar mechanisms are operating in the oil and fuel markets, with increases in demand accompanied by a lower-than-expected response by OPEC to the recent unrest in north Africa.

Figure 14: Many global food and energy prices rose sharply through 2010 and into 2011...
(indexed to 100 in January 2008)



Source: World Bank international commodity price data

Figure 15: , with the March disaster in Japan and slowing growth elsewhere bringing the first price falls in many months
(indexed to 100 in January 2008)



Source: World Bank international commodity price data

Prices are likely to have peaked, but risk remaining near current levels. While good harvests in East Asia and the Pacific and other regions as well as slower projected growth rates in China and other countries will mitigate food price increases and shortages, these are not expected to resolve the structural gap between supply and demand. Rice prices were declining moderately in several countries in East Asia due to the arrival of off-season varieties, and a good harvest, and this has slowed food price inflation. For oil while slower

projected economic growth will somewhat ease the pressure on prices, structural issues are expected to continue and prices are likely to stay high in the medium-term.

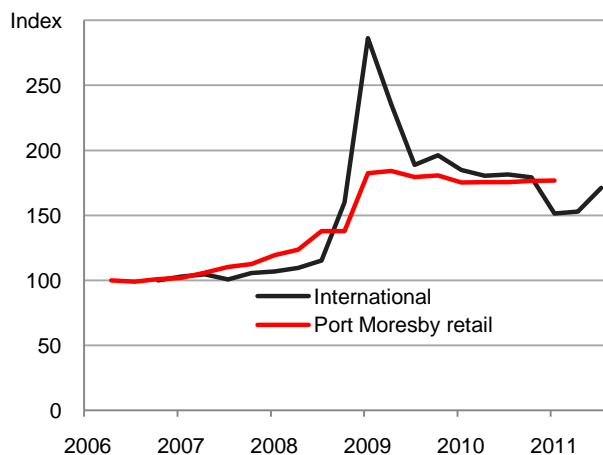
Growing commodity prices pose several major risks to emerging economies like PNG. Rising imported food and fuel prices add to domestic price pressures, accelerating inflation. This will directly impact the urban poor, who spend a larger share of their incomes on imported food prices than the average PNG household.

Fortunately, little of these movements in global food prices has impacted PNG prices to date. In the fourth quarter of 2010 (the most recent data available), food prices as measured in the Consumer Price Index were 5.6 percent higher than a year earlier and cereals prices 4.0 percent higher, below the underlying inflation rate. Indeed this is consistent with experience during the food price increase of 2008, when there was little connection between local and global wheat prices, while rice prices stepped up by only a fraction of the increase in global spot prices.

Most households rely on food they grow themselves, so insulating themselves from global food price movements. Across Papua New Guinea, locally grown foods, dominated by sweet potatoes, provide 68 percent of food energy; in contrast, imported rice provides an estimated 9 percent and flour-based foods 5 percent. (R Bourke & T Harwood (2009) *Food and Agriculture in PNG*, ANU, Canberra.) Gardening even extends to relatively densely populated Port Moresby.

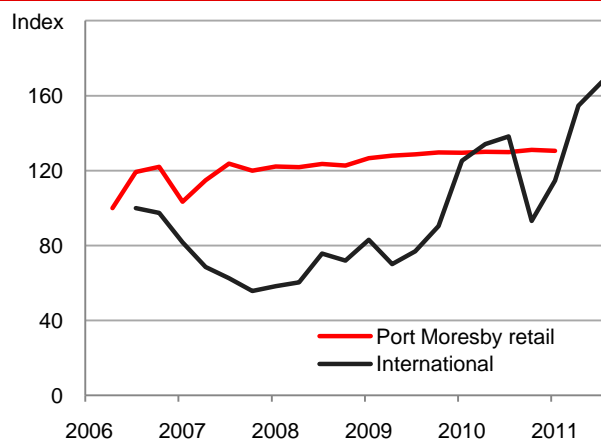
When these food prices do rise, poorer urban households, particularly those in settler communities without access to land, are the most affected. These households are unable to substitute from imported food items to own production. Further, urban households are often less protected by traditional social safety nets due to their distance from their larger family, and that little protection becomes even more strained during periods of food price stress.

Figure 17: ... a loose relationship with international prices for rice, which has been affected by increasing wholesale competition...
(sugar prices indexed to 100 in Q1 2006, international price advanced by 2 quarters)



Sources: NSO, World Bank international commodity price data

Figure 16: The pass-through into local retail prices varies by commodity – with very little in the sugar market
(sugar prices indexed to 100 in Q1 2006, international price advanced by 2 quarters)



Sources: NSO, World Bank international commodity price data, and World Bank staff calculations

Figure 18: ... but a tight connection for fuel prices, suggesting further rises in local petrol price are imminent
(petrol prices indexed to 100 in Q1 2006, international price advanced by 1 quarter)



Sources: NSO, World Bank international commodity price data

Recent rises in fuel prices may have a far larger impact on household welfare. The dispersed and remote distribution of the population means that increases in fuel prices affect all goods, and the one-third increase in global oil prices around the turn of 2011 has only partially appeared in local prices, given the lags in processing, shipping and distribution. Petrol prices rose 5 percent in April to PGK 3.87 per liter (USD 1.52) in Port Moresby, about 10 percent higher than twelve months earlier; diesel and kerosene prices have risen by more. Poorer households in remoter areas, for example in the Highlands, spend a larger share of their incomes on transport and kerosene than households elsewhere (D Mellor (2010), 'Social Impact of Commodity Price Volatility in Papua New Guinea', in *The Impact of the Global Economic Crisis on Poverty and Sustainable Development in Asia*, ADB).

Sources: NSO, UNDP and World Bank staff

3. Policy makers are taking some steps to ensure current growth is sustainable

Managing resurgent commodity prices, and the investment they've brought, is a challenge for economic policy makers

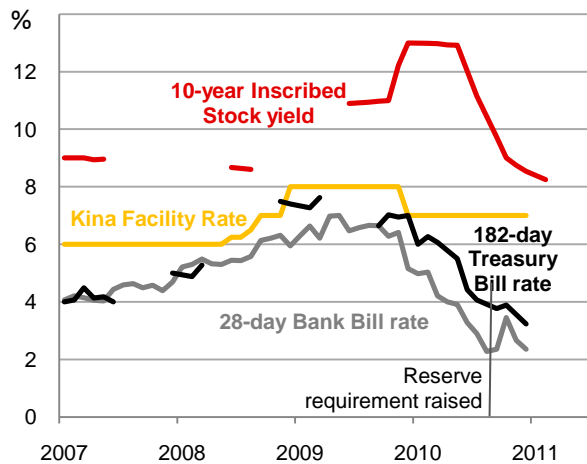
The impact on PNG's economy of resurgent commodity prices and the investment this is bringing presents a new challenge for policy makers. Policy makers need to ensure that the current strength does not become unsustainable, leading to inflation outbreaks. Or that, like the early 1990s experience, higher revenues resulting from the positive shock to PNG's export incomes are not saved for times when prices are low and thus benefits are only short-lived. At the same time, given that only a few areas and industries are able to benefit from higher commodity prices, another challenge for policy makers is how to give all of Papua New Guinea's citizens access to these gains. These challenges are not unique to Papua New Guinea – policy makers from Australia to Brazil, Indonesia, Mongolia and several African countries are grappling with many of these issues.

The stance of monetary policy has tightened slightly

To control inflationary pressures, BPNG slightly tightened the stance of monetary policy. It maintained the Kina facility rate at 7.0 percent through April, unchanged since December 2009. It did, however, increase the cash reserve ratio from 3.0 percent to 4.0 percent in October 2010. This absorbed some of the high liquidity in the banking system – a one percent increase in the reserve requirement (the funds banks are required to hold at the central bank) effectively takes about PGK 120 million out of circulation (at late 2010 deposit levels). The move led to immediate rises in bank bill rates of tens of basis points. But this rise was only temporary: by January yields had fallen back to mid-2010 levels. In response BPNG increased its issuance of short-term paper, which helped lift short-term interest rates back to November levels. Long-term yields continued to fall, with average yields on 10 year bonds at 8.25 percent in February's auction, compared with nearly 13 percent a year earlier. (Figure 19)

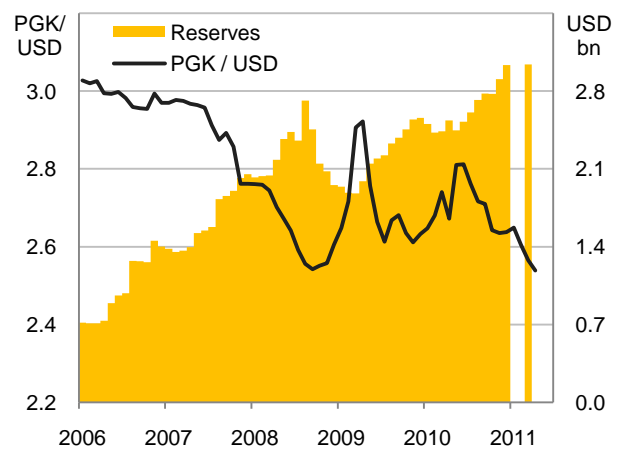
Average borrowing rates have risen very slightly in response to these developments, while deposit rates have fallen slightly, increasing banks' interest margins. Banks' lending to the private sector has continued to grow at 17 to 18 percent year-on-year, keeping pace with the rate of nominal growth of the overall economy. Meanwhile, the policy presented in the 2011 Budget to hold all new government Trust Accounts at BPNG will also reduce the excess liquidity in the banking system. This transition is likely to be gradual, given that the government currently holds over PGK 2 billion at commercial banks in various accounts compared with about PGK 1 billion at BPNG. The broad money supply rose by 10 percent in 2010, aided by higher accretion of foreign reserves.

Figure 19: The increase in reserve requirements had only a fleeting effect on short-term interest rates (interest or yield, percent)



Source: BPNG

Figure 20: Reserves have been accumulating as the Kina appreciates against the weakening USD (PGK per USD and billions of USD of reserves)



Sources: BPNG and World Bank

BPNG has been allowing foreign exchange reserves to accumulate, while the Kina has moved relatively little against PNG's major trading partners' exchange rates

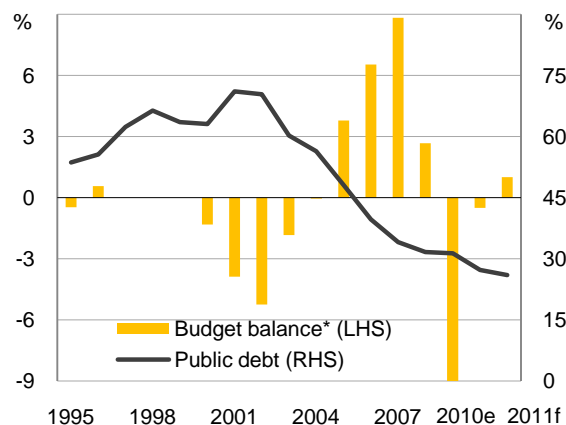
The other tool available to the central bank to reduce inflationary pressures is to allow the exchange rate to appreciate, so reducing the cost of imported goods. The downside to this is that it reduces the Kina income of exporters and the competitiveness of local firms competing against imports (which become cheaper in Kina terms). At present, the impact on exporters' incomes is mitigated by the strength of PNG's export prices. Against the USD, the Kina has appreciated by 5 percent in the year to April 2011 (to 2.54 per USD). But this has been against a weakening USD – the USD has depreciated by at least this amount against most currencies. Against the Australian dollar, the currency of PNG's key trade partner, the Kina has depreciated by 2.3 percent. Foreign reserves continued to rise up to the turn of 2011, exceeding USD 3 billion by December 2010 and remained near that level in late March – amounting to a healthy 10 months of import cover. (Figure 20)

With the 2011 budget, the government has largely unwound 2009's stimulus

The government has returned fiscal policy to a neutral stance, after the significant fiscal impulse and slippages from the medium-term fiscal strategy (MTFS) in 2009. The 2011 Budget is projected to record a modest surplus (near 1 percent of GDP), following a small deficit estimated in 2010 and a deficit of over 9 percent of GDP in 2009 (adjusting for Trust Account transactions). The 2010 and 2011 budget positions reflect a commitment to ensuring fiscal policy operates within the MTFS. In the first eleven months of 2010 the central government recorded a higher-than-expected overall surplus, of PGK 1.6 billion, part of which it used to reduce debt and to address unfunded superannuation obligations. Total government debt fell to PGK 6.6 billion or about 26 percent of GDP at the end of Q4. (Figure 21)

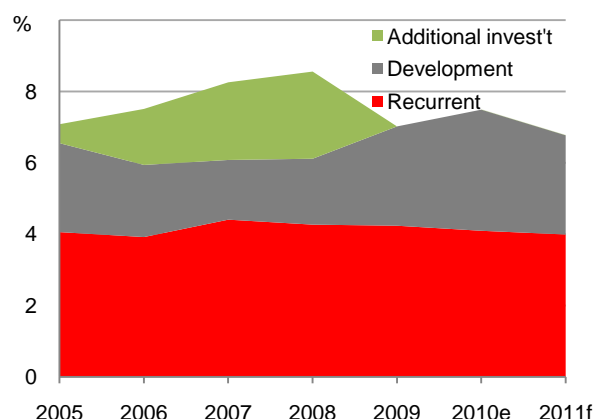
The budget for 2011 (33.4 percent of GDP) allocates a large share of funds to education, health and infrastructure. The government has also re-engaged in the tax and tariff reform agenda. This year's budget adjusts housing benefits tax exemption rates to better target those with greatest needs. It also 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.

Figure 21: 2011's budget unwinds the stimulus of 2009 and resumes the reduction in public debt (percent of GDP)



Note: * Budget balances adjusted for financing through Trust Account transactions. Sources: Treasury, IMF, World Bank staff calculations

Figure 22: ...but continues the trend increase in development spending at the cost of recurrent spending (billions of 2010 Kina, deflated by CPI inflation)



Note: Expenditures have not been adjusted for Trust Account transactions. Sources: Treasury, NSO, World Bank staff calculations

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 flat or falling in real terms. (Figure 22) Development spending needs to address current capacity constraints, without adding unduly to demand pressures. This may mean sequencing construction-intensive programs later in the Medium-Term Development Plan, when they 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, which would fund planned increases in spending.

...and taken important steps to place public finances on firmer ground into the coming years by establishing the basic framework of a system of sovereign wealth funds to manage volatile resource revenues

The 2011 Budget takes important steps to ensuring that PNG can continue its recent macroeconomic stability even as the share of volatile mineral 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. Revenues from natural resources tend to be extremely volatile and unpredictable, reflecting the large swings in the underlying prices. For example, PNG-LNG's revenues will be linked to north Asian crude oil prices, and these are particularly volatile, as demonstrated by the recent swings in crude oil prices, from near USD 150 in mid-2008 to one-fifth of that price in early 2009 to near USD 110 by early 2011.

Ensuring that the wealth from natural resource revenues is shared across generations, and that the volatility in these prices does not destabilize the larger economy, can be achieved through saving part of the revenues, and through ongoing investment of the remainder in the country's productive physical and human capacity. The 2011 Budget proposes creating three Funds. Two of these will be for inter-generational sharing and investment. The third Fund seeks to protect PNG's public finances and economy from these fluctuations by saving revenues when prices are high to support 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 the nascent manufacturing sector once the current peak in commodity prices and construction activity passes. It will also limit the impact on the already excessive liquidity in the banking system, and improve the effectiveness of monetary policy as a tool to achieve macroeconomic stability. But achieving these goals requires getting the details of the Funds' design right, in particular the rules to determine how much to spend out of the Funds and when. This will be a politically and technically challenging task and has been assigned to a high-level working group through 2011.

4. The immediate outlook is positive, but ensuring that it is sustained and shared remains a challenge

Optimism continues to surround PNG's economic outlook...

Optimism continues to surround PNG's medium-term economic outlook, but the risks are significant, as the government recognizes. While the momentum of 2010 is likely to continue into 2011, growth is expected to slow modestly from these strong rates, towards 5 percent in 2012. Consumer prices are likely to accelerate in 2011 and risk rising further in 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, with some concerns about the feasibility of this timetable raised by disruptions at some construction sites in January; the developers have since stated that despite these transitory disruptions, construction overall remains on schedule. Before the LNG project comes on-stream and starts generating significant revenue streams for the movement, public finances will be pressured by declining revenues as existing mines age and oil wells are depleted.

...but significant progress in improving service delivery will be required to ensure this growth is sustained and translates into improved living standards for all Papua New Guineans

Ensuring that current resource investments translate into sustained improvements in Papua New Guineans' quality of life requires both continued solid macroeconomic management and a focus on more effective delivery of public services. The Sovereign Wealth Fund framework currently being prepared to manage volatile resource revenues is one element to this. Reforms to improve the effectiveness with which government spending translates into local public services, and the ability of central agencies to monitor how funds are spent are others. (Box 3 reports on a survey of the characteristics of communities that have received local public investments in recent years.) Resurgent commodity prices, the domestic capacity constraints, and politicians' desire to demonstrate their effectiveness at bringing resources to their constituencies in the lead-up to the 2012 elections are all sources of risks to the immediate outlook. Meanwhile ensuring that PNG's institutions can manage these risks and share access to the benefits of resurgent commodity prices remains the longer-term challenge.

Box 3: Capital spending at the local level – findings of a survey on the link between community involvement and spending

Papua New Guinea has instituted numerous institutional changes over the past fifteen years with the aim of bringing government closer to the people, improving accountability and, by extension, strengthening local infrastructure development and service delivery.

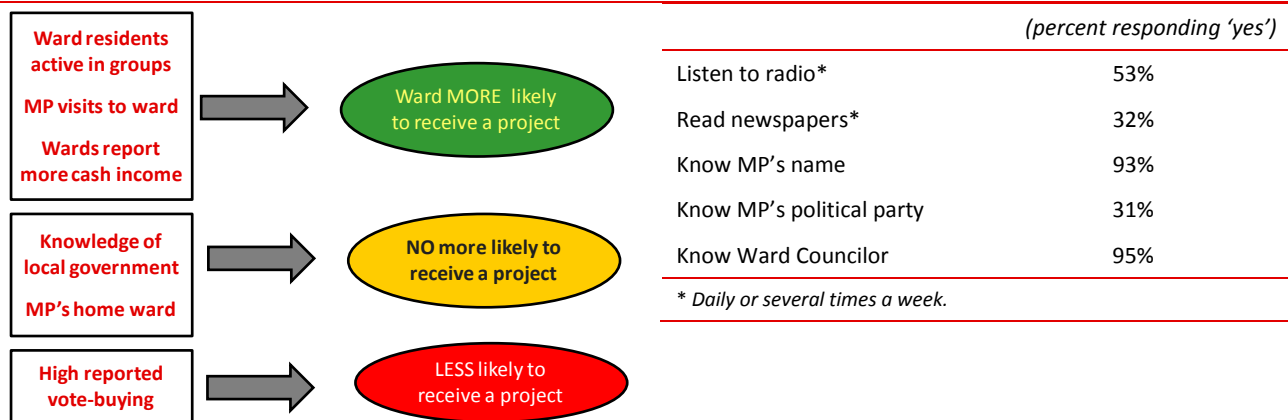
In partnership with the PNG Institute of National Affairs, the World Bank has conducted empirical work to understand the political economy of local level project delivery. In particular, the survey has sought to determine whether institutional changes, such as the constitution of Joint District Planning and Budget Priorities Committees and the institution of Limited Preferential Voting has led to delivery of goods and services to a broader constituency and less conflict-prone development.

Mixed-methods research, including a survey of 1100 households across 49 wards in 9 districts, has found that for those wards surveyed, the most likely predictor of a ward receiving a project is the amount of local collective action, as measured by membership of non-church groups. Knowledge of the local government system has no correlation with project delivery, suggesting a weak effect of the formal institutions for project delivery.

Interestingly, the MPs' home wards appear to have no effect on the delivery of projects, whereas more reports of vote buying is associated with lower project delivery.

The survey also found relatively high levels of community knowledge, as measured by access to news sources as well as strong engagement in political affairs (93% of respondents reported voting in the 2007 election).

Figure 23: Which wards are most likely to report new projects? Figure 24: Media access and knowledge



High levels of engagement together with the strong positive influence of collective action on project delivery suggests there may be merit in developing accountability and feedback measures to link MPs and district development committees more closely with citizens.

Source: Full results are reported in Hasnain, Zahid, Philip Keefer and Nicholas Menzies (forthcoming) 'How Capital Projects are Allocated in Papua New Guinean Villages: The Influence of Local Collective Action, Local-level Institutions, and Electoral Politics', World Bank.

This Papua New Guinea Economic Briefing was prepared at the World Bank office in Papua New Guinea, drawing on material produced across the World Bank Group. It reports on and synthesizes recent quarters' key developments in the national economy, assesses the outlook, and some implications for future policy. It is intended to prompt further discussion of economic issues in Papua New Guinea among a wide audience, including policy makers, business leaders, and the community of analysts and professionals engaged in Papua New Guinea's development.

Tim Bulman (Country Economist) prepared this Update, under the direction of Vivek Suri (Lead Economist, Pacific Department). It benefited from comments and suggestions from members of the PNG World Bank Group country office team, and was reviewed by the World Bank in Papua New Guinea Country Manager, Laura Bailey. Media queries should be directed to Raymond Palangat (rpalangat@worldbank.org).