

CHAPTER 2. ECONOMIC OUTLOOK

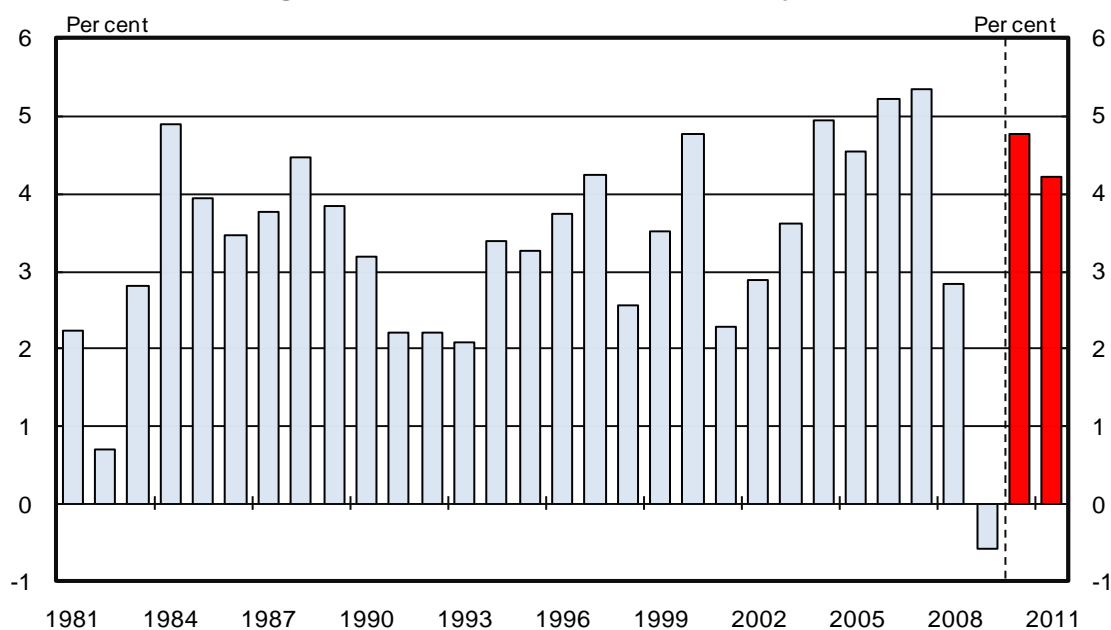
2.1 INTERNATIONAL ECONOMIC OUTLOOK

World Economic Growth

The global economic recovery in 2010 has been firmer than expected. However, a number of setbacks has made the recovery more fragile and uncertain. At the beginning of the year, there was optimism that the worst was over, owing to the strong and decisive actions by governments around the world in containing the fallout from the financial crisis. This optimism quickly evaporated in mid-May when the sovereign debt crisis broke out in the Euro area, firstly in Greece and then in Portugal, Spain, Italy and Ireland - this was a major setback and dented confidence in the sustainability and strength of the global economic recovery. Heightened market volatility and declining risk appetite induced by the selling of sovereign debt instruments in the Euro area shook banking systems in the region. Moreover, some economic data indicated that recovery in the US economy was not as strong as anticipated, increasing the chances of the US economy slipping back into another recession. There were also fears of a stronger than anticipated slowdown in China, as the Chinese Government attempted to cool overheating parts of the economy. However, despite these setbacks the global recovery has continued, driven by the emerging and developing economies, particularly China.

The International Monetary Fund (IMF) in its October 2010 World Economic Outlook (WEO) projects the global economy to expand by 4.8 per cent in 2010. This solid growth is expected to be driven by the emerging and developing countries, mainly China, India, Brazil and other Asian Economies. In advanced economies, economic growth is expected to remain slow and sluggish.

Figure 1: World Economic Growth Projections



Source: International Monetary Fund (IMF)

In 2011, world economic growth is projected to moderate slightly to 4.2 per cent. In advanced economies, growth is expected to slowdown, as fiscally-constrained governments withdraw fiscal stimulus at a time when private sector demand remains weak and may not be able to fill the void. In emerging and developing economies, economic growth is projected to moderate from the second half of 2010 and into 2011.

Advanced economies are expected to grow by 2.7 per cent in 2010. This is relatively low considering that these economies are recovering from the deepest recession since World War II. The US economy is expected to grow by 2.6 per cent in 2010, with output still well below pre-crisis levels. Much of the weakness is due to sluggish personal consumption – by far the biggest component of US GDP. There are several reasons for this weakness. First, household net worth has deteriorated sharply, due to significant falls in US housing prices. Second, unemployment is high, with the duration of joblessness continuing to lengthen. The weak labor market has affected incomes and the ability to obtain credit, and there is job uncertainty for those currently employed. Third, banks are still reluctant to lend to consumers, as they struggle to reduce leverage and restore balance sheets. In 2011, US economic growth is projected to moderate to 2.3 per cent, as consumer demand is expected to remain weak, and as the adjustment in the financial and public sectors continue.

Japan and the Euro area are expected to grow by 2.8 per cent and 1.7 per cent respectively in 2010. Output levels are also below pre-crisis levels. In Japan, the recovery has been largely driven by external demand. Growth in the Euro area picked up in the second quarter of 2010 which was led by Germany. While this presents a modest recovery, the Euro area heavy dependence on bank credit is restraining demand as banks continue to be unusually cautious in lending. Economic growth is expected to moderate in 2011, with Japan and the Euro area growing by 1.5 per cent. This reflects the winding down of policy stimulus as there is little flexibility in government finance to continue to stimulate growth, sluggish consumer demand, persistent high unemployment and weaker external demand expected from major trading partners, especially from the US.

Emerging and developing economies are expected to expand by 7.1 per cent in 2010. China continues to be the key driver of growth, with the economy's strong position before and after the crisis powering growth in the rest of Asia. Proactive policy measures implemented in response to crisis has provided the backdrop for continued strong growth in China. With the recovery well and truly on a solid footing, the economy is now in the middle of a transition from public to private sector led growth. Other strong performing emerging and developing economies include India and Brazil. Growth in emerging and developing economies is expected to moderate slightly to 6.4 per cent in 2011, largely reflecting the expected slowdown in China's rate of growth as it moves to cool some of its overheating sectors, and the winding down of policy stimulus across the region.

Going forward, for a sustained and healthy recovery to gain a more stable foothold, economies with large public deficits and debt will need to formulate a credible pathway back to fiscal sustainability. At the same time, fiscally constrained governments will need to consider the appropriate timing for withdrawal of public stimulus so as not to derail recovery efforts. The financial sector, which was at the heart of the global financial crisis in 2008, will need to continue the process of repair and reform. In addition, for a balanced recovery, both the advanced and emerging and developing economies need to work together to correct some of the external imbalances that exist in the global economy.

Over the medium term, world economic growth is projected to average 4.5 per cent per annum. This is slower than the growth witnessed in the five years leading up to the

global financial crisis and is largely due to the time needed for the earlier discussed adjustments to be implemented in both the advanced, and emerging and developing economies. Downside risks remain elevated and are a concern as markets and institutions are expected to remain fragile for some time.

Unemployment

Unemployment in advanced economies has receded only modestly from peak levels. Current estimates are that more than 210 million people across the globe are unemployed, an increase of over 30 million since 2007. Around three-quarters of the increase occurred in the advanced economies, with the remainder in emerging market economies.

In the United States, the unemployed face record-long periods of joblessness, with recent payroll data pointing to a slowdown in employment growth in the second quarter of 2010. In the Euro area, the labour market showed signs of resilience in Germany, taking into account the magnitude of the recession. However, in Spain, unemployment is not showing any signs of coming down from high levels. This has been attributed to labour market rigidities and the collapse of the construction sector. In the emerging and developing economies, unemployment has broadly declined in line with the strength of the recovery.

Inflation

Inflation in the advanced economies is projected to remain low amid concerns of high levels of excess capacity and unemployment. In 2010, inflation is forecast to be a mild 1.4 per cent, up from 0.1 per cent in 2009. In 2011, inflation is expected to remain muted at 1.3 per cent, as economic growth remains sluggish. Under present circumstances, deflation is the more pertinent risk for some of the advanced economies, as risks to activity are clearly on the downside: households remain saddled with appreciable debt; the financial system remains vulnerable; and expectations could gradually catch up to actual inflation, putting further downward pressure on prices and wages.

In contrast, inflation in emerging and developing economies has picked up quite strongly since 2009, as emerging and developing economies have rebounded much more strongly than advanced economies following the global recession. In 2010, inflation in the emerging and developing economies is forecast to be 6.2 per cent, compared to 5.2 per cent in 2009. In 2011, inflation in emerging and developing economies is expected to ease to around 5.2 per cent, as inflationary pressures ease due to the moderation in the pace of economic growth.

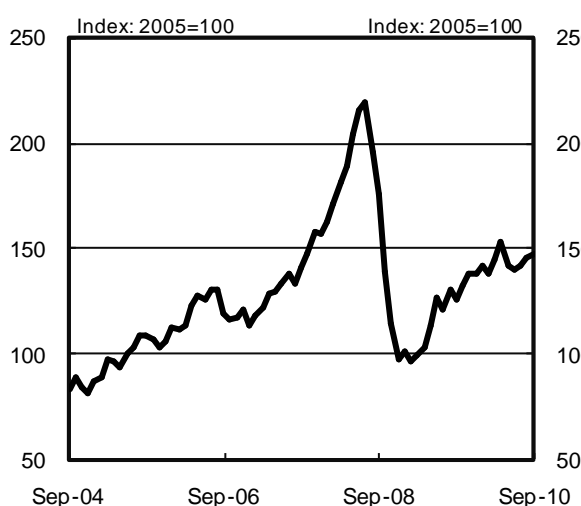
Commodity Prices

Commodity prices have experienced some sharp swings since the global financial crisis. This has been associated with an unusual degree of uncertainty in the global economy, where the recovery remains fragile and uneven. In 2010, commodity prices have continued to rebound from the large falls observed in late 2008 and early 2009. However, the path of recovery has been volatile as financial markets seek clear directions of the global economic recovery from mixed economic signals. In general, commodity prices strengthened in the beginning of the year with growing optimism in the global economic recovery. This stalled around May 2010 with the onset of the sovereign debt problems in the Euro area, combined with concerns regarding the strength of the US economic recovery and the slowdown of Chinese economic growth. Commodity prices have picked up strongly again in the second half of 2010. While some of the recent price increases can be attributed to changes in

economic fundamentals, there is a concern among some analysts and commentators that prices for some commodities have been influenced by speculative behavior and the weakening of the US dollar. In this uncertain environment, it is possible that those speculative expectations may not eventuate, which could lead to the possibility of a sizeable decline in commodity prices.

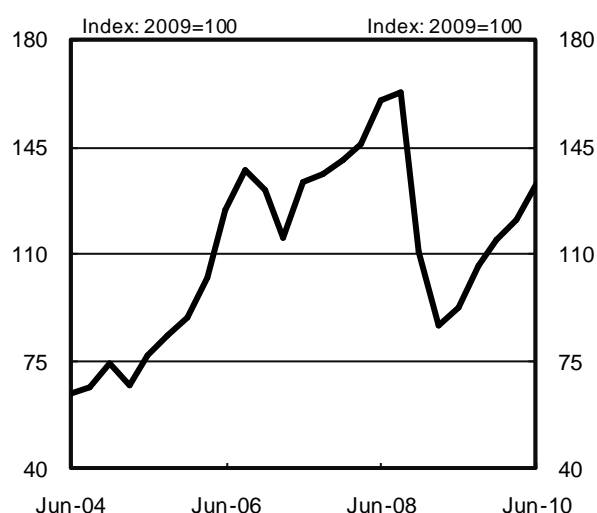
The IMF All Commodity Price Index shows that commodity prices have increased across the board (Figure 2). In September, prices increased by 4.0 per cent since the beginning of the year, and are 17.0 per cent higher compared to September 2009. However, for the PNG economy and government revenue the PNG Export-Weighted Price Index is the more relevant indicator (Figure 3). This shows that prices have increased by 9.0 per cent since the beginning of the year and are 44.0 per cent higher in the June quarter 2010 compared to the same time last year.

Figure 2: IMF All Commodity Price Index



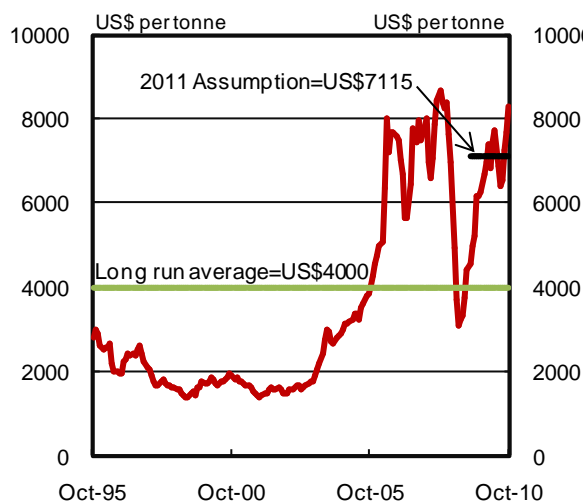
Source: IMF and Bank of Papua New Guinea

Figure 3: PNG Export Weighted Index

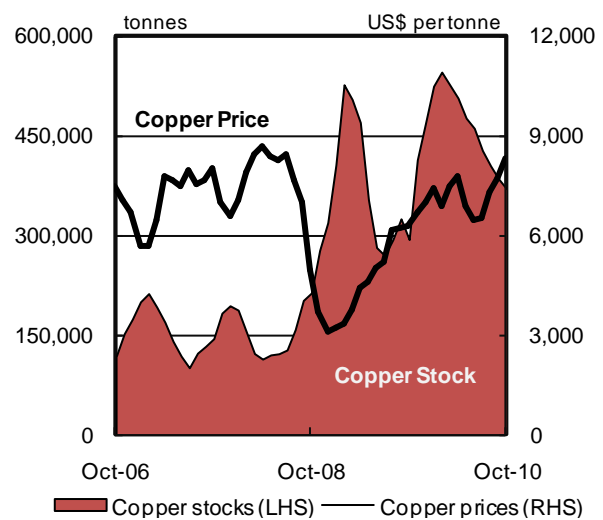


The following discussion are centered on the main mineral, petroleum and agricultural commodities that PNG exports.

Copper prices surged higher in 2010 as the global economy improved. Early in the year, copper prices peaked around US\$7,950 per tonne. As discussed earlier, the growing uncertainty surrounding the global economic recovery led to spot prices falling to US\$6,100 per tonne in June. Prices have since surged higher with spot prices trading above US\$8,500 per tonne in October (well above long-term prices), driven by weakness in the US dollar and the strong growth of capital-intensive emerging economies. To the end of October 2010, copper prices averaged around US\$7,286 per tonne, which is 41.0 per cent higher compared to the average price in 2009.

Figure 4: Copper Prices

Source: Department of Treasury & London Metals Exchange

Figure 5: Copper prices and stocks

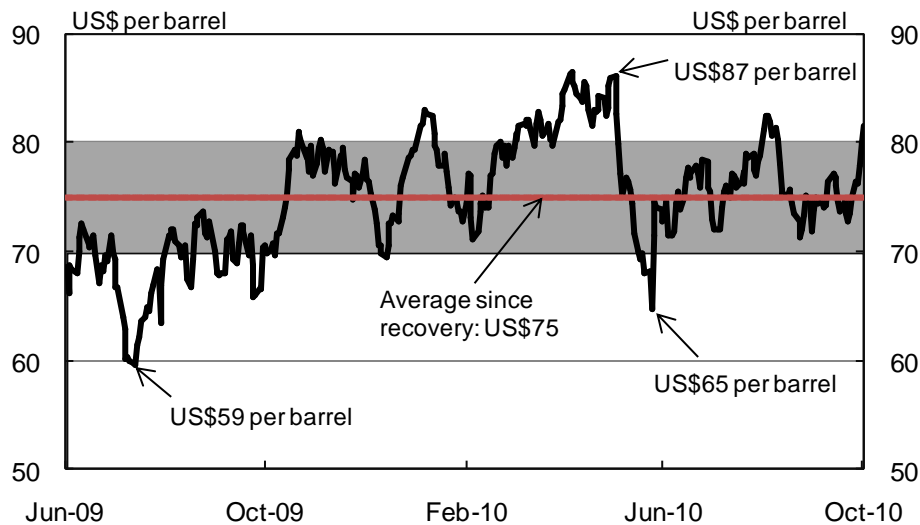
Interestingly, copper prices are now approaching the previous peaks experienced in late 2007. However, Figure 5 shows that previous peaks were associated with relatively tighter supply (as indicated by the low stock levels in the London Metals Exchange).

Copper prices are assumed to average US\$7,115 per tonne in 2011. This assumption takes into account the anticipated increase in future consumption demand, especially in emerging economies, and the possible risk of a pull back in prices due to the fragile state of the global economy.

Oil prices have also increased in 2010, rebounding from lows in late 2008 and early 2009. In 2010, oil prices increased to as high as US\$87.0 per barrel before falling to around US\$65.0 per barrel in May. Prices have since recovered, to be above US\$80.0 per barrel in October 2010. To the end of October, the West Texas Intermediate (WTI) oil prices have averaged around US\$78.0 per barrel in 2010, which is 26.0 per cent higher compared to the average price in 2009.

Figure 6 shows that prices have largely traded between US\$70.0 to US\$80.0 per barrel since the middle of 2009.

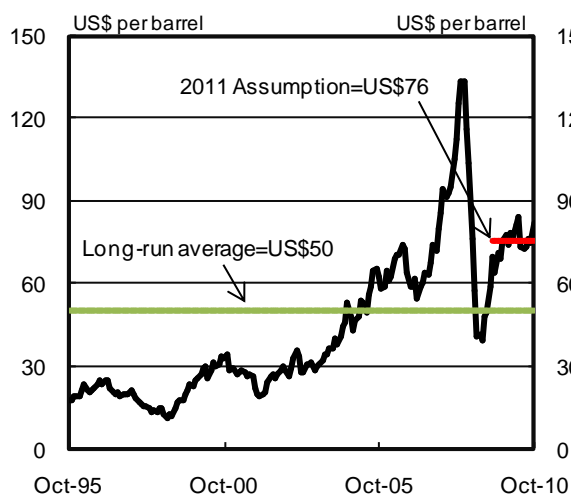
Figure 6: Oil prices



Source: Department of Treasury and US Energy Information Administration

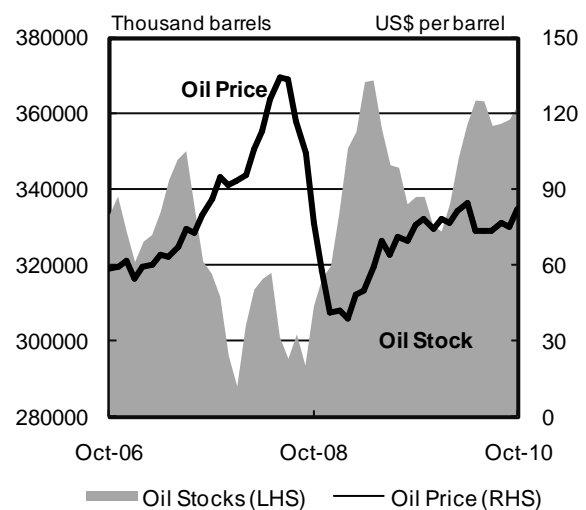
According to Saudi Arabia, OPEC's most influential member, an oil price between US\$70.0 and US\$80.0 per barrel is ideal. In addition, non-OPEC oil producers have also increased supply, driven by high oil prices and the low cost of production. Combined with the relatively high level of oil inventory in the United States (the world's largest oil consumer – see Figure 8), this could curb any substantial price increases in the near term. In 2011, oil prices are assumed to average US\$76.0 per barrel, consistent with the price range observed in 2010.

Figure 7: Oil Prices - Long Term



Source: Department of Treasury and US Energy Information Administration

Figure 8: Oil prices against stocks



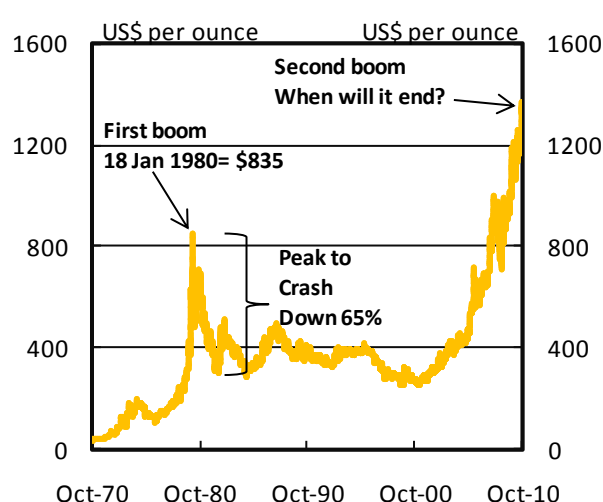
Gold prices have continued to rise sharply in 2010 to record levels, increasing by as much as 20.0 per cent since the beginning of the year. Gold's safe haven status and the weakness in the US dollar has played a significant role in the rapid increase in gold prices, with gold trading well above US\$1,300 per ounce in October 2010. The surge in gold prices into record territory has been quite rapid. As discussed earlier, while changes in fundamentals support some of the increases in commodity prices, the strength and pace at which prices have moved in 2010 have raised concerns that a gold price bubble may be developing. To the end of October, prices have averaged around US\$1,194 per ounce in 2010, which is 23.0 per cent higher compared to the average price in 2009.

The current boom in gold prices which started in early 2004 has seen the price increase by over 200.0 per cent. As shown in the Figure 10, a similar boom in prices also occurred in the late 1970's when prices rose rapidly. However, after reaching a peak in January 1980, prices crashed, falling back very sharply. It is important that previous episodes of commodity price surges and falls are not forgotten when assessing the rapid rise in the price of some of these commodities. The gold price is assumed to be US\$1,150 per ounce in 2011, taking into account the possibility of pull back in prices should the US dollar strengthen and the world economic recovery becomes more stable.

Figure 9: Gold Prices

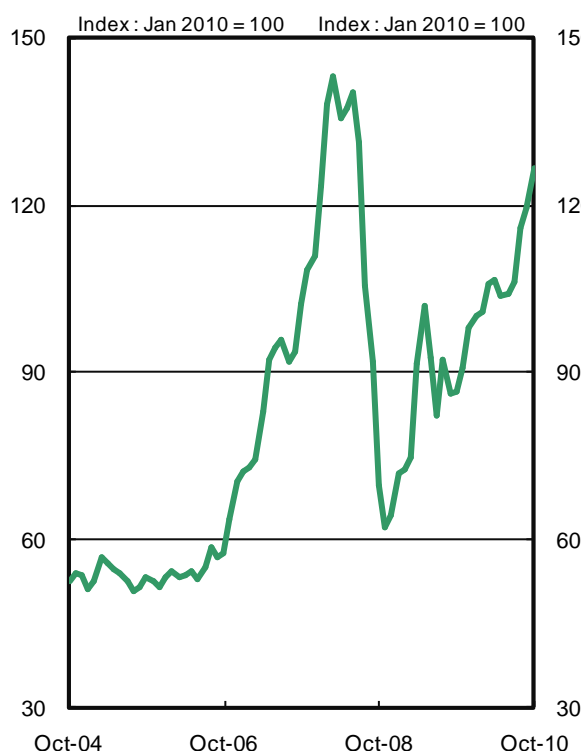
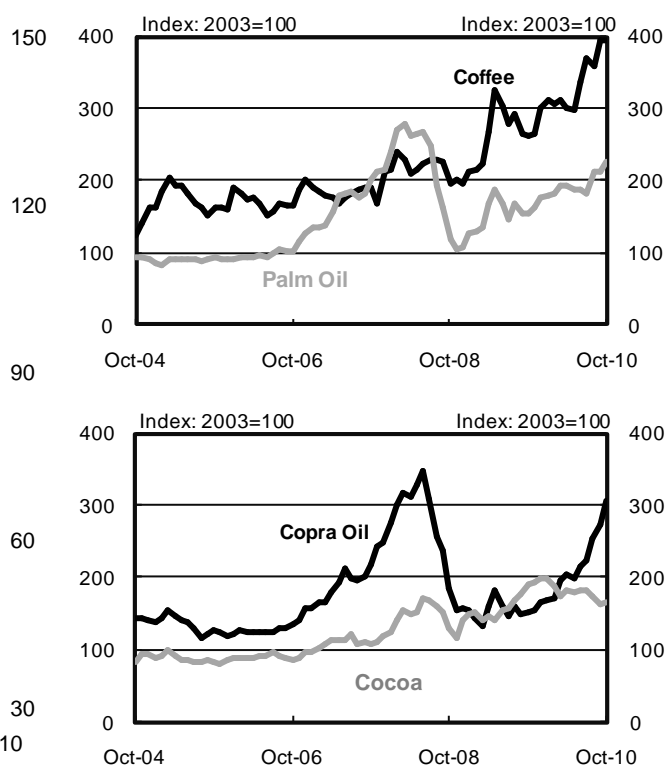


Figure 10: Tale of Two Gold Booms



Source: Department of Treasury and Bank of England;

Prices of agriculture commodities have also rebounded in the first half of 2010 and are expected to grow stronger in 2011 from their lows in late 2008 and 2009. As shown in Figure 11, the Export Weighted Agricultural Price Index, which tracks growth across key export commodities in the agriculture sector, has increased by as much as 27.0 per cent since the beginning of 2010 and is 46.0 per cent higher in October 2010 than a year earlier. The improvement in the global economy at the beginning of the year has seen demand for agriculture commodities improve significantly and this has been supported by some concerns of tight supply due to lower global agricultural stocks. This has left the market more vulnerable to supply disruptions than would have normally been the case. On average in 2010, the price of palm oil have traded around US\$808 per tonne, coffee around US\$226 per tonne, cocoa around US\$3,162 per tonne and coconut oil around US\$1,027 per tonne.

Figure 11: PNG Export Weighted Agriculture Price Index**Figure 12: Price Index of Key PNG cash crops**

Source: Department of Treasury and Reuters

There will be challenges for commodity prices to sustain strong increases in 2011, as world economic growth is expected to moderate slightly. Given the influence that commodity prices have on government revenue in PNG, the commodity price assumptions have been formulated taking into consideration the improving global economy and the aforementioned risk.

Exchange rates

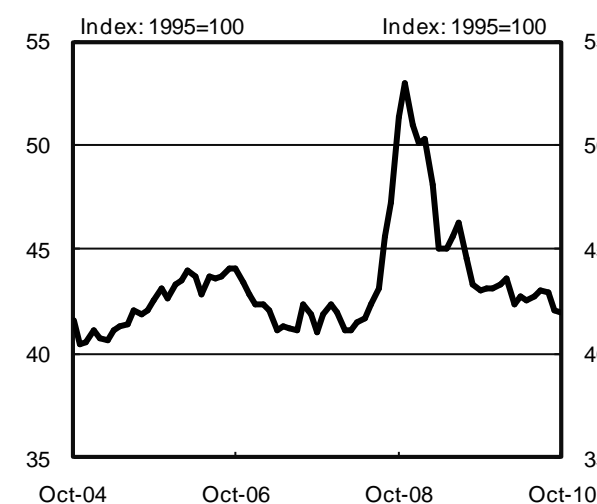
PNG's Import Trade Weighted Index (TWI) depreciated slightly by 2.5 per cent over the year to October 2010. The lower import TWI compared to the corresponding period of 2009 has been largely driven by the depreciation of the Kina against the Australian dollar, Malaysia ringgit, Japanese Yen, and Singapore dollar. The Kina depreciated by 9.0 per cent against the Malaysian ringgit, 7.5 per cent against Japanese Yen, 5.7 per cent against Australian dollar and 4.9 per cent against the Singapore dollar. This has been partially offset by the appreciation of Kina against Euro by 8.8 per cent and the US dollar by 2.0 per cent.

Against the major trading currencies, the Kina has fallen in value against the Australian dollar, driven by the strength of demand for the Australian dollar. Unlike other advanced economies, Australia did not experience a recession and has emerged from the global downturn relatively quickly, with a robust financial system and low unemployment. Furthermore, strong commodity prices and relatively high interest rates compared to other economies has made Australian denominated assets more attractive. The depreciation of

the Kina against the Australian dollar is expected to increase inflationary pressure in the PNG economy, with rising import cost passing through to higher consumer prices.

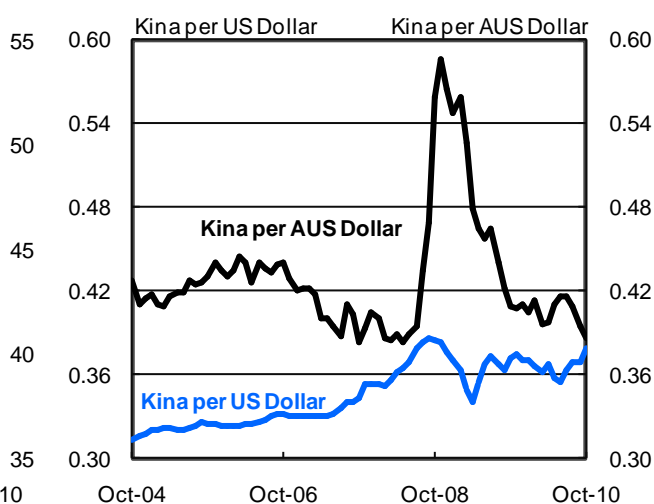
Against the US dollar, the Kina has appreciated by 2.0 per cent over the year to October 2010. This partly reflects the expectation of quantitative easing (injection of liquidity) by the US Federal Reserve, which further reduces the value of the US dollar and mining companies moving funds into PNG to meet tax obligations. The slight rise in the value of the Kina against the US dollar is likely to marginally reduce the Kina value of US denominated export earnings.

Figure 13: Imported Weighted Trade index



Source: Bank of PNG and Department of Treasury

Figure 14: Exchange Rate Developments



Source: Bank of PNG and Department of Treasury

2.2 DOMESTIC ECONOMIC OUTLOOK

The outlook for domestic economic growth is very positive, with the PNG economy forecast to grow uninterrupted for the eleventh consecutive year in 2011. This is an impressive achievement, considering that over this time there have been a number of challenges, especially with the global financial crisis in 2008 and the subsequent global recession in 2009. To a larger extent, the progress of the PNG economy can be attributed to a more stable political and macroeconomic environment. This has been supported by the Government's prudent fiscal management and microeconomic reforms, which have created a more dynamic and competitive environment. Substantial progress has also been made in reforming and strengthening PNG's financial infrastructure.

In 2010, the PNG economy moved into a new phase, with the commencement of the PNG LNG project, the largest private sector investment undertaken in this country. For 2011, the economy is expected to continue to grow strongly, as the construction work of the PNG LNG project ramps up. This is anticipated to bring substantial benefits to a number of industries in the economy, either through the direct provision of goods and services to the project or indirectly through increased spending in the economy.

However, while this is a welcome development, a key challenge for the Government is to ensure that price stability is maintained in the face of significant inflationary pressures that are likely to arise in the near term.

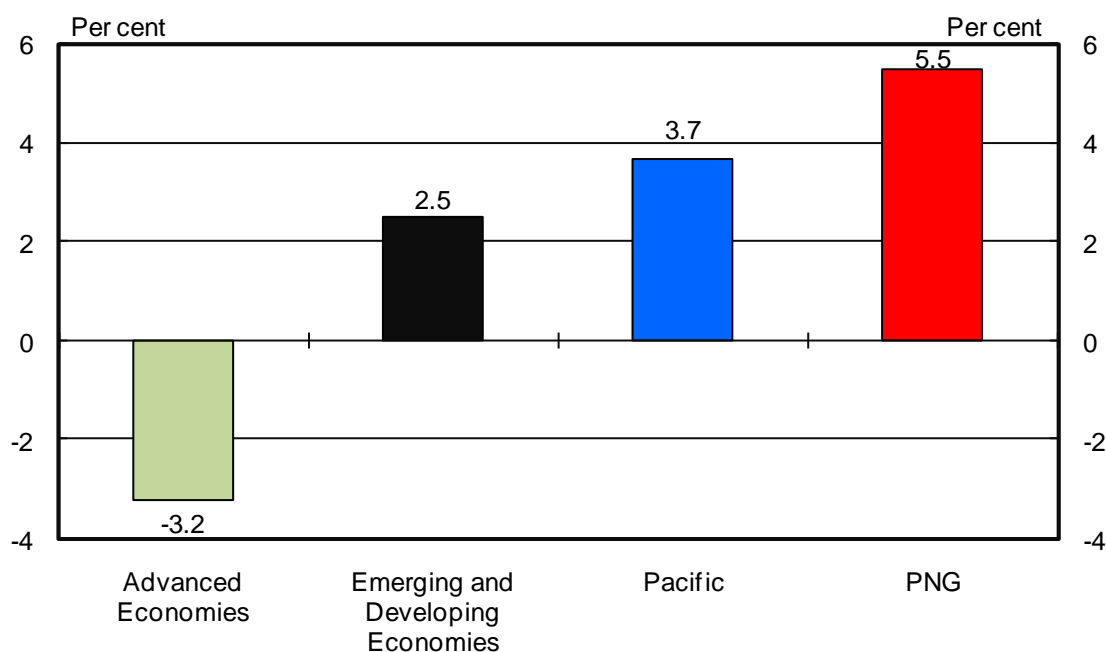
2.3 GROSS DOMESTIC PRODUCT

2009 Update

The PNG economy was able to navigate the global recession in 2009 better than expected. Business activity remained solid, buoyed by the expectation of the PNG LNG project commencing and confidence remained high following two very strong years of economic growth in 2007 and 2008. The financial sector was also resilient to the problems faced overseas, due to a strong domestic funding base, relatively low exposure to troubled international instruments and well managed balance sheets. This allowed the finance industry to continue its important role of supporting economic growth through financial intermediation to the private sector. The most heavily affected sectors were the agriculture, forestry and fisheries and manufacturing sectors, which experienced a decline in export demand and prices, due to the contraction of global demand.

The economy grew by an estimated 5.5 per cent in 2009, which was lower than growth experienced in 2008 but higher than the 4.5 per cent forecast at the time of the 2010 Budget. Total estimated non-mining GDP grew by a strong 6.3 per cent in 2009, down from 7.6 per cent in 2008. Figure 15 shows that despite the softer growth in 2009, the PNG economy performed relatively well during the global recession.

Figure 15: Comparative Economic Growth in 2009



Source: Department of Treasury for PNG growth estimate, IMF for advanced, emerging & developing economies and ADB for the Pacific estimate.

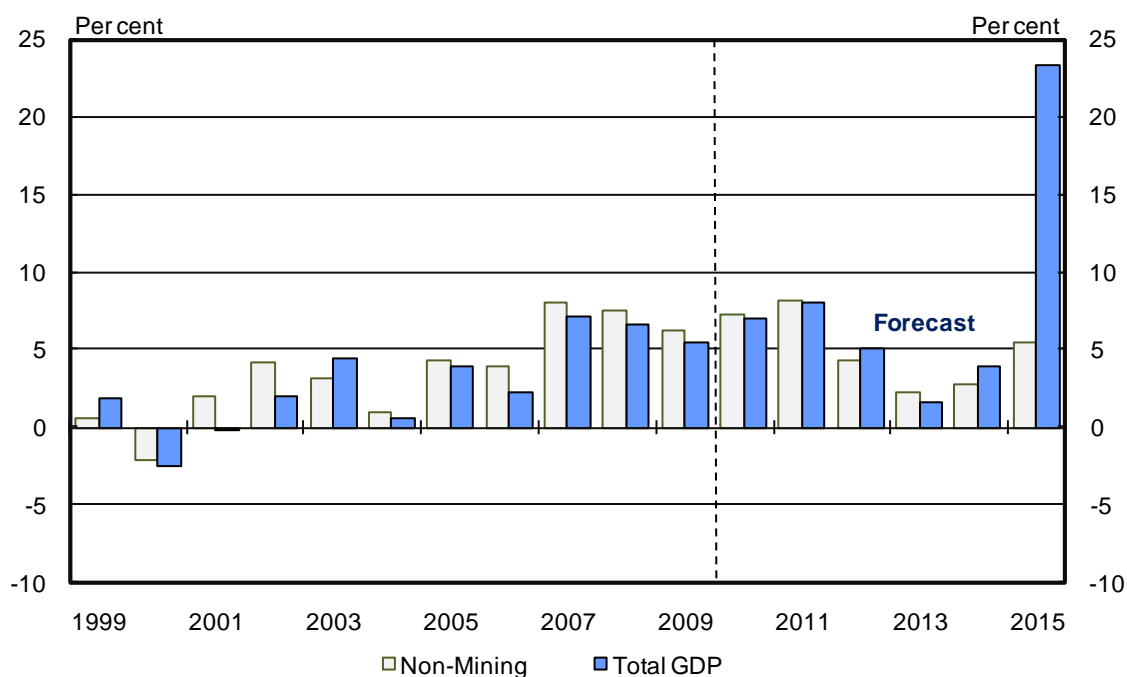
2010 Update

The PNG economy is expected to rebound and grow very strongly at 7.1 per cent in 2010. This is lower than the 8.5 per cent forecast at the time of the 2010 Budget and 7.5 per cent projected in the Mid-Year Economic and Fiscal Outlook (MYEFO). Although economic growth has been somewhat slower than anticipated in the first half of the year, economic

activity is expected to pick up in the latter half of 2010 driven by the expected ramp up in construction activity associated with the PNG LNG project. The downward revision from the previous updates is due to a number of factors.

- A number of mines have experienced a range of problems that have led to lower productions; these include Ramu Nickel, Ok Tedi and Porgera.
- Coffee and Cocoa production is expected to be lower in 2010 due to weather related issues and cocoa pod borer.
- A slight delay in the construction work of the PNG LNG project in 2010. The project has been affected to some extent by landowner issues delaying progress at different stages during the year. However, the commencement of LNG production in 2014 is not expected to be affected.

Figure 16: Economic Growth 1999 - 2015



Source: Department of Treasury

The mining and quarrying sector is expected to grow by 7.6 per cent in 2010. This is much higher than 0.1 per cent growth in 2009 due to the commencement and progression of production at some of the new mines, including Ramu Nickel and Hidden Valley. However, the forecast growth is well below the 2010 Budget projection of 23.4 per cent, reflecting the downgrade revision to first year mine production at Ramu Nickel and lower than expected copper and gold production at Ok Tedi due to the strike action taken by employees in April. In addition, lower gold production is also expected from Porgera following unfavorable weather conditions, infrastructure related issues and illegal mining activities affecting mine operations during the year.

The oil and gas extraction sector is expected to decline by 4.6 per cent in 2010. This is slightly better than the decline of 18.6 per cent forecast in the 2010 Budget. There have

been some improvements in the production process at Kutubu, Gobe and SE Mananda in 2010, which has improved extraction rates, resulting in the upward revision in 2010. Overall, the oil and gas sector continues to decline, reflecting the natural production decline in all existing oil fields.

Total non-mining GDP is expected to grow at 7.3 per cent in 2010, up from 6.3 per cent in 2009.

The agriculture, forestry, fisheries sector is expected to grow by 3.5 per cent in 2010. This follows weak growth of 0.7 per cent recorded in 2009, which saw trade disruptions due to the global recession. The rebound reflects higher production across most agricultural products, driven by stronger commodity prices on global markets. While this is a solid rebound, it is slower than the 2010 Budget projection of 4.8 per cent. The downward revision to growth since the 2010 Budget is mainly due to lower than expected coffee and cocoa production in 2010. The recent dry weather experienced in the coffee growing regions of the Highlands has affected production for the first half of the year. In addition, the negative impact of the cocoa pod borer continues to affect production in East New Britain, leading to a downgrading of total production from the main cocoa producer in the country. Offsetting these negative developments in coffee and cocoa are the stronger forecast production for palm oil and copra, as more farmers are tending to their plantations in response to higher prices in 2010.

The construction sector is expected to grow by a very strong 14.0 per cent in 2010. The expansion of private sector development has already seen the construction of a number of residential and business complexes, especially around Port Moresby and Lae. While growth is slightly lower than the 17.0 per cent experienced in 2009, activity is at high levels, reflecting very strong growth in this sector over the past few years. Growth in the sector is also being limited by capacity constraints.

The transport, storage and communication sector is expected to grow by 16.5 per cent in 2010. According to Treasury's business liaison visits, more expansion is expected in the communication segment, with the roll-out of additional mobile phone site towers in 2010. The transport and storage segment is also expected to experience strong growth, with increased demand for transport and storage services associated with the increased activity flowing on from the PNG LNG and other mining projects.

The manufacturing sector is expected to grow strongly by 6.0 per cent in 2010, rebounding from 0.2 per cent in 2009. This is attributed to improving global demand and a stronger domestic economy. Visits to businesses indicate that the vibrant domestic economy has translated into higher disposable incomes, which is having a positive impact on consumer spending for locally manufactured goods. Businesses in this sector have also noticed that consumers have become more sophisticated and are demanding a wider variety of goods. This has seen local manufacturers improving the range of products they deliver into the market, as well as a greater demand for imported goods.

The electricity, gas and water sector is expected to grow strongly at 8.7 per cent in 2010, driven by the additional activity generated by the PNG LNG project. However, according to Treasury's business liaison visits, the sector is also facing a wider range of infrastructure problems relating to power lines, dams and roads, which are affecting current services and expansion plans. The Government is mindful of these issues and is working closely with the relevant State Owned Enterprises to solve some of these issues.

Wholesale and retail trade is forecast to grow by a strong 12.0 per cent in 2010. Businesses have pointed out that the exceptional economic growth over the past few years has created more employment opportunities in the economy and higher wages. Combined with the increase in the minimum wage, this has led to an increase in household disposable incomes, providing a positive impetus to consumption spending.

Finance, real estate and business services is expected to grow by 9.5 per cent in 2010, driven by strong demand for financial services as businesses are expected to continue taking advantage of increased investment opportunities associated with the PNG LNG project and the strong domestic economy. Real estate and business services are also expected to increase in line with strong economic activity.

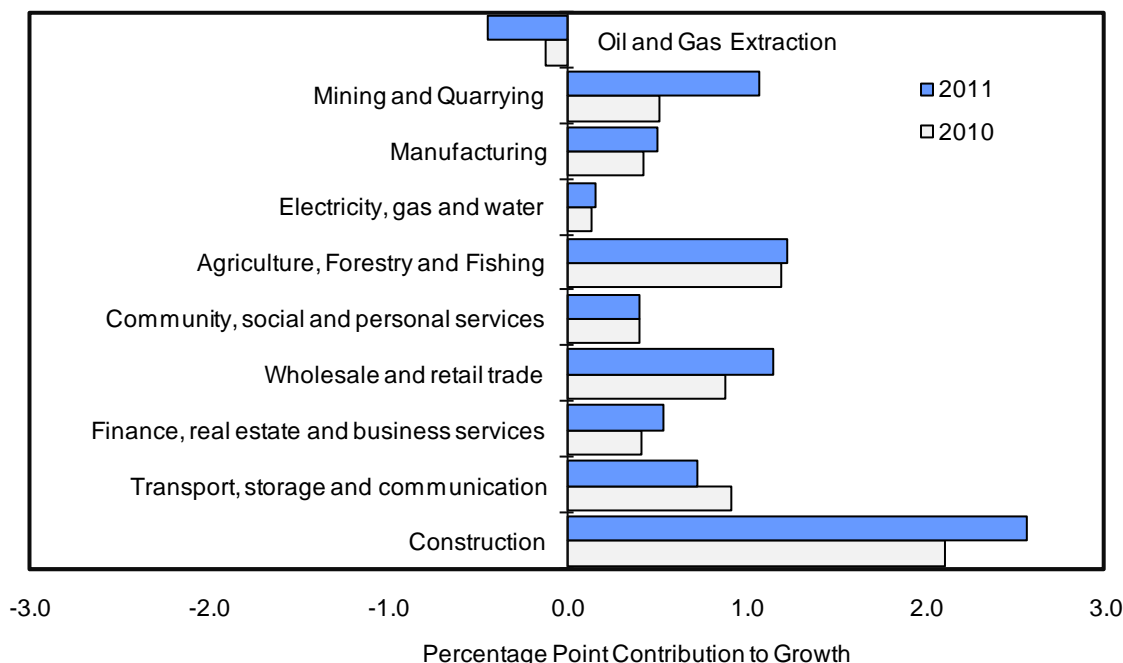
2011 Outlook

Real GDP is expected to increase by a strong 8.0 per cent in 2011, largely driven by the expected ramp up in PNG LNG construction, which will have a direct impact on the construction and transport sectors. The additional activity created by the PNG LNG project is also expected to provide a significant boost to activity in other parts of the economy, with rising incomes and consumption from businesses and households. Conditions in the global economy are expected to remain supportive of the export-orientated industries.

Economic growth in 2011 has been revised up from the 2010 Budget forecast; this largely reflects the expected delays in the construction phase of the PNG LNG project in 2010 being pushed into 2011 and the resumption of normal production activity in a number of major mines that experienced some difficulties in 2010.

The mining and quarrying sector is expected to grow by a very strong 15.6 per cent in 2011, largely due to the ramp up of production at the Ramu Nickel mine. This is supported by higher production at Ok Tedi and Porgera, which are expected to return to normal operations following disruptions in 2010. Smaller new mines like Simberi and Hidden Valley are also expected to contribute to growth as they improve capacity in 2011. The petroleum sector is expected to decline by 19.5 per cent in 2011, due to lower extraction rates from maturing oil fields.

Non-mining GDP is expected to grow by 8.2 per cent in 2011, largely driven by stronger growth in the construction and wholesale and retail trade sectors. All non-mining industries are expected to expand in 2011.

Figure 17: Contribution to growth by sectors, 2010 and 2011

Source: Department of Treasury

The agriculture, forestry, fisheries sector is expected to grow by 3.7 per cent in 2011. This is higher than in 2010 and reflects an expected rebound in coffee production after the weather related disruptions in 2010. Despite this, the coffee bi-annual season remains unpredictable and poses some risks to production if a negative season unfolds. Other cash crops like cocoa, copra and palm oil are also forecast to expand, driven by high prices and improved growing conditions.

The construction sector is expected to grow by a very strong 16.0 per cent in 2011, driven by construction activity created by the PNG LNG project, higher Government investment and strong private sector investment that has risen as a result of the rapid expansion in the domestic economy. The slight acceleration to growth from 2010 reflects the deferral of some construction projects in 2010 into 2011, in particular some of the PNG LNG construction. However, Treasury's business liaison visits indicate that capacity is tightening in the economy, particularly in the construction sector. The availability of scarce resources is also likely to constraint the growth of domestic construction activity. Increasingly, additional construction projects will need to be undertaken by foreign firms, which will have a smaller value add to production in PNG.

The transport, storage and communication sector is expected to grow by 12.0 per cent in 2011. Activity in this sector will be driven by the continuing expansion in the mobile phone industry, as service providers make additional investment to improve coverage and attract more users. This includes the roll-out of additional site towers and introduction of a wider range of products into the market. The transport and storage sector is also expected to grow strongly to meet the demands of the PNG LNG project and the increased business activity in the domestic economy. Overall, growth is slightly lower than in 2010, reflecting some maturation in the communication sector, which has experienced tremendous growth over the past few years.

For the rest of the economy, the ramp up in the PNG LNG project is expected to provide a boost to activity, as increased profitability, higher employment and strong wages and salary growth flows through to a number of sectors that do not have direct links to the project. Strong double digit growth is expected for wholesale and retail trade, finance, real estate and business services and electricity, gas and water.

Medium Term Outlook

Economic growth is expected to ease over the medium term, especially in 2013 when the PNG LNG construction phase winds down. In addition, the declining production from the maturing oil fields and the slowdown of activity at Ok Tedi as it moves to closure in 2014 (pending expansion plans) will have a negative impact on growth. Strong performing sectors such as construction and communication are also likely to grow more slowly than in previous years. Nevertheless, the medium-term forecasts do not yet incorporate the prospect of a second LNG project coming on stream, which provides upside risk to the forecasts presented. In 2014 and 2015, PNG LNG production is expected to come on line, providing a very large boost to GDP growth.

Agriculture, Forestry, Fisheries

Over the medium term, the agriculture sector is expected to expand, especially in the palm oil industry, which is expecting improved capacity through new mills and replanting programs. While copra production is also expected to grow, it is highly sensitive to prices and is likely to contribute to growth as long as prices remain high in the medium term. Coffee production depends on the weather conditions and the bi-annual season. The cocoa industry is expected to continue its implementation of improved farming techniques and to carry out awareness in relation to the cocoa pod borer as the industry continues its efforts to educate farmers about better ways to sustain production.

The forestry sector is expected to decline, as most key logging licenses expire and as most logging species become scarce. The sustainability of logging is a concern and the Government needs to consider ways of reforestation to improve the sustainability of the industry. The fisheries sector is expected to maintain solid growth over the medium term, driven by downstream activities and improved community related programs aimed at improving small business. The National Fisheries Authority is also expected to undertake a program in the medium term aimed at providing fish farmers with credit facilities in an attempt to support local businesses in the industry.

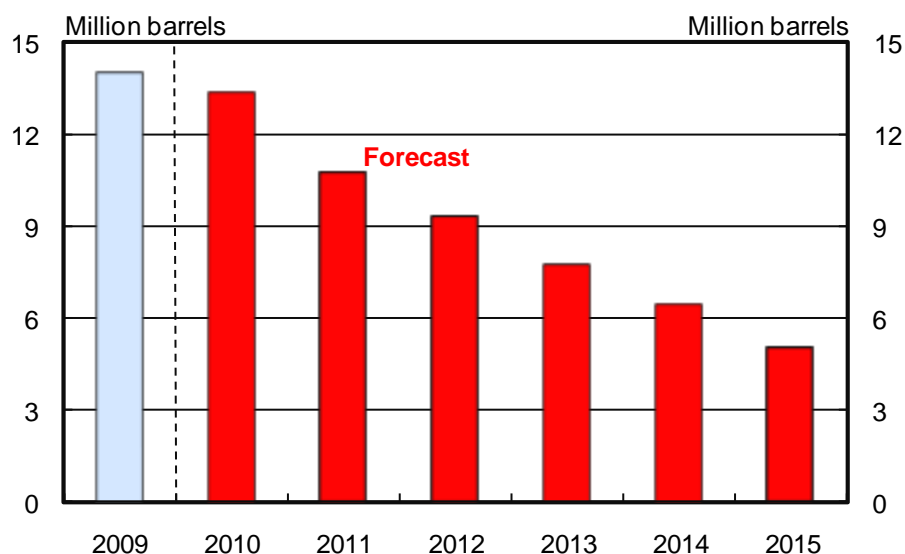
Mining and Petroleum

The Mining and Quarrying sector is expected to grow very strongly in 2011 and 2012 as recent and new mines realise full production. However, in 2013, production is expected to decline as mature mines like Ok Tedi wind down operations and prepare for closure in 2014. Ramu Nickel is expected to commence production in the latter stages of 2010, ramping up to full production in 2012, with production expected to remain steady thereafter.

The declining trend of oil extraction is expected to continue to weigh down on the Petroleum sector, with production rates expected to decline from around 13 million barrels expected in 2010 to 5 million barrels in 2015. This continues to reflect the rundown of reserves from existing fields. Marginal fields like South East Mananda and Gobe are likely to end earlier than previously expected. While production of oil may be declining at an increasing pace, the

PNG LNG project which is anticipated to commence production of LNG in 2014 and provide a significant boost to production in the petroleum and gas sector.

Figure 18: Declining oil production over the medium term



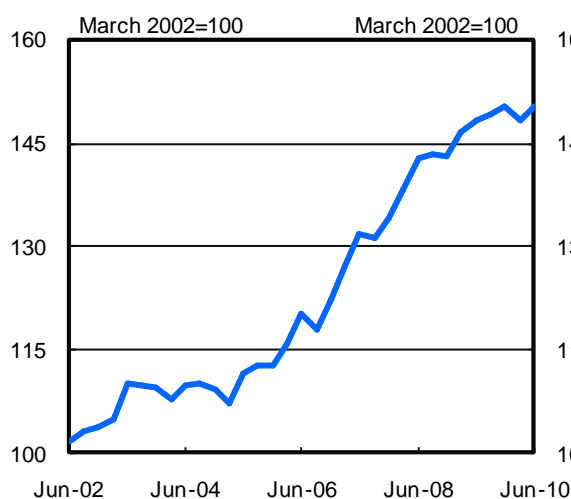
Source: Department of Treasury and Department of Petroleum & Energy

2.4 LABOUR MARKET

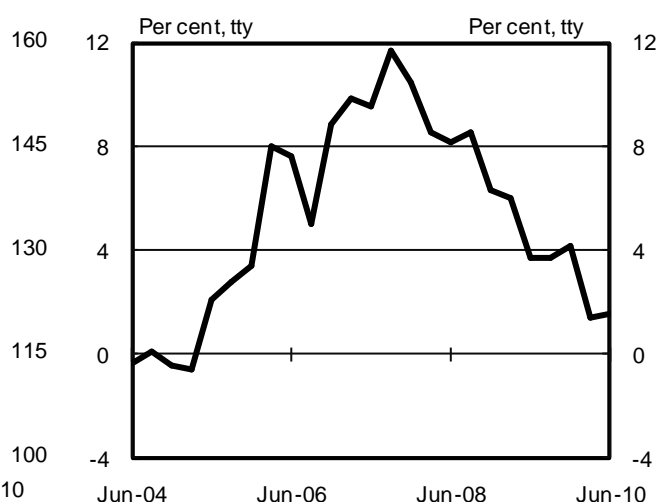
PNG has experienced strong private sector employment growth since June 2005, although the rate of growth has eased over the past two years. This sustained employment growth has been largely driven by a period of uninterrupted economic growth.

More recently, employment growth has eased back to low single digit rates, which to some extent is due to the softer economic conditions in 2009. In addition, the Bank of PNG (BPNG) employment survey is likely to be understating employment growth, as the survey does not capture all employment from the PNG LNG contractors.

The BPNG employment index showed that employment in the formal private sector increased by 1.3 per cent in the June quarter 2010 (compared to a 1.1 per cent decline in March) to be 1.6 per cent higher through the year.

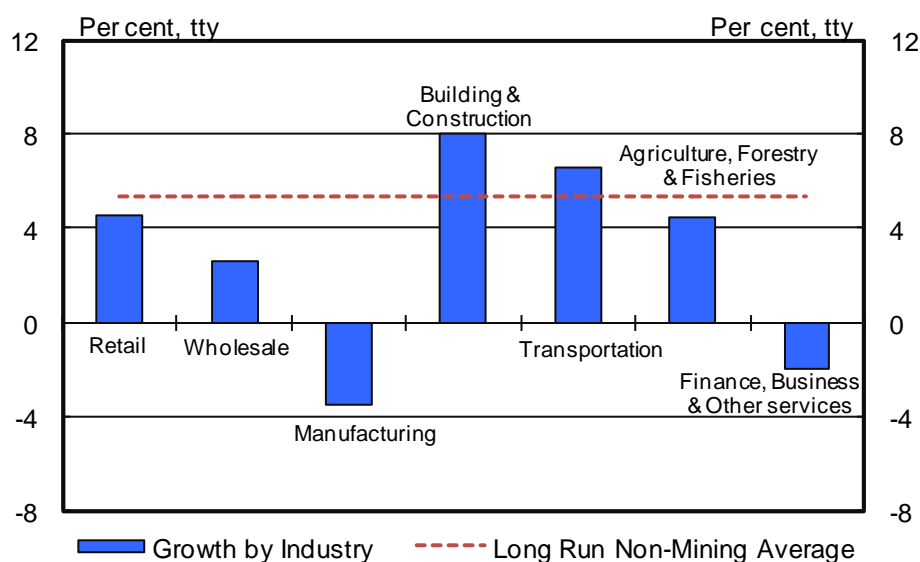
Figure 19: Employment Index

Source: Bank of PNG and Department of Treasury

Figure 20: Total Employment growth

Source: Bank of PNG and Department of Treasury

In the June quarter 2010, employment increased in most sectors of the economy except in the manufacturing and finance, business and other services sectors. Compared to employment levels a year ago, the strongest increases were observed in the Building and Construction and Transport sector, which were 8.0 per cent and 6.6 per cent higher respectively, followed by the mineral, retail and agriculture sector. The increase reflected higher activity associated with the construction phase of the PNG LNG project and other mining projects, and the harvesting of coffee and palm oil.

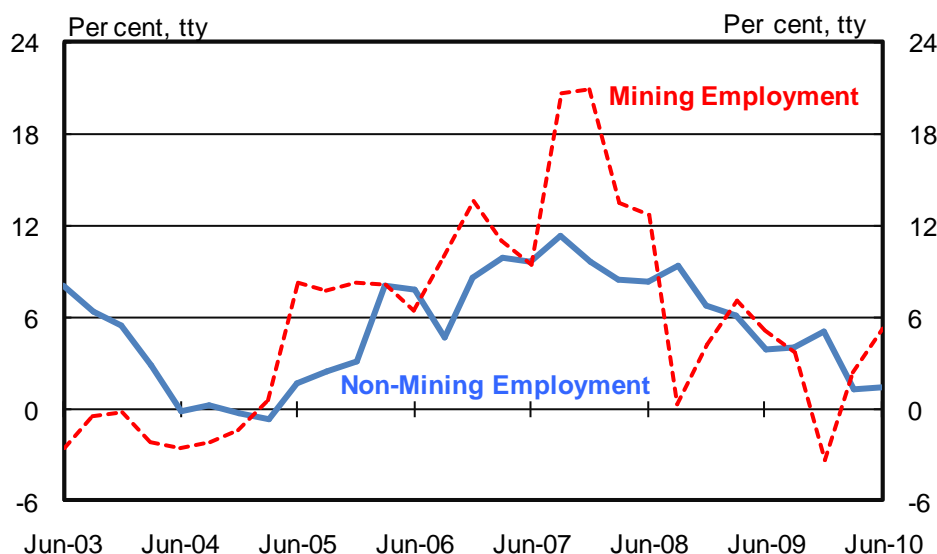
Figure 21: Industry Employment growth - Year to June quarter 2010

Source: Bank of PNG and Department of Treasury

In the mineral sector, employment is beginning to pick up again, buoyed by stronger commodity prices and growing global demand. Mineral employment grew by 3.0 per cent in the June quarter 2010, to be 5.2 per cent higher through the year, with the rise in employment reflecting activities associated with new mining projects coming on stream.

Excluding the mineral sector, employment increased by 1.3 per cent in the June quarter 2010, to be 1.3 per cent higher through the year.

Figure 22: Mining and Non-Mining employment



Source: BPNG and Department of Treasury

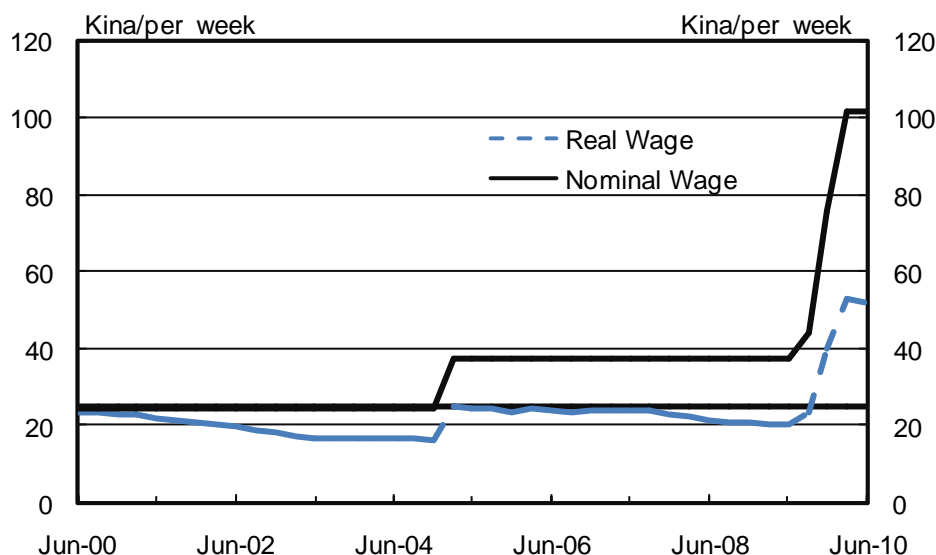
With the global economic recovery on a more solid footing and with the PNG LNG construction ramping up in late 2010 and into 2011, it is expected that employment growth will begin to pick up again. However, the difficulties of businesses finding skilled labour remains a constraint on employment growth. This can only be addressed through the improvement in training and the investment in human capital. The Government is addressing this concern through the Medium-Term Development Plan. However, human capital improvement is a long-term process where benefits will not be realized in the short term.

Wages Growth

Nominal salary and wages in the economy has increased over recent years, in line with strong employment growth and wage increases in PNG. It is expected that wages growth will remain strong, particularly for skilled labour and in the faster growing sectors of the economy. As the economy continues to expand, businesses are finding it increasingly difficult to find skilled labour from the existing labour pool. As a result, employers have resorted to a number of measures to bridge supply constraints, including greater focus on training and development, importing labour abroad and paying higher wages including bonuses and incentives to retain and compete for skilled employees.

Anecdotes from businesses combined with strong increases in personal income tax revenue suggests that wages growth has been very strong, particularly over the last year.

For non-skilled labour, there have been substantial wage increases in the past year as the two stage increase to the minimum wage as determined by the Minimum Wage Board (MWB) has come into effect.

Figure 23: Minimum Wages

Source: Bank of PNG, National Statistics Office and Treasury

The MWB approved the new minimum wage increase from the previous rate of K37.20 per week. Upon approval, the new wage rates were implemented in two phases. The first phase was an adjustment in the minimum wage to K1.72 per hour or K75.68 per week (based on a 44-hour week) to be implemented 26 weeks after the effective date of the MWB Determination. The second adjustment was to take the full determined hourly rate to K2.29 per hour or K101.76 a week, to be implemented 40 weeks after the effective date of the MWB Determination.

2.5 PRICES

Inflation remains persistent in PNG as domestic resources are stretched by the rapid expansion that the economy has undergone in the past few years. The strains on capacity are showing, with businesses finding it increasingly difficult to find suitable labour and land for further expansion. This is translating into strong wages growth and rapidly increasing prices associated with the use and development of land. In the near term, these inflationary pressures are expected to increase, with the ramp up in the construction of the PNG LNG project and the significant increase in Government expenditure.

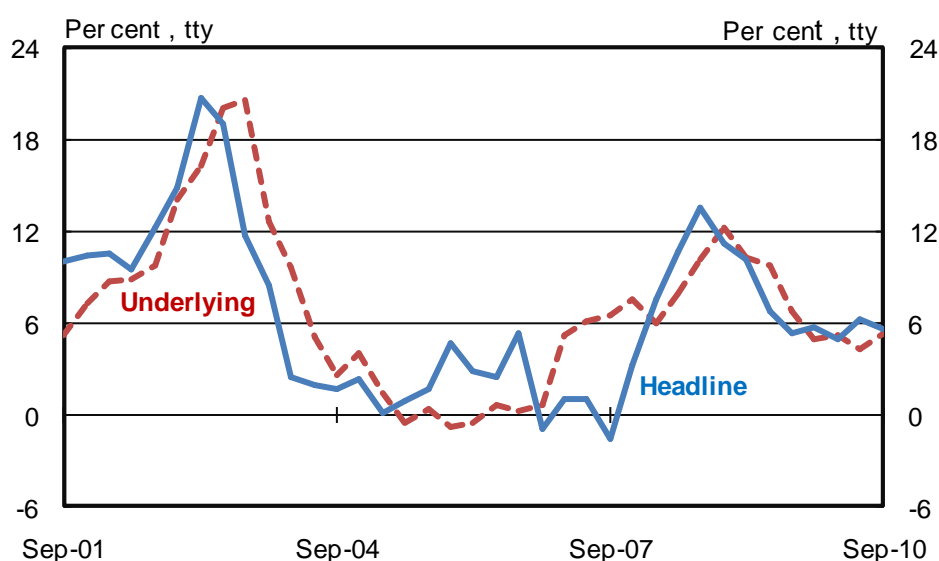
One of the key challenges for a developing economy like PNG is to manage the resource boom well so that rapid economic expansion does not translate into continuously high inflation. Inflation represents a real problem, for ordinary households and businesses. For households, higher inflation translates into rising cost of living, as the price of general goods and services increases; this ultimately leads to lower household wellbeing. For businesses, higher inflation translates into a higher cost of doing business, due to rising input costs. In the business environment, uncertain price movements can also lead to uncertainty in relation to actual business investment and therefore can act as a drag on long-term economic growth. The Government needs to carefully balance the inflationary pressures that are building in the economy to address development needs of the country.

2010 Update

In the September quarter 2010, the headline consumer price index (CPI) increased by 1.3 per cent, to be 5.6 per cent higher through the year. The most significant price increases were recorded in fruit and vegetables, clothing and footwear, council charges, alcoholic drinks and motor vehicle purchases. Surprisingly, compared to the previous quarter, measured inflation eased with the most significant price moderations found in a number of food items, such as fruit and vegetables, cereals and meat and fish.

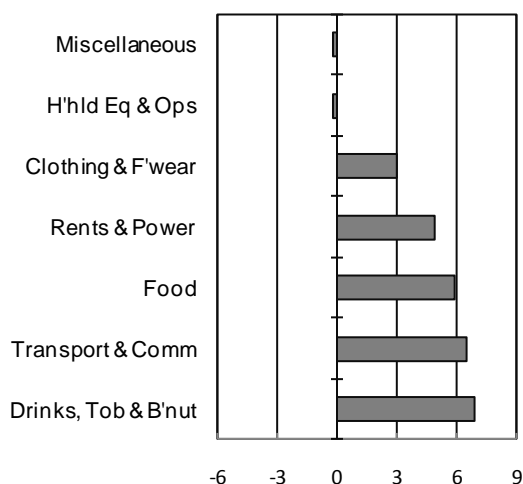
The exclusion-based measure of annual underlying inflation increased slightly, with prices rising by 5.4 per cent in the September quarter 2010, up from 5.3 per cent in the previous quarter. The Central Bank's trimmed mean measure also indicated that annual underlying inflation was 5.7 per cent in the September quarter, slightly down from 5.8 per cent in the June quarter.

Figure 24: Consumer Price Index, through-the-year growth



Source: NSO and the Department of Treasury

All regions recorded price increases in the September quarter, with the strongest increases experienced in Lae and Goroka which recorded quarterly price increases of 2.2 per cent and 1.4 per cent respectively. Compared to September quarter 2009, the largest consumer price increases were experienced in Madang and Goroka, which recorded through-the-year inflation of 8.3 per cent and 7.7 per cent respectively.

Figure 25: Through-the-year CPI by group

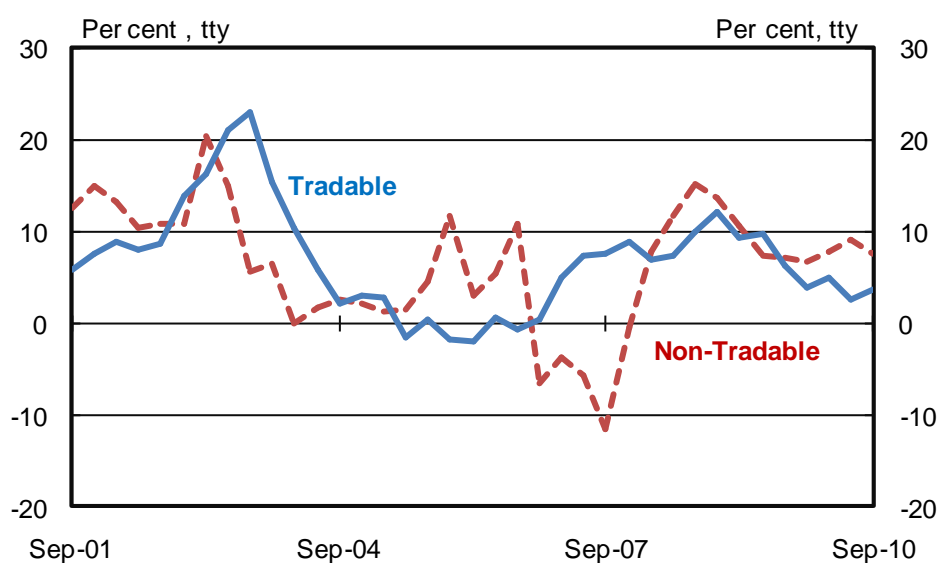
Source: NSO and the Department of Treasury

Figure 26: Through-the-year CPI by Region

	Quarterly	Through the year
Port Moresby	1.0	4.9
Goroka	1.4	7.7
Lae	2.2	5.5
Madang	0.7	8.3
Rabaul	0.6	4.0
Total	1.3	5.6

Tradable and Non-Tradable Inflation

Prices of imported (or tradeable) goods have edged up slightly, increasing by 3.8 per cent through the year to the September quarter 2010 compared to 3.7 per cent through the year to the June quarter. The downward trend in tradable inflation since 2008 has helped to contain overall inflation, but this could reverse if the world economic recovery leads to stronger international prices.

Figure 27: Tradable and Non-Tradable Inflation, 2001-2010

Source: NSO, and the Department of Treasury

Figure 27 shows that annual non-tradable (i.e. domestically generated) inflation has been rising for a number of quarters, although it moderated slightly in the September quarter 2010. Non-tradable inflation prices continued to grow strongly, rising by 1.5 per cent in the September quarter 2010, to be 7.6 per cent higher through the year. Non-tradable inflation is expected to remain strong and rise in the near term due to capacity constraints in the economy. This is not unexpected given the economy has grown strongly for a number of years, which has absorbed available resources. The significant increase in aggregate demand has outstripped expansion in the capacity of the economy, which is now manifesting into higher prices for the different factors of production.

Fortunately, businesses in PNG have been able to alleviate some of these constraints, such as skilled labour and capital, by drawing on resources from abroad. This has been made easier with a number of countries still operating at below full capacity following the global recession in 2009. As the world economic recovery gathers momentum, PNG will face increasing competition for these external resources, which is expected to lead to higher input costs.

Although the recent trend in the measured inflation figures point to some moderation in inflationary pressures, annual inflation remains significantly above those levels recorded in the years prior to 2008. While the strong international cost pressures experienced in 2008 were picked up in the official statistics, primarily through higher food and fuel prices, there is a concern that current domestic inflationary pressures are being understated in the official statistics produced by the National Statistical Office (NSO). Anecdotal evidence from business liaison visits, suggest that inflation could have been as high as double digits in the past year, with a number of businesses factoring these figures into their negotiations rather than using official price statistics.

For example, there are a number of domestic expenditure items such as the price of dwelling rentals which are reported to have been unchanged in NSO figures for the past two decades. This is despite the enormous increase in dwelling rents that have been observed over the past few years, which highlights inadequacies in the official statistics. Furthermore, the weightings in the expenditure basket were taken in the 1970s. These outdated weights do not properly reflect the increasing importance of expenditure on items such as fuel and housing. Once a new household expenditure survey is compiled by the NSO, the survey data will provide a timely update to the weightings used in the consumer price index expenditure basket.

Inflation Outlook

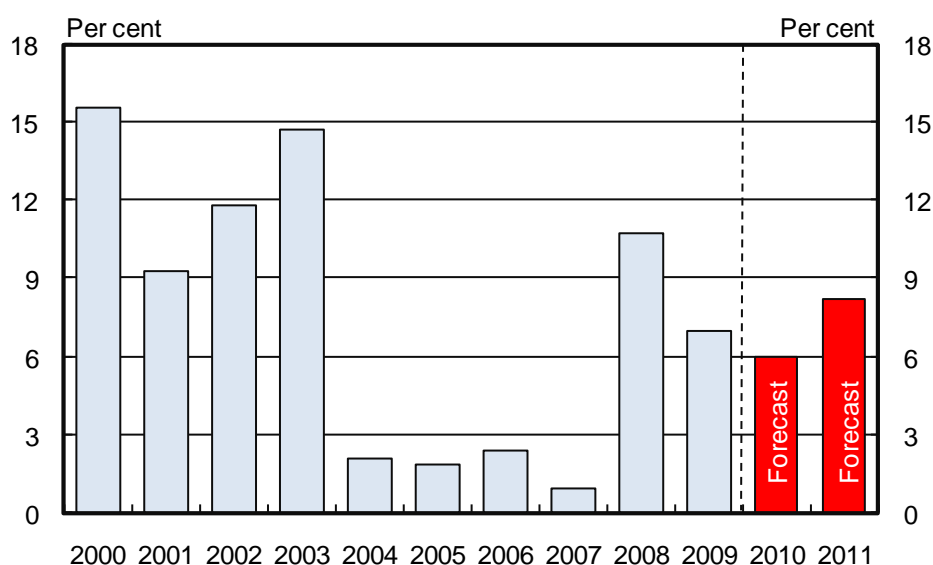
Inflation increased significantly in 2008 and has remained at relatively high levels compared to the low inflation period of 2004 and 2007. Looking ahead, inflation is anticipated to increase, posing a risk to macroeconomic stability.

Treasury has revised its annual headline inflation projection for 2010 to be around 6.0 per cent, a slight downward revision from the MYEFO estimate of 7.0 per cent. The downward revision to the 2010 projection from previous updates is based on the following factors:

- A lower inflation outcome recorded in the first nine months of 2010, which has been driven by a moderation in price growth of key expenditure groups such as; food, drinks, tobacco and betel nut.

- The slight downward revision to real GDP growth in 2010, including some delay in the construction phase of the PNG LNG project has eased inflationary pressures.
- In 2009, there was a significant increase in the amount of funds coming out of Government trust funds. This was expected to add to aggregate demand through increased spending in the economy. However, some of those funds are yet to be spent on domestic goods and services. It is expected that when those funds are spent they are likely to add to inflationary pressures.

Figure 28: Actual and Projected inflation; 2010-2011



Source: NSO, Bank of PNG and Department of Treasury

In 2011, headline inflation is projected to rise to 8.2 per cent, revised up from 8.0 per cent projected in the Mid-year Economic and Fiscal Outlook (MYEFO). The higher inflation outlook takes into account the following factors.

- Aggregate demand is anticipated to be stronger in 2011, which will see increased investment and spending activity, this is likely to add to rising inflationary pressures.
- PNG LNG construction activity is expected to ramp up in 2011, which will put pressure on existing resources in the economy.
- Shortage of skilled labour and other capacity constraints has been a problem for a while and is expected to become tighter. This has led to strong wage increases for skilled labour, as business compete for skilled workers. The other chronic problem is the shortage of land, which has caused higher rental prices for offices and accommodation. The pressure on these scarce resources is expected to intensify in 2011.

- Government spending has increased substantially in recent years. Given the capacity constraints in the economy, the additional aggregate demand created by public spending is expected to translate into higher prices.
- The depreciation of the Kina against the Australian dollar implies that prices of basic goods and services imported from Australia will rise. This also means that both the domestic and imported inflation are likely to trend upwards, as businesses pass on higher prices to consumers.

Over the medium term, inflation is assumed to gradually moderate to around 5.0 per cent per annum, which represents the long-term average inflation rate in PNG. This assumption is based on the effective implementation of monetary policy in anchoring inflation expectations. However, should monetary policy respond too slowly or fiscal policy becomes too expansionary, there is a risk that inflation will be higher than the medium-term assumption.

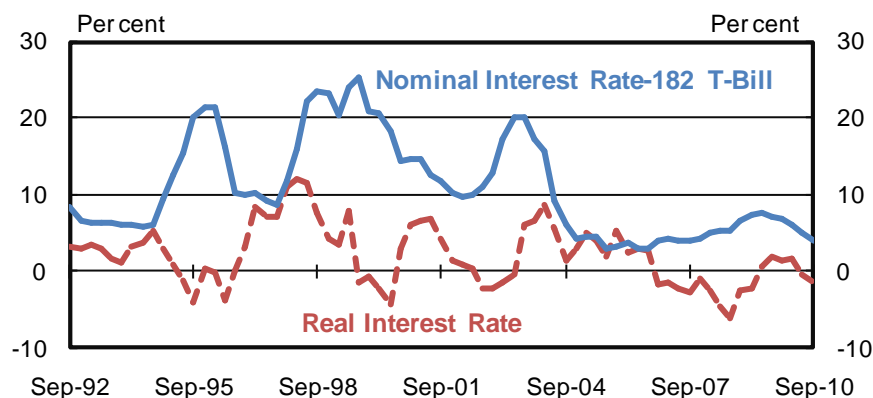
The key challenge for the Government is to contain inflation so that it does not accelerate rapidly. Inflationary pressures are currently high in the domestic economy and are anticipated to accelerate further as the economy absorbs the significant impact of the PNG LNG project.

Over the near term there is a potential for the economy to grow more strongly than anticipated should other new mining ventures and the second LNG project eventuate. This means that risks to the inflation forecasts remain elevated.

2.6 MONETARY DEVELOPMENTS

Key interest rates such as the Kina facility rate (KFR) which is used by Bank of PNG (BPNG) to signal its monetary policy stance has been maintained at 7.0 per cent since December 2009. BPNG stated that this KFR setting was to prevent increases in inflation driven by high domestic demand associated with Government spending and the commencement of the construction phase of the PNG LNG project. There was also a growing concern of inflationary pressures emanating from imported inflation, with the Kina depreciating against its major trading partners (especially against the Australian dollar) and the excess liquidity within the economy. Nevertheless, Figure 29 indicates that real interest rates are at very low levels, which represents a risk to consumer and asset price inflation when the economy is growing strongly.

The repo interest rate has remained unchanged since December 2009. However, domestic interest rates for short-term securities and deposits have continued to decline over the course of 2010. The lower deposit rates were attributed to excess liquidity in the banking system, which is due to high foreign exchange inflows and increased government spending.

Figure 29: Nominal and Real Interest Rates

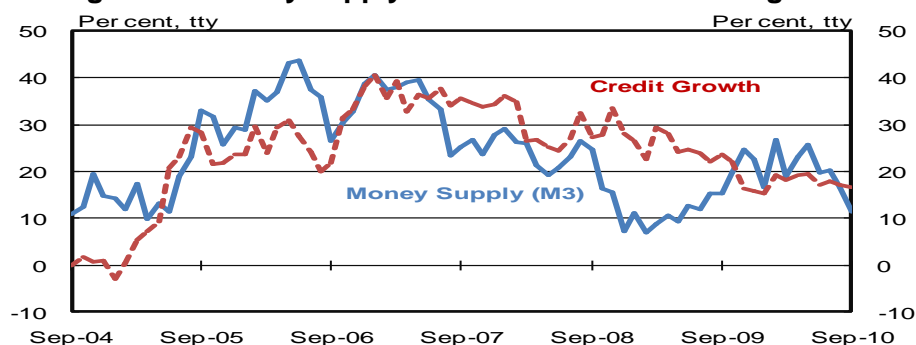
Source: Bank of PNG

The annual growth of broad money supply (M3*) was 11.4 per cent over the year to September 2010. The growth in the money supply was mainly due to higher net foreign assets of depository corporations and private sector credit growth extended by other depository corporations. The growth in the monetary base was mainly attributed to the drawdown of funds by the Government kept in trust accounts which impact the level of currency in circulation and deposits of commercial banks. Liquidity remains at high levels which exerted downward pressure on domestic interest rates. To help diffuse such a high level of liquidity in the banking system, the Central Bank issued new net Central Bank Bills (CBBs) totalling K773.3 million over the nine months to September 2010 and increased the cash reserve requirements from 3 per cent to 4 per cent of total deposits in October.

In 2010, BPNG projects broad money supply to grow by 20.6 per cent, resulting from higher growth in credit by the private sector while the monetary base is expected to grow by 14.9 per cent. In 2011, both the money supply and monetary base growth should moderate slightly to 19.8 per cent and 13.0 per cent respectively.

In the year to September 2010, total private sector credit increased by 16.6 per cent compared to 23.6 per cent in the corresponding period of 2009. High levels of credit growth poses a threat to inflation via additional spending in the economy, which can lead to higher asset and consumer prices.

In 2010, BPNG projects private sector credit to grow by 16.0 per cent, rising to 17.0 per cent in 2011.

Figure 30: Money supply and Private Sector credit growth

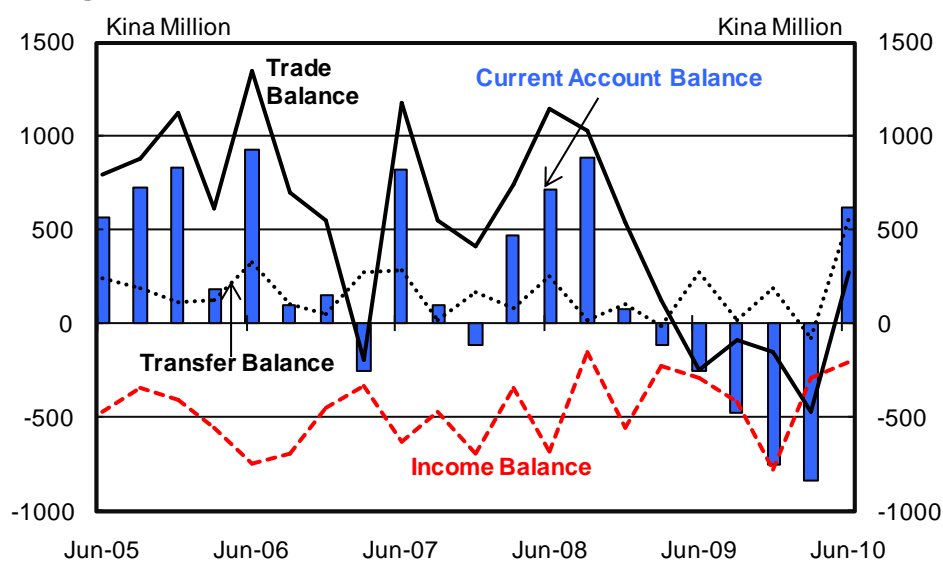
Source: Bank of PNG

2.7 BALANCE OF PAYMENTS AND INTERNATIONAL PRICES

Balance of payment data show that PNG's trade activity with the rest of the world continued to improve over the course of 2010, reflecting improvements in the external environment and stronger domestic economic activity. This has seen a significant pick up in the export and import of goods and services. The value of exports was 46.4 per cent higher in the June quarter 2010 compared to the corresponding quarter in 2009. Similarly, export volumes rose by 8.1 per cent, while the value of imports was 19.6 per cent higher.

A current account surplus of K692 million was recorded by the Bank of PNG (BPNG) in the June quarter 2010 - the first surplus since December quarter 2008. This was largely driven by the trade balance moving from a deficit to a surplus position in the June quarter, due to a combination of stronger export volumes and prices. Supporting this was an improvement in the transfer balance and a narrowing of the net income deficit. Over the first six months of 2010, the current account balance recorded a deficit of K216 million or 0.8 per cent of GDP, with the June quarter surplus partially offsetting the March quarter deficit of K908 million.

Figure 31: Drivers of the Current Account Balance 2005-2010



Department of Treasury and Bank of PNG

A current account deficit of K6,878 million or 26.6 per cent of GDP is forecast for 2010, which is substantially larger than the annualised current account deficit recorded by the BPNG over the first six months of the year.¹ This large discrepancy is due to problems associated with measuring the impact arising from the PNG LNG project. Treasury understands that BPNG's published figures currently understate transactions relating to the PNG LNG project, as a number of key contractors are not captured in the BPNG survey. As a result, these differences are likely to persist until this measurement issue is resolved.

¹ In BPNG's September Monetary Policy Statement, a current account deficit of K11.9 billion is forecast in 2010. The significant difference between the forecast is likely to relate to the assumed profile and impact of the PNG LNG project on the current account balance.

The revised deficit in 2010 is slightly below the 2010 Budget forecast deficit of K6,924 million or 26.8 per cent of GDP, largely reflecting some delays in the PNG LNG project and an upward revision to exports in line with stronger commodity prices and volumes in the first six months of the year. Partially offsetting this is a larger than anticipated increase in imports of goods and services relating to mining projects.

While the projected current account deficit is broadly in line with the 2010 Budget forecast, the composition of the deficit has changed. In particular, the net income deficit has been significantly revised up, as the compensation of employees abroad was previously incorrectly recorded under the imports of goods and services.

According to BPNG, a trade surplus of K460.0 million was recorded in the June quarter 2010 compared to a deficit of K662 million in the March quarter. This was the first time the trade account has been in surplus since the global recession in 2009, owing to higher export prices and volumes and lower merchandise imports. In particular, service imports were 25 per cent lower in the June quarter compared to the March quarter, especially in other financial services, construction services and transportation. Over the first six months of 2010, the trade balance recorded a deficit of K202 million or 0.8 per cent of GDP.

The trade deficit is expected to widen to K2,917 million (11.3 per cent of GDP) in 2010. This is largely due to higher imports of goods and services as the PNG LNG project increases construction activity in the second half of the year and as general imports rise with the strengthening of domestic economic activity.

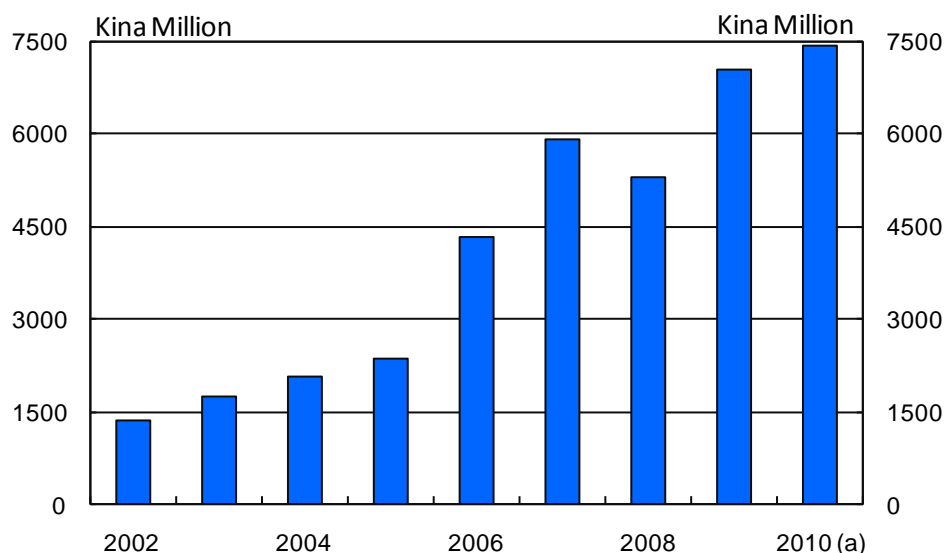
According to BPNG, a net income deficit of K184 million was recorded in the June quarter 2010 compared to a deficit of K314 million recorded in the previous quarter. The narrowing of the net income deficit was attributed to lower compensation of employees, interest and income payments during the quarter. Over the first six months of 2010, the net income deficit was K498 million or 1.9 per cent of GDP.

The net income deficit is expected to widen to K4,299.4 million (16.6 per cent of GDP) in 2010. This is largely due to higher compensation of employees relating to the PNG LNG project and higher dividends payments associated with increased mining profitability from strong commodity prices in 2010.

A transfer surplus of K416 million was recorded in the June quarter 2010 compared to a smaller surplus of K68 million in the March quarter. The higher surplus was attributed to higher receipts from gifts and grants combined with slightly lower family maintenance transfer payments. Over the first six months of 2010, the transfer balance recorded a surplus of K484 million or 1.9 per cent of GDP.

The surplus in the net transfer balance is expected to fall to K339 million in 2010 (1.3 per cent of GDP). This is slightly lower than the first six months of 2010 and reflects an anticipated increase in the transfer of family maintenance payments in line with stronger economic growth in PNG.

The gold and foreign exchange reserves held by Bank of PNG at the end of September 2010 were K7,432.9 million (US\$2.8 billion). This is equivalent to 5.5 months of total imports and 15.7 months of non-mineral imports.

Figure 32: International Reserves (Kina Million)

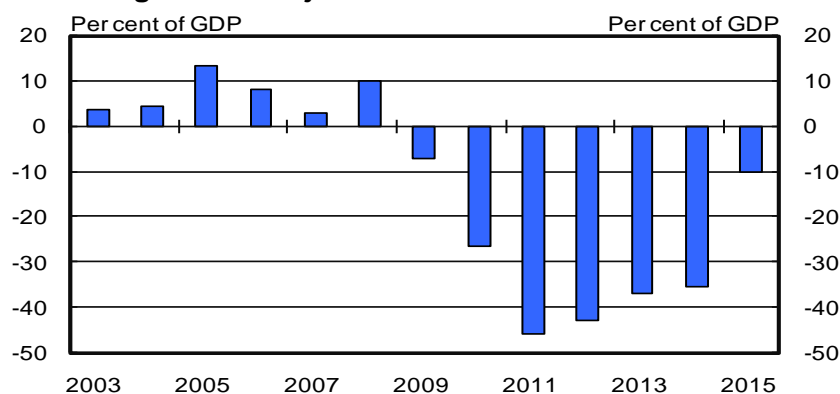
Source: Bank of PNG

(a) Includes reserves level to end September 2010

2011 Outlook

In 2011, a large current account deficit estimated at K13,207.8 million or 46 per cent of GDP is expected. The substantial increase in the current account deficit is largely driven by the widening in the trade and income deficit, as spending on the PNG LNG project increases in 2011. The extent of the shock to the economy associated with the construction of the PNG LNG project makes these estimates more subject to error than is usual. Stronger economic growth and incomes are also expected to result in higher general import spending.

Partially offsetting the substantial rise in the value of imports is an expected increase in agricultural and mineral exports. This reflects the expansion in production across the agriculture sector due to favourable conditions expected in 2011 and the increased rate of production at new mines like Ramu Nickel and Hidden Valley.

Figure 33: Projected Current Account Balance

Source: Department of Treasury and Bank of PNG

Medium-Term Outlook

Over the medium term the trade deficit is expected to narrow, largely driven by the significant moderation in the value of imports as the construction phase of the PNG LNG project winds down. Partially offsetting this will be the lower value of mineral exports, with commodity prices assumed to return to long-run prices by the end of the projection period, export volumes declining due to maturing oil fields and lower extraction expected from Ok Tedi as it prepares to shutdown (pending approval of proposed extensions) in 2013. By 2015, the trade balance is expected to transition from a deficit to a surplus of 2.0 per cent of GDP, boosted by the anticipated increase in mineral exports arising from LNG production.

The income deficit is expected to narrow over the medium term. This is due to lower dividend payments as mining profits decline with assumed falling commodity prices and lower compensation of employee payments as the LNG project winds down. Although from 2015 onwards with the increase in LNG exports, income payments relating to dividends and interest repayments are expected to increase significantly. The income deficit is projected to be around 12.3 per cent of GDP in 2015.

Overall, the current account balance is projected to remain in a large deficit over the medium term, driven by the import of capital and labour for the PNG LNG project and lower mineral commodity exports due to the assumption of a return to long-term prices and lower volumes. However, the deficit is projected to moderate in line with the winding down of construction spending on the PNG LNG project. As the LNG gas project begins to ramp up production, exports are expected to significantly increase leading to an improvement in the current account. It is anticipated that beyond 2015, the current account balance will move into a larger surplus position in line with LNG exports.

2.8 RISKS TO THE ECONOMIC AND FISCAL OUTLOOK

On balance, the risks to the economic and fiscal outlook are tilted to the downside.

As a small open economy, PNG is vulnerable to shocks in the global economy. While the global recession of 2009 did not severely impact PNG, it still had a negative effect on PNG's export industries and government revenue, through lower export volumes and significant falls to key commodity prices. Fortunately, the impact on PNG's export sector was relatively short lived, as the world economy strengthened over the course of 2009. As discussed in the international outlook section, the global economic recovery has been fragile with an unusual degree of uncertainty. This means that developments in the world economy remain a significant risk to PNG's economic outlook.

The uncertainty in the global economy has also resulted in volatile commodity prices, which present a key risk to the revenue forecasts. This is particularly so, with commodity prices trading well above long-term averages and at or near record levels in some instances. Should there be a negative shock to the global economy, it is likely that commodity prices will pull back significantly. In addition, if the Kina appreciates against the US dollar, this will translate into lower mineral and petroleum tax revenues when measured in Kina terms.

In the past, sharp commodity price movements had a substantial impact on total Government revenue in PNG. The vulnerability of PNG Government revenue to commodity price movements remains substantial but it has diminished over recent years due to sustained robust economic growth deepening the non-mineral tax base. This broadening of the revenue base is a welcome development in reducing the risks that PNG faces from

sharp swings in commodity prices. However, this trend will reverse once taxation revenue starts to flow from LNG production.

On the domestic front, the economy is about to experience a large adjustment with the PNG LNG construction ramping up in 2011. Given the enormity of this project, the consequences could prove hard to predict, especially in relation to the impact on inflation. There are already worrying signs of inflationary pressures building up, especially wage pressures, fuelled by increased aggregate demand associated with the rise in investment and other spending. The economy's limited resources, especially the shortage of skilled labor and land has caused higher wage and rental prices for offices and accommodation. The pressure on these scarce resources is expected to intensify and inflation is expected to increase further as the economy absorbs the substantial impact of the PNG LNG project. Therefore, the risk to inflation is heavily skewed to the upside, especially if a price-wage spiral develops as workers try to keep pace with the expected rising cost of living.

As well as the risk to consumer price inflation, another significant development has been the rapid increase in asset prices, particularly in residential and commercial property. In both segments of the property market, there has been tremendous growth in capital gains and rental income, driven by the pace of economic expansion, shortage of land and the access to relatively cheap credit. While the severe shortage of land limits the market's response to high asset prices, there is a risk that residential and commercial property may be overvalued. With the winding down of construction of the PNG LNG project anticipated in 2013, there is the risk of a correction in asset prices unless another large project fills the void.

The economic outlook assumes that fiscal discipline is maintained. The Government is strongly committed to meeting its Medium Term Development Strategy Plan (MTDSP) 2010-2015. However, with the impact of the PNG LNG project exerting intense pressure on the economy, many parts of the economy are already working at full capacity. Under these circumstances, great care will be required with additional Government spending not to exacerbate excess demand, in order to ensure that macroeconomic stability is maintained. The loss of fiscal discipline would have negative impacts on the domestic economy and investor confidence.

Other domestic economic risks include possible delays to the construction of the PNG LNG project, especially in relation to landowner issues, and supply disruptions to other mining projects due to strikes, landowner problems and weather related risks such as droughts, floods and landslides.

On the upside, a stronger than anticipated global economic outlook, would be beneficial to PNG's export sector, and could see commodity prices being higher than assumed in this Budget. In addition, there are a number of mining and gas projects which are currently under active consideration (for example the second LNG project proposed by InterOil). Should these projects proceed, this would provide a significant boost to economic growth in the near term, and a more positive revenue outlook over the longer term.