June 2003
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Papua New Guinea: 2003 Article IV Consultation and Request for an Extension of Repurchase Expectations—Staff Report; Staff Statement; Public Information Notice and on the Executive Board Discussion; and Statement by the Executive Director for Papua New Guinea

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2003 Article IV consultation with Papua New Guinea and request for an extension of repurchase expectations, the following documents have been released and are included in this package:

- the staff report for the combined 2003 Article IV consultation and request for an extension of repurchase expectations, prepared by a staff team of the IMF, following discussions that ended on **February 18, 2003**, with the officials of Papua New Guinea on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 25, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **June 3, 2003** updating information on recent economic developments.

- a Public Information Notice (PIN), **summarizing the views of the Executive Board as expressed during its June 4, 2003, discussion** of the staff report on issues related to the Article IV consultation.

- a statement by the Executive Director for Papua New Guinea.

The document(s) listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

PAPUA NEW GUINEA

Staff Report for the 2003 Article IV Consultation and Request for an Extension of Repurchase Expectations

Prepared by the Asia and Pacific Department

(In consultation with other departments)

Approved by Steven Dunaway and Liam P. Ebrill

April 25, 2003

- The 2003 Article IV consultation discussions were held in Port Moresby during February 9–18, 2003. The staff team comprised Messrs. Browne (Head), Orsmond, Berezin (all APD), and Kapteyn (PDR), and was assisted by Mr. Yadav (Senior Resident Representative). Mr. Callaghan (OED) participated in the discussions.
- The team met with Prime Minister Somare, Finance Minister Philemon, the Ministerial Economic Committee, Bank of Papua New Guinea Governor Kamit, other senior government and central bank officials, and representatives of the private sector, civil society, and the donor community.
- Papua New Guinea completed successfully an 18-month Stand-By Arrangement in September 2001, and all the program documents were published.
- The Executive Board completed the 2002 Article IV consultation on June 5, 2002.
- Papua New Guinea has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.
- The quality, coverage, provision, and timeliness of economic statistics continue to impede economic analysis and the effective surveillance of policies. Papua New Guinea subscribes to neither the GDDS nor the SDDS.
- This report was written by Messrs. Browne and Orsmond.

Contents

EXECUTIVE SUMMARY

Macroeconomic developments

- Since the mid-1990s, Papua New Guinea's growth performance has been weak and poverty has increased due to an unfavorable external environment, loose macroeconomic policies, and deep-seated structural impediments to growth. Real GDP declined by 3 percent in 2002 due to drought and election-related violence that affected mining and agricultural output. Inflation increased to almost 15 percent and the current account deteriorated sharply.

- The government elected in August 2002 started to tighten fiscal policy although the deficit was 5½ percent of GDP in 2002, much higher than budgeted. Improved public expenditure control and monetary conditions, including markedly higher interest rates, helped to strengthen the exchange rate and halt reserve losses during November 2002 to early March 2003. However, foreign investor confidence remains fragile.

Key policy issues

- The discussions focused on the strong and comprehensive actions that are needed to restore macroeconomic stability in the short term, especially by reducing the budget deficit, and to promote structural reform in order to lift private sector activity and alleviate poverty in the medium term.

- Expenditure pressures threaten the achievement of the targeted lower fiscal deficit in 2003. The staff team expressed the need for a supplementary budget as soon as possible, while the authorities noted that expenditure control procedures have been improved.

- Substantial additional adjustment measures will be necessary to hold the medium-term budget deficit to around 1 percent of GDP in 2004 and beyond, and permit a steady decline in the central government debt-to-GDP ratio from its present high level.

- Wide-ranging structural reforms are vital for growth prospects in both the urban areas and the agricultural sector. In addition, reversal of the long-standing governance and law and order difficulties is urgently required.

- Provided that the fiscal position is consolidated and structural measures are implemented, inflation would decline and interest rates could be gradually reduced to help the private sector.

- The floating exchange rate regime, which has served the economy well in facilitating orderly adjustment to external shocks, should be retained. With adjustment policies, the present levels of the exchange rate and competitiveness are broadly appropriate.

I. BACKGROUND

1. **Papua New Guinea fared relatively well in the first two decades after independence in 1975, with real GDP growth averaging 4 percent**. As a resource-rich country, Papua New Guinea benefited from large-scale foreign investment in its mining and petroleum sectors. In the second half of the 1990s, however, average real GDP growth slowed to less than 1 percent a year. This outturn reflected growing governance and law and order problems, lack of new mineral exploration activities, neglect of physical infrastructure in the rural areas that inhibited agricultural production, and the decline in export prices during the Asian crisis. As investor confidence evaporated, private capital outflows intensified, the kina depreciated, and international reserves fell sharply.

2. **The policies undertaken by the government headed by Sir Mekere Morauta (in office from July 1999 to August 2002) aimed to stabilize the economy and foster private sector-led growth through structural reforms**. The government's program received financial assistance from the Fund in the form of a Stand-By Arrangement (from March 2000 to September 2001) and from other multilateral agencies and bilateral donors. This helped to overcome the serious macroeconomic imbalances, with a reduction in the inflation rate and an increase in the level of net international reserves. However, the pace of structural reform was slower than envisaged, and with the gradual winding down of existing mining projects, the economy contracted during 2000–02 by a cumulative 8 percent. Furthermore, the fiscal discipline that Papua New Guinea displayed during the Stand-By Arrangement was not sustained in the lead up to the June 2002 election.

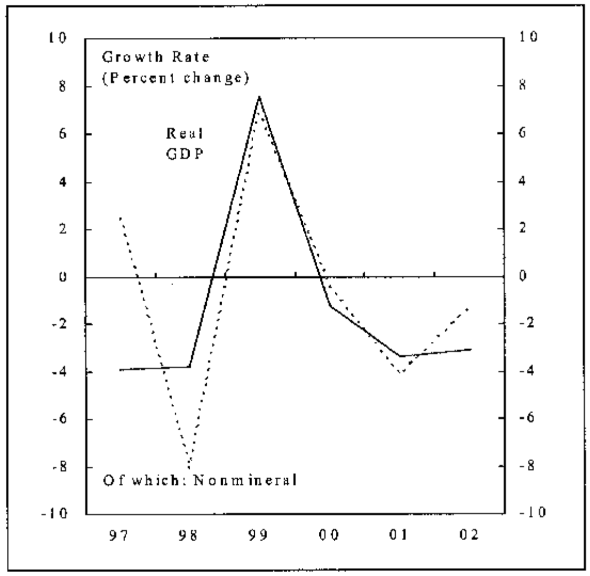
3. **At the conclusion of the last Article IV consultation in June 2002, executive directors commended the steps taken during 2000–01 to address the macroeconomic problems, while noting the subsequent sharp deterioration in the fiscal balance**. They urged that both revenue measures and cuts in nonpriority expenditures be put in place promptly following the election as part of a comprehensive medium-term strategy to limit the budget deficit and reduce the risks to external debt sustainability, while increasing infrastructure and poverty-alleviation spending. Directors stated that monetary policy should aim to ensure that inflation was kept in check. In addition, they called for wide-ranging structural measures, especially civil service reforms, enhanced public sector transparency, progress with the privatization of state-owned enterprises, and efforts to promote private sector activity including through a supportive legal environment.

4. **In line with these recommendations, the government elected in August 2002, led by Sir Michael Somare (Prime Minister during 1975–80 and 1982–85), started to tighten fiscal and monetary policies in late 2002**. Measures included stricter public expenditure control and higher interest rates. Nonetheless, inroads into the daunting economic policy challenges facing the government have so far been modest. Much still needs to be done to restore macroeconomic stability and promote sustainable growth through structural reforms, especially in view of the projected decline in mineral production over at least the next several years. These tasks are further complicated because of the large extent of poverty in the country, the rapid population growth rate, low life expectancy, an infant

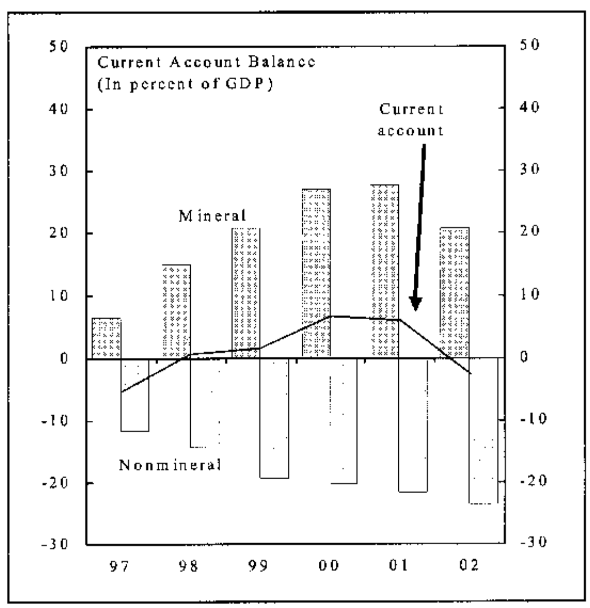
mortality rate that is well above regional norms, widespread corruption, and the fragmented political system. In addition, the country faces a sharp increase in external debt obligations to the Fund and the Australian government in 2003–05, arising from support provided during 1999-2001.

II. Recent Economic Developments

5. **Real GDP is estimated to have declined by 3 percent in 2002 and inflation in the year to December 2002 accelerated to 15 percent (up from 10 percent at end-2001).** Production of crude oil and gold fell sharply, mainly because of the continued depletion of known reserves at existing projects. In addition, output and exports were affected by the impact of the El Niño drought on river-based shipments from Ok Tedi's copper and gold mine, and the temporary closure of the Porgera gold mine due to disruptions caused by vandalism to power pylons. Nonmineral output dropped as agricultural production and sales were adversely affected by election-related violence in the Highlands region and by the poor state of rural infrastructure, especially roads. Formal sector employment in the urban areas also decreased. Meanwhile, consumer prices increased rapidly, reflecting fiscal slippage and the pass through of the kina's depreciation (Table 1).

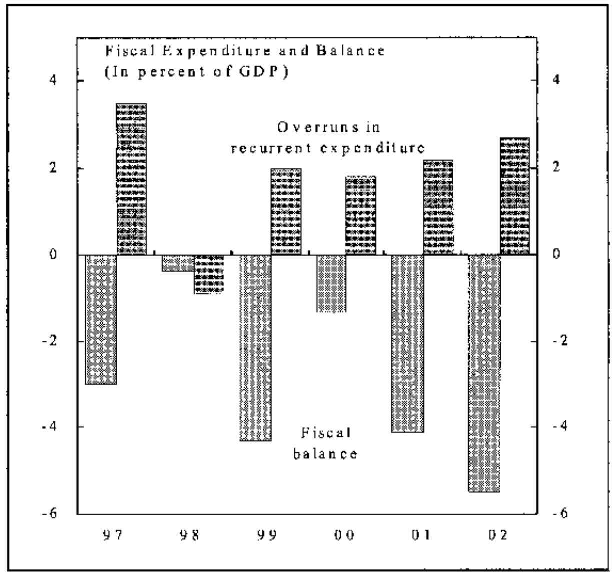


6. **The current account balance deteriorated sharply in 2002, swinging from a surplus of 6 percent of GDP in 2001 to an estimated deficit of 2½ percent of GDP.** The large decline in the volume of mineral exports was only partly offset by higher commodity export prices and lower import demand. As in 2001, the capital account was also in deficit. Large net government debt repayments, lower inflows of direct investment, and increased commercial bank holdings of foreign assets were only partially offset by higher private sector inflows to the mining sector, owing to the sales of government shares (Table 2). As a result, the overall balance of payments



showed a deficit, compared with the surplus recorded for 2001.

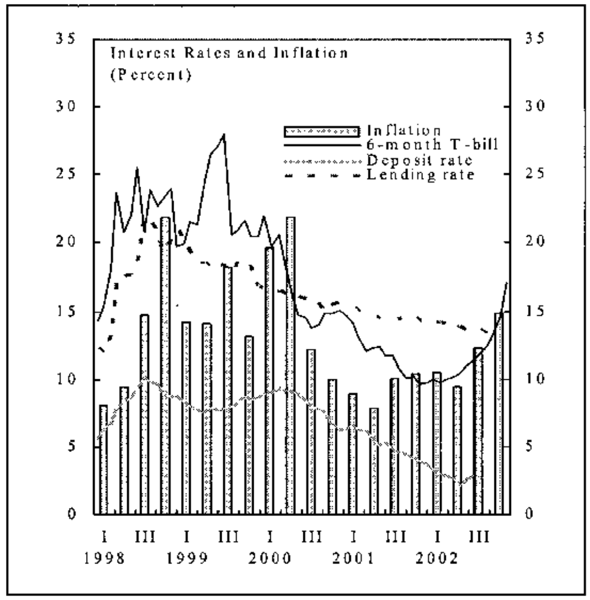
7. **The 2002 budget initially targeted a deficit of 2 percent of GDP, but this target was exceeded substantially in the first half of the year**. The kina deficit by mid-2002 was already equivalent to 3-4 percent of annual GDP, due to unbudgeted expenditure and cost overruns on the Yumi-Yet bridges project (an expensive endeavor contracted nontransparently in late 2001 and financed by a nonconcessional external loan), spending on the national elections, failure to control the wage and salary bill, excessive disbursements under the rural development program, and the elimination of school fees.[1] In late August, the new government passed a supplementary budget that sought to contain the 2002 deficit to 3.4 percent of GDP by curtailing current and development outlays. The authorities succeeded in reducing the deficit, albeit by less than expected. Based on below-the-line financing data, the staff estimates the deficit at 5.5 percent of GDP in 2002, although the authorities' deficit estimate is only 4.1 percent of GDP derived from the recorded above-the-line outturn (Tables 3 and 4). The authorities have not yet reconciled these differences.



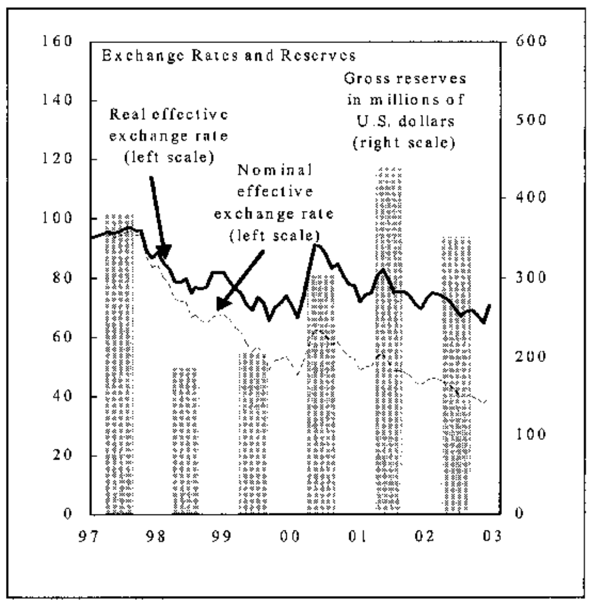
8. **The central government debt-to-GDP ratio increased to 73½ percent at end-2002, compared with 60 percent of GDP just two years earlier, reflecting the expanding budget deficit and the kina depreciation**. Since two-thirds of this debt is denominated in foreign currency, the high external debt ratio (50 percent of GDP) is the main concern in the indicators of external vulnerability for Papua New Guinea (Tables 5 and 6). The domestic debt-to-GDP ratio has increased more gradually, and at end-2002 stood at 23½ percent of GDP. However, the bulk of the government's domestic debt comprises one-month treasury bills and hence could be subject to considerable rollover risk.

[1]The fiscal deficit during the first half of 2002 was in part financed by proceeds from the sale of the then publicly owned Papua New Guinea Banking Corporation (PNGBC)—the country's largest bank—to Bank South Pacific in March 2002.

9. **For much of 2002, monetary policy was expansionary**. In particular, the central bank retired its own bills in order to provide liquidity to the commercial banks, which allowed banks to purchase treasury bills issued to finance the widening fiscal deficit without crowding-out effects (Table 7). With the excess liquidity conditions, in addition to the poor budgetary performance, the kina exchange rate depreciated against the U.S. dollar by 12 percent in the ten months to October, despite frequent intervention by the central bank. In this period, gross reserves declined from \$440 million at end-2001 (six months of nonmineral imports) to \$356 million (4½ months), and the country's sovereign credit rating was downgraded.



10. **The Bank of Papua New Guinea (BPNG) began to tighten monetary conditions in early November, increasing its key Kina Facility Rate (KFR) by 150 basis points (in line with the recommendations of a visiting staff mission)**. Since the start of 2003, the KFR has been increased by a further 100 basis points (to 15 percent). Treasury bill yields have increased, and stood at over 19 percent in early April (around 4 percent in real terms) compared with 12 percent at end-October. Broad money growth slowed and pressure in the exchange market eased following the increase in interest rates. The kina exchange rate strengthened from \$0.22 per kina in November 2002 to \$0.28 cents in early March 2003 (the same level as at end-2001) and reserves remained about stable during this period. However, more recently, the exchange rate has weakened because of higher import demand, and reserves have fallen as a result of central bank intervention.



III. Report on the Discussions

11. **The discussions focused on the policies needed to restore macroeconomic stability in the short term, especially through tighter fiscal policy, in order to reverse the adverse debt trend, while setting in place policies to lift the medium-term growth**

rate and reduce poverty. In 2003, real GDP is expected to grow at around 2 percent and the current account to move back into surplus, due to the subsiding of the temporary factors that reduced mineral and agricultural output and exports last year, along with the somewhat stronger outlook projected in the latest WEO assumptions for the world prices for most of Papua New Guinea's commodity exports. In this context, the authorities expressed their intention to build on the initial steps already taken to tighten fiscal and monetary policies with a view to maintaining a stable exchange rate, reducing inflation to below 10 percent by year-end, and placing the debt ratio on a firm downward trend. The staff team welcomed the positive start that had been made toward these goals, while stressing the need for additional comprehensive early actions to reduce the budget deficit and accelerate the implementation of structural measures.

12. **The staff and the authorities agreed that raising per capita incomes over the medium term will be a difficult task requiring a sustained reform effort** (Box 1). Mineral and petroleum output, and the associated fiscal revenues and exports, will decline rapidly as existing projects exhaust their reserves. At this stage, a proposed natural gas pipeline to Queensland is the only major new resource project in prospect, but even if initiated during 2003, it would not come on stream until 2007.[2] Moreover, agricultural production is increasingly devoted to subsistence crops as the sale of cash crops is limited by poor access to markets. Activity in the urban areas continues to be hampered by the weak business climate that has prevailed in recent years. Added to this challenging situation, there are near- and medium-term risks, given the high inflation rate and fiscal deficit, volatile commodity prices for Papua New Guinea's major exports, and falling reserves.

13. **In these circumstances, the discussions devoted attention to measures that would help to enhance medium-term growth, especially strong and wide-ranging structural reforms to strengthen public sector efficiency, facilitate private sector activity, and help to improve social indicators**. An adjustment scenario was developed where growth in nonmineral output over the medium term would be sufficiently robust to offset the downward trend in mineral and petroleum output. The objectives of this scenario, and the broad policy directions that would underpin them, built on the authorities' medium-term fiscal and development programs that were first presented to the Fund during the 2002 Annual Meetings (Box 2). While these programs are appropriately comprehensive, implementation has so far been limited. During the discussions, the staff team stressed the need for further specificity of the policy agenda, which could in due course form the basis for a poverty-reduction strategy with Fund financial support, as well as underscoring the importance of restoring law and order, reducing corruption, and improving governance.

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[2] If constructed, the Queensland gas pipeline could generate income of around 3–4 percent of GDP a year, according to a recent private-sector study. To date, firm sales contracts for PNG-produced gas are below the minimum level required for viability of the project.

A. Fiscal Policy

14. **In recognition of the need to regain firm control over the fiscal sector, the 2003 budget appropriately targets a fiscal deficit of 2 percent of GDP**. Revenue including grants is expected to decline by ½ percent of GDP (to 29 percent). Lower tax receipts arise from a decrease in the effective tax rate on corporate income (from 31.25 percent to 30 percent), a 5 percentage point reduction in import tariffs, and the trend decline in mineral and petroleum receipts. This more than offsets projected revenue gains from an adjustment to specific excise tax rates charged on alcohol and tobacco products (from 2.5 percent to 4 percent each six months) and expected improvements in tax administration. The budget also introduces several tax concessions to encourage new exploration and mineral activity, although these will have a minimal revenue impact this year.[3] The staff team expressed concern about the decline in the revenue effort, given the public debt vulnerabilities.

15. **Recurrent expenditure is projected by the authorities to decline by 2½ percent of GDP (to 21 percent) in the 2003 budget**. This reflects a freeze on civil service and provincial wages and employment in 2003,[4] the reintroduction of school fees, and sharp reductions in provincial transfers and in goods and nonwage services (even beyond the one-off costs incurred last year for the general election). Appropriations are increased in order to clear most of the identified budget arrears (which total around 1 percent of GDP) and for higher domestic interest payments in response to the recent increase in rates. Development expenditures are projected to remain at 10 percent of GDP at end-2002, with improvements in the national highway system given priority, although the Yumi-Yet bridges allocation remains sizeable and the quality of much of the development spending needs to be improved.

16. **The mission expressed concern that additional expenditure pressures could threaten the achievement of the authorities' deficit target**. While welcoming the objectives of reducing current spending and improving rural infrastructure, the staff questioned the effectiveness of the current recruitment freeze, emphasizing that payroll overruns could adversely affect expenditure on goods and services and the development budget. In addition, it was noted that on-budget current expenditure has historically exceeded its appropriation by a wide margin and this could occur again if the wage bill was not

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[3]For new mining activity, the tax changes allow greater tax deductions for exploration expenditure, double deduction with an accelerated depreciation schedule, and an indefinite loss carry forward. The tax rate for profits arising from petroleum exploration licenses issued between 2003–08 has been lowered from 45 percent to 30 percent. For further details, see the accompanying *Selected Issues* paper.

[4]The total nominal wage bill is budgeted to increase by 3½ percent, due to the hiring of teachers and the phase in of mandatory pension contributions. The government has agreed that public sector unions can negotiate during 2003 a cost-of-living increase that will be paid in 2004.

brought under strict control. The government also faces strong local political pressures for higher development spending. Even if the authorities largely succeed in cutting expenditure on the scale proposed in the budget, when coupled with last year's large (and unexplained) expenditures totaling over 1 percent of GDP based on the below-the-line financing data, the staff estimated that the fiscal deficit in 2003 would be at least 3½ percent of GDP, well above the authorities' target.

17. **Discussion turned to the additional fiscal actions that should be undertaken to ensure that the government's deficit target in 2003 is achieved**. In this context, the staff proposed early recourse to a supplementary budget that would provide an important signal of the government's resolve to strengthen confidence in economic management. This would also provide an opportunity to show that an appropriate and sustainable mix of revenue and expenditure adjustments is in place to reflect the medium-term priorities. The staff team suggested that consideration could be given to an increase in the VAT rate (currently set at 10 percent) and in some excise rates. On the expenditure side, the staff urged that strong actions to contain the wage bill and reduce inefficient development spending (such as the Yumi-Yet bridges project) be initiated as soon as possible. Additional containment measures could reflect the preliminary findings expected in June of the Public Expenditure and Rationalization Review (PERR), which is being prepared with the assistance of the World Bank, the Asian Development Bank (AsDB), and AusAID.

18. **While not ruling out a supplementary budget, the authorities questioned whether this would be the most appropriate approach**. There was a concern that a supplementary budget could imply a lack of confidence in the government's policies to date, and it could be preferable to rely on the implementation of the expenditure restraint measures that had been put in place in the budget, including monthly checks of expenditure against appropriations, and the placement of financial controllers in the main spending departments. The authorities mentioned that the finance minister had ruled out additional new tax measures during the lifetime of this government in his budget speech. They also noted the government's decision not to phase out the mining levy (a tariff surcharge applied to mining sector imports), which the staff team supported.

B. Monetary and Exchange Rate Policies and External Debt

19. **The authorities stated that the most pressing goal of monetary policy in 2003 was to counter the recent high inflationary trend, and in this regard, agreed with the staff that the present level of interest rates should for now be maintained**. When the fiscal position has been firmly consolidated, confidence in the currency ensured, and inflation placed on a clear declining path, interest rates could be gradually reduced, but premature easing of monetary conditions would carry considerable risks. The authorities noted that the key KFR is now serving as an effective signal of the stance of monetary policy, as evidenced by the concurrent increase in treasury bill yields in recent months. They also commented on their enhanced ability to manage liquidity through the introduction in January 2003 of a two–

seven day repurchase facility and the reopening of a tap facility for treasury bills that is aimed at small nonbank investors.[5]

20. **The staff team and the authorities agreed that the floating exchange rate continues to serve the economy well, and plays an important role in facilitating an orderly adjustment to external shocks.** Following the real effective depreciation in recent years, for the near term the end-2002 nominal level of the exchange rate (around $0.25 per kina) and the level of competitiveness were seen as broadly appropriate. Given the low level of reserves, and the propensity of the country to external shocks, the discussions underscored the critical role that an improved macroeconomic stance would have to play in providing greater stability to the exchange rate in order not to exacerbate debt dynamics. The staff team stressed that, to enhance competitiveness, structural reform efforts need to be stepped up and export diversification increased, particularly in view of the poor mineral export prospects for the coming years.

21. **With regard to debt servicing, the current account and overall balance of payments positions are expected to be unfavorable over the medium term, due in part to the large debt repayment obligations that Papua New Guinea faces.** Further, although the current account is expected to improve temporarily in 2003, and the war in Iraq is not expected to have an adverse impact on Papua New Guinea, the current projections for the overall balance of payments position and level of international reserves in 2003 are weaker than had been projected at the time of the Stand-By Arrangement. In addition, the world commodity prices have recently been changing rapidly (especially for crude petroleum and gold). Against this background, the authorities have requested an extension of their repurchase expectations to the Fund that fall due in the twelve-month period commencing on July 25, 2003 (Annex VII). If the Executive Board approves the request for an extension, the repurchases would become due on the date of the obligation one year later (Table 8 and Annex I).

C. Structural Reforms

22. **Widespread structural reforms are needed to address the impediments to private sector growth in order to facilitate higher investment and employment and a decline in poverty levels.** In the mining sector, these impediments include concerns about law and order, particularly in the volatile Highlands area, and the communal-based property rights over land. Agricultural output is adversely affected by the poor state of rural transportation, roadside bandits, and the inability of many small producers to access credit markets. The forestry sector is plagued by governance problems. Urban employment is

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[5]With Fund technical assistance, the central bank's accounting practices are being strengthened, which could lead to a more accurate recording of its holdings of government debt and profits.

negatively impacted by high crime rates, low education levels, and lack of growth of small- and medium-sized businesses.

23. **The authorities emphasized that, in line with its export-led growth strategy, they are undertaking initiatives to confront many of these difficulties.** The law and order and corruption problems are being addressed through ongoing improvements in legal enforcement practices, and the establishment of an Independent Commission against Corruption (ICAC), although they noted that progress in these areas would take some time. Agricultural output will be promoted through the focus on rural roads in the government's development program and through microfinance programs. The government has also stated its commitment to ensure that forestry development proceeds are based on sound resource planning and supervision. In regard to growth of private sector activity in the urban areas, the newly established Independent Consumer and Competition Commission (ICCC) has been given greater responsibility for adjusting controlled prices (including for utilities) and for more aggressively implementing new competition laws that come into force in May 2003. The government is expected to establish a "one-stop shop" to streamline license approval for new investment and to grant work permits and visas more liberally. The staff team welcomed these initiatives but noted the critical need for them to be fully and expeditiously implemented.

24. **Public sector reform remains focused on efforts to improve efficiency, governance, service delivery, and accountability**. In this regard, with support from the AsDB, oversight budgetary agencies are being strengthened, and the authorities intend to integrate civil service staffing registers and payroll systems in order to improve resource planning and to eliminate ghost workers and undue benefits at the central and provincial levels. Given the limited progress in recent years, the staff team encouraged the authorities to move more rapidly on these tasks. A separate multi year donor-supported program to downsize the defense force is under way, and the authorities are reviewing procurement practices with assistance from donors. These efforts, if fully implemented, could make a useful contribution toward achieving the authorities' ambitious goal to identify gross expenditure savings of up to 5 percent of GDP over the medium term (in the context of the PERR), although net savings will be lower after increases in priority development and poverty-alleviation expenditures are taken into account.

25. **The authorities explained that they would soon change the inter-governmental revenue transfer system in response to the Supreme Court ruling last year that the VAT is unconstitutional**. In addition to renaming the tax as a goods and services tax (GST), the provinces' share of collections will increase from 30 percent to 32 percent of total receipts in January 2004.[6] A commission is currently considering how to adjust transfers to take into account the differences in revenue generation and collection capacities of each province. The

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[6]For details on the Supreme Court ruling and the associated changes to the revenue-sharing arrangements, see the *Tax Summary* in the accompanying *Selected Issues* paper.

staff team raised the need to address the poor service delivery and inefficient development priorities (including neglect of feeder roads to the national highways) under existing arrangements. After the efficiency of provincial expenditure has been strengthened, the staff team stated that any additional resources that are transferred to the provinces would need to be matched by increased expenditure responsibilities.

26. **There is considerable scope to strengthen the financial condition of public enterprises, virtually all of which are making losses.** The government has released a White Paper outlining its approach to the management of government assets. To ensure a more arms-length relationship, ownership of all enterprises is vested in the Independent Public Business Commission, which has responsibility for monitoring their financial condition and debts and for improving corporate governance. For core public enterprises (including Air Niugini, PNG Power, Post PNG, and the Water Board), the focus will be on improving their management and services. Privatization for now will be limited to the sale of noncore assets, primarily real estate, and minority State shareholdings in small enterprises; the sale of the Motor Vehicle Insurance Limited and partial sale of Telikom could also be considered in due course. The People's Unit Trust and Community Services Trust that were established to purchase shares in privatized entities at a discount rate will be closed. During the discussions, the staff team urged a cautious approach in injecting cash as part of the efforts to rehabilitate public assets.

27. **The multi-year trade tariff reduction program is on track.** Virtually all tariffs were reduced by 5 percentage points from January 2003 as scheduled; the last and final stage is scheduled for January 2006, after which all tariffs will fall into one of four tiers that will range between 0–40 percent. With three-fourths of imports entering duty free, the simple average tariff rate is 6 percent (and just 4 percent for nonagricultural goods), and Papua New Guinea is rated one (least restrictive) on the Fund's index of trade restrictiveness. During 2002, Papua New Guinea also signaled its willingness to ratify the Pacific Island Countries Trade Agreement (PICTA), as well as the Pacific Agreement on Closer Economic Relations (PACER).[7] There are no significant nontariff barriers, but the authorities continue to impose export taxes on logs, mineral ores and concentrates, sandalwood, and crocodile skins.

28. **The authorities considered that vulnerability of the financial sector was not a major concern, although they agreed that more needs to be done to strengthen banking supervision.** The financial sector primarily is comprised of one large domestically owned bank (Bank South Pacific after it bought PNGBC) and branches of two major Australian banks. All banks report that their ratios of nonperforming loans to total assets now vary between 3–7 percent, compared with a banking system average of over 10 percent in 2001, and the capital adequacy ratio is reported by the banks to be above the 11 percent legal

[7]PICTA establishes a free trade area over the next decade among the Pacific island countries. PACER sets out procedures that can in due course allow countries that have ratified PICTA to have greater access to Australian and New Zealand markets.

minimum requirement. With technical assistance from the Fund, BPNG is strengthening its prudential regulations, oversight capacity, and the reporting requirements by the financial sector in line with international norms. Staff supported these efforts, but noted that, to date, there have been few on-site inspections, which are necessary to ensure full compliance with the new standards. The authorities are in the process of completing the Fund's questionnaire on anti-money laundering and combating the financing of terrorism.

29. **The National Statistics Office (NSO) outlined the steps that are under way to address the weaknesses in the national, fiscal, monetary, and trade accounts**. An AusAID statistical advisor has been appointed, and the NSO intends to release the national accounts for 1999–2000 by mid-2003. With the assistance of PFTAC, Papua New Guinea is toward participation in the Fund's General Data Dissemination System (GDDS). Attempts are also being made to better integrate the customs data with the balance of payments data compiled by BPNG. The World Bank is assisting in a project to track poverty indicators, and work to undertake a new household survey is being discussed.

D. Medium-Term Outlook

30. **The staff pointed to the need to reduce the near- and medium-term risks faced by Papua New Guinea**. Absent additional fiscal actions, the budget deficit would further increase to around 5 percent of GDP by 2008, primarily due to the anticipated decline in receipts from the mineral and petroleum sectors. In these circumstances, inflation would remain high, international reserves would fall, and poverty levels would deteriorate further. The absence of structural reforms necessary to revive private sector growth would depress urban and rural incomes, exacerbate the government's debt dynamics, weaken revenue collection, and probably necessitate cutbacks to priority development programs.

31. **By contrast, the authorities' objectives, which seemed plausible to the staff, foresaw that, with firm pursuit of structural reforms and macroeconomic policies to permit a stable exchange rate and a progressive decline in inflation, nonmineral output could grow by 2½ percent in 2004 and gradually rise thereafter to reach 3–3½ percent by 2008 (Table 9)**. Under this scenario, employment opportunities would expand and overall real GDP would gradually increase, although per capita incomes may not increase substantially given the anticipated sharp decline in mineral and petroleum output. The key policy variable underpinning these objectives is the achievement of a fiscal deficit of no more than 2 percent in 2003 and a fiscal deficit that averages around 1 percent of GDP during 2004–08. Achieving this target would permit a decline in the ratio of gross central government debt to 64½ percent of GDP by 2008 (9 percentage points lower than at end-2002), with external debt falling to around 40 percent of GDP, consistent with a manageable debt-service burden.

32. **Against this background, the staff team discussed the policies necessary to deliver the required degree of fiscal consolidation over the medium term**. The PERR process should aim to achieve fiscal sustainability, especially downsizing of the civil service payroll, identifying and cutting inefficient development projects, and strengthening budget

institutions and systems. Nevertheless, given the concurrent need to increase core social spending, the adjustments required to meet the medium-term fiscal deficit target will be too large to be achieved by cuts alone. Hence, the staff team indicated that additional revenue measures, including higher indirect taxes, would be required to replace part of the decline in mineral receipts.

33. **During the discussions, it was recognized that even assuming this degree of fiscal restraint is achieved, considerable vulnerabilities to the medium-term outlook would remain**. The magnitude of the current account deterioration due largely to the decline in mineral exports is expected to reach 6 percentage points of GDP by 2008. When coupled with the large debt obligations, the authorities' and staff's projections imply that Papua New Guinea would still face (with flat aid flows, which seem consistent with present donor policies) an external financing gap of at least 1 percent of GDP a year in order to keep international reserves at an average of four months of nonmineral imports. In addition, the central government debt ratio is highly vulnerable to shocks. The staff team estimated that a 30 percent depreciation in the real exchange rate would increase the debt-to-GDP ratio by around 15 percent. The effects of a combined shock to the primary balance, real GDP growth, interest rates, and the exchange rate would also be serious (Box 3).

34. **In light of these vulnerabilities, the authorities expressed an interest in having their reform program supported by financial resources from the Fund**. The staff team responded that immediate actions would be needed to restore macroeconomic stability, including stronger fiscal actions in 2003 and accelerated structural reforms to facilitate faster medium-term sustainable growth and alleviate poverty. On this basis, a Poverty Reduction and Growth Facility (PRGF) arrangement could be considered in due course, although this would require a Board decision adding Papua New Guinea to the list of countries eligible for the PRGF. The staff team emphasized that the Fund stands ready to assist the authorities in reaching their reform objectives, although the prospects for any Fund arrangement would depend crucially on the strength of the adjustment actions taken.

IV. Staff Appraisal

35. **The authorities face a formidable task to reduce the budget deficit to sustainable levels, remove the deep-seated structural impediments to private sector growth, and improve social indicators over the medium term**. Without full implementation of the authorities' medium-term objectives, the risks associated with macroeconomic instability, adverse debt dynamics, and a further deterioration in growth prospects loom large. Prompt and comprehensive measures are a matter of urgency to strengthen confidence in economic management in Papua New Guinea. Specifically, a supplementary budget is needed as soon as possible to foster macroeconomic stability, which will require new fiscal measures, especially to control expenditure. Early and determined action is also required to reduce corruption, improve law and order, enhance public sector efficiency, and facilitate higher private sector employment.

36. **While the recent improved public expenditure control is welcome, without additional action, it seems unlikely that the budget deficit will be brought back in line with the authorities' target of 2 percent of GDP for 2003.** The wage freeze agreement should make a contribution to achieving this target, although there is insufficient evidence that the wage and salary bill is yet under control, especially because of the lack of effectiveness of past hiring freezes. These issues need to be addressed quickly. Moreover, cuts in low priority development spending and abandonment of the Yumi-Yet bridges project are necessary and any further nonconcessional lending should be eschewed. Any postponement of fiscal consolidation now will put a heavy burden on the 2004 budget and delay the shift to poverty reduction and growth.

37. **Lower fiscal deficits over the medium term are essential to reduce the debt burden and its associated vulnerabilities**. Further revenue measures are required, including increases in indirect tax rates; the pressures to reduce the mining levy must continue to be resisted. Expenditure reductions should, to the extent possible, be guided by the findings of the PERR, focusing on lowering the government wage bill in 2004 and beyond, to permit increases in infrastructure and poverty-alleviation outlays, which are vital to promote higher growth. In the context of the planned changes to the inter-governmental transfer system, there should be no increase in resources to the provinces unless accompanied by an increase in their expenditure responsibilities. Even then, the changes should first be predicated on enhancing the quality of provincial expenditures.

38. **The operations of the main public enterprises require strengthening, in order to contribute to public sector efficiency and reduce transfers from the budget and borrowing from the domestic banking system**. Given their poor financial performance, the injection of new funds, including to the noncore bodies slated for privatization, should be limited. The authorities' intention to improve the efficiency of assets under state management, as expressed in their recent policy paper is a positive development, as is the decision to close the People's Unit Trust and the Community Services Trust.

39. **Monetary policy, with positive real interest rates, must continue to aim at reducing inflation pressures and preserving the external position**. However, if the appropriate consolidation of the fiscal position is reached, there is confidence in the currency, and inflation pressures recede, official interest rates could be gradually relaxed in due course. The present level of the exchange rate seems broadly appropriate to maintain competitiveness, and further weakening of the kina would exacerbate the external debt dynamics. An improved macroeconomic stance is critical to achieving a stable exchange rate, backed by strong structural reform policies to enhance competitiveness over the medium term.

40. **Efforts to strengthen the financial sector should be continued and Fund technical assistance is being continued for this purpose**. It is important to ensure that the proposed prudential standards for the banks and the rest of the financial sector are effectively implemented, including through increased use of on-site inspections, reporting by banks that

is based on international standards, and that prudential regulations are thereafter rigorously enforced. This is particularly true for the recently merged Bank South Pacific.

41. **Strong actions to support growth of private rural and urban sector activity are critical to generate employment in the nonmineral sector and reduce poverty levels.** This will not be achieved without firmer efforts to strengthen law and order, governance and accountability at all levels of government. Positive intentions must be translated into actual results. The establishment last year of the ICCC was a step forward in depoliticizing changes in utility and other controlled prices. The new legislation to prevent anti-competitive behavior, as well as the further progress in the multi year trade reform program, are also steps in the right direction. Improvements in infrastructure would revitalize the rural area, including to the Highlands Highway and feeder roads.

42. **Provision of more and better quality economic statistics, including regular reconciliation of above- and below-the-line fiscal financing data, are also required to help the public and private sector in preparing their medium-term plans**. It is a serious concern that the official government data and the central bank figures on the 2002 budget deficit differ substantially.

43. **Provided that decisive and comprehensive economic policy actions are taken, it could be possible to initiate negotiations later this year on a Fund arrangement to assist the authorities in encouraging donor support and closing the potential medium-term balance of payments financing gaps**. In the interim, the staff supports the authorities' request to extend their repurchase expectations to the Fund in light of the weakness in Papua New Guinea's balance of payments position and the deterioration in key external indicators mainly because of lower mineral exports over the medium term.

44. **It is proposed that the next Article IV consultation be conducted on the standard 12-month cycle.**

Box 1. Papua New Guinea: Impediments to Growth and Poverty Alleviation

Papua New Guinea's per capita real GDP in 2002 was lower than at the time of independence in 1975. Social and poverty indicators remain poor, with average life expectancy 20 years below that of Australia and infant mortality 10 times higher than in developed countries. Efforts to eradicate poverty have been hampered by the impediments to growth and by the poor delivery of social services, especially in the rural area, and significant impediments to growth remain in all sectors.

Mineral and petroleum sector: Papua New Guinea has substantial deposits of gold, copper, and oil. Since independence, the mineral sector has generated fiscal revenues of about 5 percent of GDP per year. However, the geographic isolation of these resources implies a high extraction cost in addition to the usual capital intensity of mining activity. Foreign companies have financed all of the major mining projects, and there are few downstream linkages since most mines operate as isolated enclaves. With the violence and collapse of the copper mine in Bougainville in the early 1990s, new exploration activity has largely dried up. Consequently, no new major projects are expected to open in the years ahead and fiscal revenues are expected to decline by up to 2 percent of GDP over the medium term. Law and order problems, especially in the Highlands region where much of the deposits are located, and ambiguous property rights over land, compounded by an ineffective court system that has fueled myriad compensation claims from loosely defined landowner groups, have hampered the ability of mining companies to operate profitably.

Forestry and tourism: Papua New Guinea has the second largest rainforest in the world. However, the forestry sector has been plagued by unsustainable and environmentally destructive practices stemming from poor governance and uncertain property rights. Given the country's natural features, bountiful coral reefs, rich culture, and proximity to the Australian market, tourism offers much potential. Due to lawlessness and undeveloped infrastructure there are very few tourists currently.

Agricultural sector: While more than 85 percent of the population lives in the rural areas, development of the formal agriculture sector has been impeded by the deteriorating roads due to the inefficient allocation of development expenditure, especially for feeder roads which fall under the responsibility of the provincial governments, and the presence of roadside bandits. Both of these factors have limited the opportunity for farmers to bring their goods to market. Large-scale farming has virtually vanished in response to security disruptions. Additionally, farmers have typically not had much access to credit since they cannot use their land as collateral due to the traditional land tenure system, and this has undermined the use of more efficient large-scale farming practices.

Urban sector: The urban centers, especially Port Moresby, have grown rapidly since independence. However, formal private urban employment has barely increased, resulting in growing unemployment and escalating criminal activities, particularly in squatter settlements. Urban employment has been hamstrung by the lack of entrepreneurial experience, low levels of education, and weak legislation to support small- and medium-sized enterprises. In addition, many of the best workers have been absorbed by the public sector and state owned enterprises, limiting the pool of skilled workers available to private firms.

Box 2. Papua New Guinea: The Authorities' Medium-Term Strategies

The government that took office in August 2002 prepared medium-term fiscal, development, and poverty-reduction strategies to guide economic policy formulation through 2007, including in the 2003 budget.

- **Medium-Term Economic and Fiscal Outlook (2002–07)**

In the absence of corrective actions, the government projected that the budget would approach 5 percent of GDP by 2007 as receipts from the minerals and petroleum sectors gradually decline, the exchange rate would depreciate by 15 percent per year, inflation would remain higher than in competitor countries, and government debt would rise to 130 percent of GDP. The document stressed the urgency of restoring fiscal discipline starting in 2003. In this regard, it was proposed that the overall deficit should be brought down to about 1 percent of GDP by 2007 to reduce the debt-to-GDP ratio to no more than 60 percent of GDP (see table). The document stated that fiscal consolidation in 2003 and beyond will entail substantial expenditure cuts, focusing on reducing the public sector wage bill and inefficient development spending, and may require limited revenue measures. The fiscal strategy would be incorporated into a broader macroeconomic framework to promote growth by maintaining macroeconomic stability, pushing ahead with governance and law and order initiatives, privatization, and improved infrastructure maintenance.

Papua New Guinea: Authorities' Medium-Term Projections 1/

	2003	2004	2005	2006	2007
Real GDP growth	1.8	2.7	1.6	-0.4	0.5
Of which: nonmineral growth	1.6	2.3	2.5	2.7	2.6
CPI (period average)	13.2	5.0	5.1	4.5	5.5
Total revenue and grants 2/	29.2	28.8	28.5	28.7	28.7
Total expenditure 2/	31.3	30.7	30.0	29.9	29.6
Overall deficit 2/	-2.0	-1.8	-1.5	-1.2	-0.9
Fiscal financing gap 2/	1.4	1.1	0.9	0.8	0.4
Gross public sector debt 2/ 3/	68.9	66.0	63.1	62.4	59.8
Of which: external debt 2/ 3/	46.0	43.6	40.9	39.8	37.4
Current account surplus 2/	4.3	2.8	4.7	3.5	2.1

1/ Based on the November 2003 budget documents.
2/ Percent of GDP
3/ Including new borrowings to cover fiscal financing gaps; excluding BPNG debt

- **Medium-Term Development Strategy**

The strategy focuses on three broad based and interrelated objectives: (i) promoting good governance by strengthening political stability, engaging in meaningful public sector reform, and enhancing transparency and accountability at all levels of government; (ii) generating export-led growth by focusing on expanding opportunities in the agriculture, fisheries, and forestry sectors, while maintaining support for the mining, petroleum, gas, and service sectors; and (iii) fostering rural development, poverty reduction, and human resource management. This agenda is expected to yield tangible benefits in key sectors of the economy. In health, the focus will remain on primary and preventive health care, with priority being given to expanding services in rural areas. In education, the goal is to move towards universal primary education, with additional support provided by local communities, provinces, and donors. For transport infrastructure, the focus will be on improving the country's road network, especially the Highlands Highway. The agriculture, forestry and fisheries sectors will be buttressed by increased investments in research, and by revitalizing the Rural Development Bank. Law and order will be strengthened by improving the delivery of justice, weeding out corruption, increasing deterrents, and restoring community-based justice systems. The document also cites the need to reduce red tape, by reviewing exchange control, immigration, custom, and investment regulations.

- **National Poverty Reduction Strategy**

The National Poverty Reduction Strategy is being prepared to lay out the agenda for poverty alleviation over a 15–20 year period, following consultations with over 800 urban and rural participants. The five pillars around which it is being developed are: to improve and strengthen governance; increase development of land and natural resources; improve and maintain capacity and management of transport and physical infrastructure; improve and expand economic growth opportunities; and strengthen and expand social services.

Box 3. Papua New Guinea: Central Government Debt Sustainability

This box presents an overview of the medium-term central government debt sustainability outlook for Papua New Guinea. The methodology draws on the *Assessing Sustainability* paper (SM/02/168), adjusted for Papua New Guinea's circumstances, where a number of stress tests are applied around the baseline scenario (which is based on the authorities' medium-term policy intentions). A more comprehensive analysis of fiscal sector stress and of total external debt dynamics is contained in the accompanying *Selected Issues* paper.

The baseline scenario is an updated version of the one presented in the last Article IV staff report (SM/02/159). These projections are largely driven by the expected sharp decline in oil production and exports due to the depletion of reserves during the period 2003–08. Mineral sector real GDP growth is expected to be negative throughout the period. Nonmineral production is expected to grow at around 3 percent per annum, backed by strong adjustment policies (including a fiscal deficit averaging only 1 percent of GDP over the medium term). Total real GDP growth is therefore expected to average around 2 percent during the projection period.

The results show that Papua New Guinea's central government debt-to-GDP ratio (excluding contingent liabilities due to data deficiencies) declines from its current level of 73½ percent to around 64½ percent by 2008, assuming there are no major negative shocks. This outlook is particularly vulnerable to exchange rate shocks. A sustained 30 percent real depreciation in the kina in 2003 increases the debt-to-GDP ratio to over 85 percent, primarily due to the large share of external debt. The impact of a shock to interest rates, the primary balance, or GDP growth leaves the central government debt at around its current high level. The long-term effects of a combined shock applied over a two-year period (specifically, a deterioration in the primary balance, interest rates, real GDP growth, and the exchange rate) would be even more serious as external debt-to-GDP ratios by 2008 would be higher than 2002 levels by over 10 percentage points (to over 85 percent of GDP).

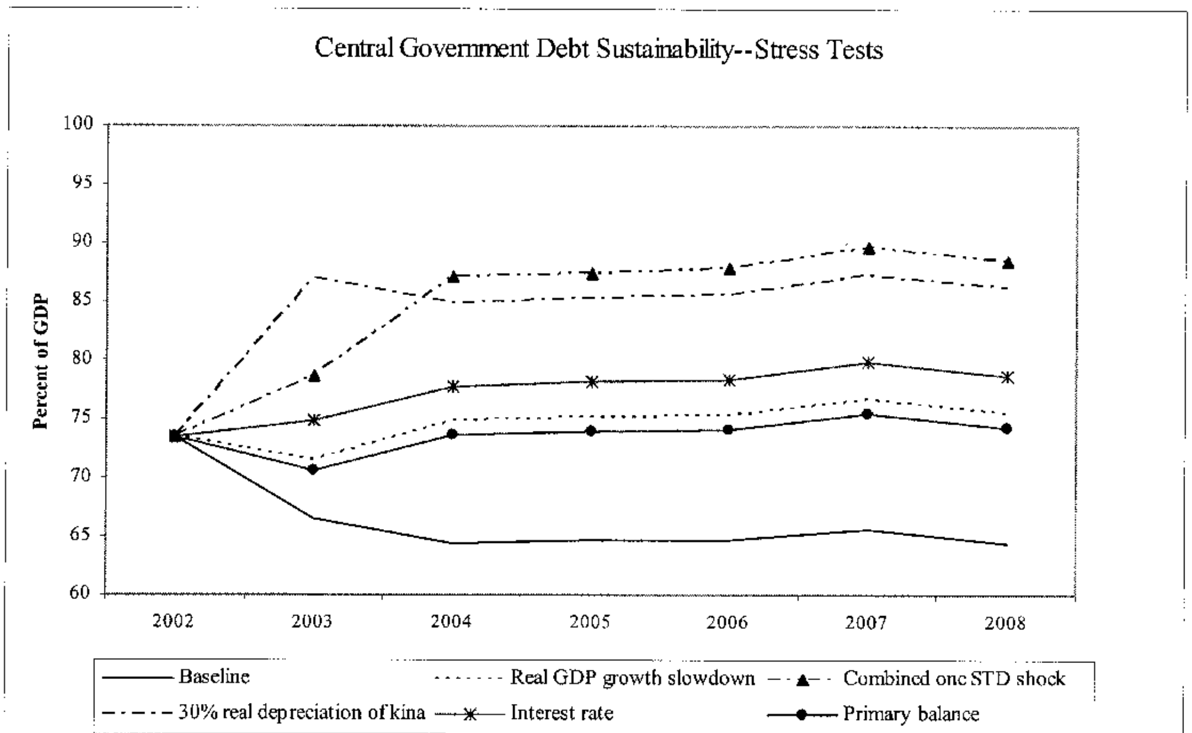

Table 1. Papua New Guinea: Selected Economic Indicators, 1998–2003

Nominal GDP (2001):	US$2.9 billion
Population (2001):	5.2 million
GDP per capita (2001):	US$558
Quota:	SDR 131.6 million

	1998	1999	2000	2001	Prel. 2002	Proj. 2003 1/
Real sector (percent change)						
Real GDP growth	-3.8	7.6	-1.3	-3.4	-3.1	1.8
Mineral	16.8	10.0	-4.0	-0.6	-9.6	-0.3
Nonmineral	-8.1	6.9	-0.5	-4.2	-1.3	2.3
CPI (annual average)	13.6	14.9	15.6	9.3	11.8	12.3
CPI (12 months)	21.8	13.2	10.0	10.3	14.8	9.0
Central government budget (percent of GDP)						
Revenue and grants	29.2	29.3	31.3	30.6	29.6	29.0
Expenditure and net lending	31.0	32.4	32.8	34.5	33.7	32.5
Measures	...	...	...	...	...	1.5
Overall balance, cash basis (excluding grants) 2/	-7.5	-8.4	-7.0	-9.4	-10.4	-8.0
Overall balance, cash basis (including grants) 2/	-0.4	-4.3	-1.4	-4.1	-5.5	-2.0
Domestic financing, net 3/	1.4	2.0	0.9	0.9	4.9	0.5
Of which : Banking system	1.7	1.2	-1.4	-2.5	5.3	0.5
External financing, net	-1.2	2.0	0.2	3.2	-1.3	-0.3
Privatization, net	0.2	0.3	0.3	0.0	1.8	0.8
Financing gap	...	...	...	...	...	1.0
Money and credit (end-period percentage change)						
Domestic credit	17.1	4.0	-4.5	-12.3	20.9	5.8
Net credit to government	15.4	11.2	-12.5	-26.1	82.0	5.1
Credit to the private sector	29.0	10.5	3.0	-1.2	-6.3	6.9
Broad money	2.5	8.8	5.4	1.9	4.2	8.0
Interest rate (182-day T-bills, end-period)	23.9	20.4	14.9	10.2	13.4	...
Balance of payments (US$ millions)						
Exports, f.o.b.	1,848	2,019	2,214	1,878	1,624	1,915
Imports, c.i.f.	-1,425	-1,525	-1,503	-1,269	-1,225	-1,298
Current account (including grants)	22	53	232	174	-74	86
(In percent of GDP)	0.6	1.5	6.7	6.0	-2.7	2.9
Overall balance	-190	-36	8	66	-96	-8
Reserves and external debt (end-period, US$ millions)						
Net international reserves	139	183	256	331	226	252
(In months of nonmining imports, c.i.f.)	1.4	1.9	3.5	4.6	3.0	3.1
Gross international reserves	187	206	304	440	343	367
(In months of nonmining imports, c.i.f.)	1.8	2.2	4.2	6.1	4.5	4.6
Public external debt-to-GDP ratio (in percent) 4/	35.6	42.2	41.8	51.4	54.4	48.6
Public external debt-service ratio (percent of GNFS exports) 4/	7.3	7.5	6.7	7.1	7.4	8.3
Exchange rates						
US$/kina (period average)	0.4856	0.3922	0.3624	0.2965	0.2490	...
US$/kina (end-period)	0.4770	0.3710	0.3255	0.2658	0.2488	...
NEER (1990=100, end-period) 5/	45.0	35.2	31.6	24.8	24.2	...
REER (1990=100, end-period) 5/	82.1	74.0	77.7	69.7	70.6	...
Nominal GDP (millions of kina)	7,789	8,781	9,515	9,821	10,881	12,107

Sources: Data provided by the Papua New Guinea authorities; and Fund staff estimates and projections.

1/ Based on staff estimates and 2003 budget documents.

2/ Measured from below the line in the fiscal accounts.

3/ Includes changes in check float.

4/ Central government and Bank of Papua New Guinea.

5/ As of end-December 2002.

Table 2. Papua New Guinea: Medium-Term Balance of Payments Outlook, 2001-08

(In millions of US dollars)

	Actual	Prel.	Projections 1/					
	2001	2002	2003	2004	2005	2006	2007	2008
Current account balance	174	-74	86	81	35	-16	-62	-100
Mineral	808	561	747	749	720	697	623	638
Nonmineral	-634	-635	-661	-669	-685	-713	-685	-738
Trade balance	609	399	617	576	500	415	264	227
Exports (f.o.b.)	1,878	1,624	1,915	1,883	1,814	1,749	1,598	1,606
Mineral	1,598	1,363	1,613	1,550	1,453	1,376	1,190	1,181
Nonmineral	280	261	301	334	361	372	408	425
Imports (c.i.f.)	-1,269	-1,225	-1,298	-1,307	-1,315	-1,333	-1,334	-1,379
Mineral	-394	-362	-380	-347	-309	-277	-227	-212
Nonmineral	-875	-863	-918	-960	-1,005	-1,056	-1,108	-1,167
Services balance	-564	-600	-673	-635	-604	-575	-470	-471
Mineral (net)	-396	-440	-487	-453	-424	-402	-340	-331
Nonmineral (net)	-168	-160	-186	-182	-180	-173	-130	-140
Unrequited transfers (net)	129	128	142	140	140	143	144	144
Official	180	168	182	182	181	181	182	183
Private	-51	-41	-40	-43	-42	-38	-38	-39
Capital account balance	-99	-72	-94	-77	-42	22	61	97
Medium- and long-term loan disbursements	-35	-157	-91	-54	-82	-74	-106	-111
Official (net)	93	-35	-45	-34	-35	-23	-34	-38
Private (net)	-128	-122	-46	-20	-47	-51	-73	-73
Direct investment (net)	74	19	90	71	73	79	62	63
Commercial banks	-27	-45	-10	-10	-10	-10	-10	-9
Other (net)	-111	111	-83	-85	-23	28	116	154
Errors and omissions	-9	50	0	0	0	0	0	0
Overall balance	66	-96	-8	4	-7	6	-1	-3
Financing	-66	96	8	-4	7	-6	1	3
Change in net international reserves (- increase)	-66	96	-27	-36	-40	-47	-21	-22
Gross official reserves	-136	97	-24	0	16	-24	-21	-22
IMF (net)	70	0	-3	-36	-56	-23	0	0
Purchases	71	0	0	0	0	0	0	0
Repurchases	-1	0	-3	-36	-56	-23	0	0
Other liabilities	-1	0	0	0	0	0	0	0
Exceptional financing	0	0	35	0	0	0	0	0
Residual Financing gap	0	0	0	32	47	41	22	25
Memorandum items:								
Current account (in percent of GDP)	6.0	-2.7	2.9	2.6	1.1	-0.5	-1.9	-3.0
Mineral	27.7	20.7	24.8	23.9	22.8	21.7	19.3	19.1
Nonmineral	-21.8	-23.4	-21.9	-21.3	-21.7	-22.2	-21.3	-22.1
Net international reserves (end year, millions of U.S. dollars)	331	226	252	288	328	374	395	417
Gross official reserves (end year, millions of U.S. dollars)	440	343	367	367	351	375	396	418
In months of nonmineral imports	6.1	4.5	4.6	4.4	4.0	4.1	4.1	4.1
External Public debt-service ratio (percent of GNFS exports) 2/	7.1	7.4	8.3	9.3	9.8	7.4	6.3	6.4
External Public debt-to-GDP ratio (in percent) 2/	51.4	54.4	48.6	44.3	41.3	39.4	38.4	36.1
External Public debt-to-GDP ratio (in percent) (with gaps) 2/	51.4	54.4	48.6	45.3	43.8	44.6	43.6	41.1

Sources: Data provided by the Papua New Guinea authorities; and Fund staff estimates.

1/ The Gas Project that could come on-line in 2007 is excluded from projections (should the project go ahead, import needs in the start-up phase would, in any event, likely be fully financed by new foreign inflows).

2/ Central government and Bank of Papua New Guinea external debt.

Table 3. Papua New Guinea: Central Government Fiscal Performance, 1998-2003

(In millions of kina)

	1998	1999	2000	2001	2002	2003	
						Budget	Proj. 1/
Revenue	2,273	2,569	2,982	3,006	3,222	3,490	3,514
Tax	1,595	1,941	2,315	2,294	2,370	2,466	2,586
Nonmineral taxes	1,355	1,675	1,780	1,739	2,005	2,116	2,194
Mineral taxes	241	266	535	555	365	350	392
Non tax	234	166	145	172	163	197	197
Of which: Mineral non tax revenue	66	37	0	42	10	28	28
Grants	444	463	522	540	689	827	732
Budget grants	161	69	31	16	21	100	100
Project grants	283	394	491	524	668	727	632
Expenditure	2,412	2,843	3,123	3,392	3,668	3,734	3,934
Recurrent	1,895	2,020	2,219	2,389	2,550	2,537	2,705
Non interest recurrent expenditures	1,560	1,628	1,790	1,956	2,110	1,958	2,110
National departments	858	969	1,141	1,203	1,357	1,192	1,290
Salaries and wages	384	393	473	502	574	584	612
Retrenchment costs	...	14	...	...	...	...	...
Arrears payments	...	149	193	91	12	60	60
Education funding	...	...	...	...	135	40	40
Goods and services	...	545	475	572	569	473	544
Structural adjustment payments	475	...	77	40	68	35	35
Provinces	566	537	527	589	588	593	637
Salaries and wages	307	384	363	420	486	495	517
Goods and services	...	85	94	98	48	60	65
Conditional grants	...	68	69	71	54	38	54
Statutory authorities	136	121	122	165	165	173	183
Interest	335	393	429	433	440	579	595
Domestic	228	261	284	253	247	386	418
Foreign	107	132	144	180	193	194	177
Development budget and net lending	517	823	905	1,003	1,118	1,197	1,229
Development budget	521	828	806	967	1,123	1,201	1,233
Project grants	...	394	491	524	668	727	632
Concessional loans	...	121	107	88	95	196	196
Nonconcessional loans	...	...	...	...	93	38	88
Domestic funds	...	313	209	356	267	240	317
Net lending	-5	-5	-3	-4	-5	-4	-4
Additional Measures	...	...	...	...	...	...	179
Overall balance (from above the line)	-139	-275	-142	-386	-445	-244	-241
Errors, omissions, and discrepancy	109	-105	13	-19	-150	0	0
Overall balance (from below the line)	-30	-379	-129	-405	-596	-244	-241
Financing	30	379	129	405	596	244	241
Foreign financing (net)	-94	180	15	314	-141	-301	-40
Domestic financing (net)	110	153	28	-35	635	180	90
Float	...	20	58	127	-99	0	-30
Asset sales	14	26	27	0	201	200	100
Financing gap	...	...	...	...	...	166	121
Memorandum Item:							
Nominal GDP (millions of kina)	7,789	8,781	9,515	9,821	10,881	11,950	12,107

Sources: Data provided by the Papua New Guinea authorities; and staff projections.

1/ Staff estimates based on present policies.

Table 4. Papua New Guinea: Central Government Fiscal Performance, 1998-2003

(In percent of GDP)

	1998	1999	2000	2001	2002	2003 Budget	2003 Proj. 1/
Revenue	29.2	29.3	31.3	30.6	29.6	29.2	29.0
Tax	20.5	22.1	24.3	23.4	21.8	20.6	21.4
Nonmineral taxes	17.4	19.1	18.7	17.7	18.4	17.7	18.1
Mineral taxes	3.1	3.0	5.6	5.7	3.4	2.9	3.2
Non tax	3.0	1.9	1.5	1.7	1.5	1.6	1.6
Of which: Mineral non tax revenue	0.8	0.4	0.0	0.4	0.1	0.2	0.2
Grants	5.7	5.3	5.5	5.5	6.3	6.9	6.0
Budget grants	2.1	0.8	0.3	0.2	0.2	0.8	0.8
Project grants	3.6	4.5	5.2	5.3	6.1	6.1	5.2
Expenditure	31.0	32.4	32.8	34.5	33.7	31.2	32.5
Recurrent	24.3	23.0	23.3	24.3	23.4	21.2	22.3
Non interest recurrent expenditures	20.0	18.5	18.8	19.9	19.4	16.4	17.4
National departments	11.0	11.0	12.0	12.2	12.5	10.0	10.7
Salaries and wages	4.9	4.5	5.0	5.1	5.3	4.9	5.1
Retrenchment costs	...	0.2	...	...	...	...	...
Arrears payments	...	1.7	2.0	0.9	0.1	0.5	0.5
Education funding	...	...	...	...	1.2	0.3	0.3
Goods and services	...	6.2	5.0	5.8	5.2	4.0	4.5
Structural adjustment payments	6.1	...	0.8	0.4	0.6	0.3	0.3
Provinces	7.3	6.1	5.5	6.0	5.4	5.0	5.3
Salaries and wages	3.9	4.4	3.8	4.3	4.5	4.1	4.3
Goods and services	...	1.0	1.0	1.0	0.4	0.5	0.5
Conditional grants	...	0.8	0.7	0.7	0.5	0.3	0.4
Statutory authorities	1.7	1.4	1.3	1.7	1.5	1.4	1.5
Interest	4.3	4.5	4.5	4.4	4.0	4.8	4.9
Domestic	2.9	3.0	3.0	2.6	2.3	3.2	3.5
Foreign	1.4	1.5	1.5	1.8	1.8	1.6	1.5
Development budget and net lending	6.6	9.4	9.5	10.2	10.3	10.0	10.2
Development budget	6.7	9.4	8.5	9.8	10.3	10.1	10.2
Project grants	...	4.5	5.2	5.3	6.1	6.1	5.2
Concessional loans	...	1.4	1.1	0.9	0.9	1.6	1.6
Nonconcessional loans	...	...	...	...	0.9	0.3	0.7
Domestic funds	...	3.6	2.2	3.6	2.5	2.0	2.6
Net lending	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Additional measures	...	...	...	...	...	...	1.5
Overall balance (from above the line)	-1.8	-3.1	-1.5	-3.9	-4.1	-2.0	-2.0
Errors, omissions, and discrepancy	1.4	-1.2	0.1	-0.2	-1.4	0.0	0.0
Overall balance (from below the line)	-0.4	-4.3	-1.4	-4.1	-5.5	-2.0	-2.0
Financing	0.4	4.3	1.4	4.1	5.5	2.0	2.0
Foreign financing (net)	-1.2	2.0	0.2	3.2	-1.3	-2.5	-0.3
Domestic financing (net)	1.4	1.7	0.3	-0.4	5.8	1.5	0.7
Float	...	0.2	0.6	1.3	-0.9	0.0	-0.2
Asset sales	0.2	0.3	0.3	0.0	1.8	1.7	0.8
Financing gap	...	...	...	...	...	1.4	1.0
Memorandum Item:							
Nominal GDP (millions of kina)	7,789	8,781	9,515	9,821	10,881	11,950	12,107

Sources: Data provided by the Papua New Guinea authorities; and staff projections.

1/ Staff estimates based on present policies.

Table 5. Papua New Guinea: External Central Government and Central Bank Debt Outstanding, 1998-2003

(In millions of U.S. dollars, unless otherwise indicated)

	1998	1999	2000	2001	2002	Proj. 2003
Total	1,346	1,452	1,442	1,498	1,474	1,465
Central government	1,298	1,348	1,394	1,390	1,357	1,350
Multilateral creditors	814	798	790	844	828	863
World Bank Group	359	334	345	380	363	351
Asian Development Bank	384	401	387	409	406	451
EU	47	60	54	52	56	57
Other	24	4	4	3	3	3
Bilateral	428	507	571	516	489	434
Australia	4	1	85	99	87	53
China	10	13	15	15	15	13
Japan	384	447	423	371	352	335
Other	30	46	48	31	35	33
Commercial creditors	56	43	33	29	41	53
Banks	39	31	30	20	37	53
Other	17	12	4	10	3	0
Central bank (BPNG)	48	103	48	108	117	115
IMF liabilities	46	23	39	107	116	114
Other	1	80	9	1	1	1
Memorandum items:						
Central government external debt/GDP (in percent)	34.3	39.2	40.4	47.7	50.1	44.8
External debt/GDP (in percent, including gaps)	35.6	42.2	41.8	51.4	54.4	48.6
GDP (in millions of US dollars)	3,782	3,444	3,448	2,912	2,709	3,013
Exports of goods and services (in millions of US dollars)	2,113	2,268	2,462	2,077	1,867	2,129
Government revenues (in millions of US dollars)	1,264	1,318	888	826	891	731

Sources: Data provided by the Papua New Guinea authorities (Loans and Revenue Division); and Fund staff estimates and projections.

Table 6. Papua New Guinea: Indicators of External Vulnerability, 1998-2002

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002
Financial indicators					
Gross central government debt 1/	67.7	60.4	60.0	70.0	73.5
Broad money (percent change, 12-month basis)	2.5	8.8	5.4	1.9	4.2
Private sector credit (percent change, 12 month basis)	29.0	10.5	3.0	-1.2	-6.3
182 day T-bill yield 1/	23.9	20.4	14.9	10.2	13.4
182 day T-bill yield (real) 2/	1.7	6.4	4.5	-0.1	-1.2
External Indicators					
Exports (percent change, 12-month basis in US$)	-15.4	9.3	9.7	-15.2	-13.5
Imports (percent change, 12-month basis in US$)	-27.7	7.0	-1.5	-15.6	-3.5
Current account balance	0.6	1.5	6.7	6.0	-2.7
Capital and financial account balance	-4.4	-1.3	0.1	-0.7	-1.0
Of which: Inward foreign direct investment	4.4	9.9	4.0	4.0	8.0
Gross official reserves (millions of US$)	187	206	304	440	343
Central Bank short-term foreign liabilities (millions of US$)	2.1	1.5	0.8	0.5	0.5
Commerical bank foreign assets (millions of US$)	136.3	106.0	96.5	112.2	153.1
Commerical bank foreign liabilities (millions of US$)	54.5	36.7	18.1	24.2	26.0
Official reserves (months of nonmineral imports, c.i.f.)	1.8	2.2	4.2	6.1	4.5
Broad money to gross reserves (ratio)	6.6	5.0	3.2	1.8	2.3
Total short-term external debt to reserves (percent) 3/	29.2	17.8	6.0	5.5	7.6
Central government and Central Bank external debt	35.6	42.2	41.8	51.4	54.4
Exchange rate (per US$, period average)	2.06	2.55	2.76	3.37	4.02
Financial Market Indicators					
Foreign currency long-term government debt rating 1/					
Moody's 4/	n.a.	B1(neg.)	B1(neg.)	B1(stab.)	B1(stab.)
Standard and Poors 5/	n.a.	B+(stab.)	B+(neg.)	B(stab.)	B(neg.)

1/ End of period.
2/ Ex-post real rate.
3/ Covers only banking system short-term external debt.
4/ Initial rating of B1 (stable) in January 1999.
5/ Initial rating of B+(stable) in January 1999. Downgraded to B (stab.) in August 2001 and B (neg.) in 2002.

Table 7. Papua New Guinea: Monetary Survey, 1998-2003

(In millions of kina)

	1998	1999	2000	2001	2002	Proj. 2003
Net foreign assets	473	699	1,053	1,580	1,419	1,646
Bank of Papua New Guinea	301	512	812	1,249	908	1,080
Foreign assets	401	574	934	1,656	1,379	1,478
Less: Foreign liabilities	100	62	122	406	471	398
Commercial banks	171	187	241	331	511	566
Net domestic assets	2,169	2,176	1,977	1,507	1,798	1,828
Domestic credit	2,716	2,825	2,699	2,367	2,862	3,029
Net credit to central government	969	1,077	943	697	1,269	1,333
Bank of Papua New Guinea	368	693	741	472	717	642
Claims on central government	1,285	795	772	746	802	728
Less: Central government deposits	917	102	31	275	86	86
Commercial banks	601	384	202	225	552	691
Claims on central government	889	596	457	535	835	974
Securities	806	572	445	528	832	971
Treasury bills	744	568	445	443	812	951
Inscribed stock	62	4	0	85	20	20
Loans	83	24	12	7	3	3
Less: Central government deposits	287	212	255	310	283	283
Claims on other sectors	1,747	1,747	1,756	1,670	1,594	1,696
Claims on the private sector	1,372	1,517	1,562	1,543	1,445	1,545
Claims on official entities	208	159	124	115	128	128
Claims on NFPE's	203	153	123	114	126	126
Claims on provincial governments	5	5	1	1	2	2
Claims on nonmonetary financial institutions	167	72	70	12	20	23
Other items, net	-547	-649	-722	-860	-1,064	-1,201
Broad money	2,642	2,875	3,030	3,087	3,217	3,474
Narrow money	1,021	1,234	1,272	1,321	1,535	1,660
Currency outside banks	277	342	285	272	366	399
Demand deposits	744	891	987	1,049	1,169	1,261
Quasi money	1,621	1,641	1,759	1,766	1,682	1,814
Memorandum items						
Reserve money growth 1/	36.2	70.0	-18.4	8.5	11.4	10.1
Narrow money growth rate 1/	11.1	20.8	3.1	3.9	16.2	8.1
Broad money growth rate 1/	2.5	8.8	5.4	1.9	4.2	8.0
Private sector credit growth rate 1/	29.0	10.5	3.0	-1.2	-6.3	6.9
Broad money multiplier	6.9	4.4	5.7	5.3	5.0	4.9
Nominal GDP (in millions of kina)	7,789	8,781	9,515	9,821	10,881	12,107
Broad money velocity	2.9	3.1	3.1	3.2	3.4	3.5
Nominal nonmineral GDP/broad money	2.3	2.3	2.3	2.2	2.4	2.5

Sources: Data provided by the Papua New Guinea authorities; and Fund staff estimates.

1/ Percent change from previous year.

Table 8. Papua New Guinea: Indicators of Capacity to Repay the Fund, 2000-08

	2000	2001	2002	2003	2004	2005	2006	2007	2008
				Projection					
Outstanding UFR (in US$)	38.8	107.4	116.2	114.3	78.1	22.7	0.0	0.0	0.0
Obligations to the IMF	21.0	4.1	2.5	6.6	38.9	57.1	23.2	0.1	0.1
Repurchases (in US$)	19.2	1.3	0.0	3.4	36.2	55.5	22.8	0.0	0.0
Charges (in US$)	1.8	2.8	2.5	3.1	2.8	1.6	0.4	0.1	0.1
Outstanding UFR in percent of:									
GDP	1.1	3.7	4.3	3.8	2.5	0.7	0.0	0.0	0.0
Exports of good and nonfactor services	1.6	5.2	6.2	5.4	3.7	1.1	0.0	0.0	0.0
External public debt	2.7	7.2	7.9	7.8	5.6	1.7	0.0	0.0	0.0
Net official international reserves	15.2	32.4	51.4	45.4	27.1	6.9	0.0	0.0	0.0
Quota	22.7	64.9	64.9	63.0	43.1	12.5	0.0	0.0	0.0
Obligations to the IMF in percent of:									
GDP	0.6	0.1	0.1	0.2	1.2	1.8	0.7	0.0	0.0
Exports of good and nonfactor services	0.9	0.2	0.1	0.3	1.8	2.8	1.2	0.0	0.0
Public debt service	12.6	2.8	1.8	3.7	19.7	28.3	15.6	0.1	0.1
Net official international reserves	8.2	1.2	1.1	2.6	13.5	17.4	6.2	0.0	0.0
Memorandum items:									
Public debt service (percent of goods and nonfactor services exports)	6.7	7.1	7.4	8.3	9.3	9.8	7.4	6.3	6.4

Sources: Data provided by the Papua New Guinea authorities; and Fund staff estimates and projections.

Table 9. Papua New Guinea: Medium-Term Scenario, 2000-08

			Prel.	Projected 1/					
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Growth and prices (change in percent)									
Real GDP 2/	-1.3	-3.4	-3.1	1.8	2.3	1.3	1.7	0.6	3.1
Mineral	-4.0	-0.6	-9.6	-0.3	1.1	-6.1	-5.1	-13.3	0.7
Nonmineral	-0.5	-4.2	-1.3	2.3	2.6	3.1	3.2	3.4	3.5
CPI (average)	15.6	9.3	11.8	12.3	6.9	4.0	2.5	2.0	2.0
Savings and investment (in percent of GDP)									
Foreign savings	-6.7	-6.0	2.7	-2.9	-2.6	-1.1	0.5	1.9	3.0
Public saving-investment balance 3/	-1.5	-3.9	-4.1	-2.0	-1.3	-0.9	-0.7	-0.5	-0.3
Private saving-investment balance 4/	8.2	9.9	1.4	4.9	3.9	2.0	0.2	-1.4	-2.6
Central government operations (in percent of GDP)									
Total revenue and grants	31.3	30.6	29.6	29.0	29.1	29.1	29.0	29.3	29.2
Of which: Mineral tax revenue	5.6	5.7	3.4	3.2	3.0	2.8	2.5	2.1	2.0
Total expenditure	32.8	34.5	33.7	32.5	30.4	30.0	29.7	29.8	29.5
Measures	...	...	...	1.5	...	...	...	...	...
Overall balance 5/	-1.4	-4.1	-5.5	-2.0	-1.3	-0.9	-0.7	-0.5	-0.3
Domestic financing (net) 6/	0.9	0.9	4.9	0.5	1.3	1.0	0.7	1.6	1.5
Foreign financing (net)	0.2	3.2	-1.3	-0.3	-1.1	-1.1	-0.7	-1.0	-1.1
Privatization (net)	0.3	0.0	1.8	0.8	0.4	0.4	0.0	0.0	0.0
Financing Gap	...	...	...	1.0	0.7	0.7	0.7	...	...
Gross central government debt (in percent of GDP) 7/	60.0	70.0	73.5	66.6	64.5	64.6	64.7	65.6	64.4
Domestic	19.6	22.3	23.4	21.8	21.6	21.6	21.6	22.8	23.4
External	40.4	47.7	50.1	44.8	42.8	43.0	43.1	42.8	40.9
Money and credit (annual percent change, end period)									
Net foreign assets	50.6	50.0	-10.6	16.0	21.2	8.8	7.0	5.2	6.1
Net domestic assets	-9.1	-23.8	19.8	1.7	-2.7	8.2	7.8	9.0	7.3
Of which: Credit to private sector	3.0	-1.2	-6.3	6.9	8.6	7.5	6.4	6.0	5.7
Broad money	5.4	1.9	4.2	8.0	8.5	8.5	7.4	7.0	6.7
Balance of payments (in millions of US$)									
Exports, f.o.b.	2,214	1,878	1,624	1,915	1,883	1,814	1,749	1,598	1,606
Of which: Mineral	1,737	1,598	1,363	1,613	1,550	1,453	1,376	1,190	1,181
Imports, c.i.f.	-1,503	-1,269	-1,225	-1,298	-1,307	-1,315	-1,333	-1,334	-1,379
Current account	232	174	-74	86	81	35	-16	-62	-100
As percentage of GDP	6.7	6.0	-2.7	2.9	2.6	1.1	-0.5	-1.9	-3.0
Overall balance (including exceptional financing)	8	66	-96	27	4	-7	6	-1	-3
External financing gap	...	...	...	...	32	47	41	22	25
Gross official reserves (in millions of US$)	304	440	343	367	367	351	375	396	418
(In months of nonmining imports, c.i.f.)	4.2	6.1	4.5	4.6	4.4	4.0	4.1	4.1	4.1
Net official reserves (in millions of US$)	256	331	226	252	288	328	374	395	417
(In months of nonmining imports, c.i.f.)	3.5	4.6	3.0	3.1	3.4	3.7	4.1	4.1	4.1
External assistance (in millions of US$)									
Grants	189	180	168	182	182	181	181	182	183
Loan disbursements	101	186	55	115	84	73	69	51	49
Memorandum:									
Nominal GDP (in millions of kina)	9,515	9,821	10,881	12,107	12,943	13,591	14,096	14,329	15,015
Nominal GDP (in millions of US$)	3,448	2,912	2,709	3,013	3,140	3,162	3,208	3,222	3,343

Sources: Department of Treasury; Bank of Papua New Guinea; and Fund staff estimates and projections.

1/ Projections for 2003-08 are based on staff estimates broadly based on government intentions.

2/ GDP figures for 2000-02 are preliminary.

3/ Central government operations only.

4/ Derived as the difference between foreign savings and the public savings-investment balance.

5/ Measured on a below the line basis.

6/ Includes changes in check float.

7/ End-period. External debt including projected financing gap.

PAPUA NEW GUINEA: FUND RELATIONS
(As of March 31, 2003)

I. **Membership Status**: Joined October 9, 1975; Article VIII

II. **General Resources Account**:	**SDR Million**	**Percent Quota**
Quota	131.60	100.00
Fund holdings of currency	216.78	164.73
Reserve position in Fund	0.37	0.28

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	9.30	100.00
Holdings	3.88	47.71

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent Quota**
Stand-By Arrangement (SBA)	85.54	65.00

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-by	3/29/00	9/28/01	85.54	85.54
Stand-by	7/14/95	12/15/97	71.48	35.34
Stand-by	7/31/91	9/30/92	26.36	0.00
Stand-by	4/25/90	6/24/91	26.36	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

Expectations basis:

	Overdue	**Forthcoming**				
	12/31/02	**2003**	**2004**	**2005**	**2006**	**2007**
Principal	0.0	14.30	42.77	28.47	0.00	0.00
Charges/interest	0.0	1.52	1.38	0.43	0.10	0.10
Total	0.0	15.82	44.15	28.90	0.10	0.10

Obligations basis:

	Overdue	**Forthcoming**				
	12/31/02	**2003**	**2004**	**2005**	**2006**	**2007**
Principal	0.0	2.50	26.25	40.27	16.52	0.00
Charges/interest	0.0	1.55	1.85	1.06	0.29	0.10
Total	0.0	4.05	28.09	41.33	16.81	0.10

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the Bank of Papua New Guinea (BPNG) was subject to a transitional assessment based on its SBA with the Fund, which was approved in March 2000 and expired in September 2001. The transitional assessment was completed on May 4, 2001, and it identified certain weaknesses and made appropriate recommendations, as reported in the 2002 Article IV staff report. The BPNG will be subject to a full safeguards assessment when its next arrangement with the Fund is approved.

VIII. Exchange Rate Arrangement:

The kina was pegged to a basket of currencies of Papua New Guinea's major trading partners from December 1976 through October 1994. Kina trading was suspended on October 4, 1994, and the currency was floated as of October 10, 1994. The exchange rate of the kina is determined freely in the interbank market in which authorized banks participate, although the central bank frequently intervenes with spot purchases or sales of foreign exchange. Exchange restrictions were imposed in August 1990 and continue to be maintained in accordance with UN Security Council Resolution 661 on Iraq.

IX. Article IV Consultation:

Papua New Guinea is on the standard 12-month consultation cycle. The last Article IV consultation discussions were held during February 27–March 11, 2002. The staff report (SM/02/159, May 22, 2002) was considered by the Executive Board and the consultation concluded on June 5, 2002.

X. Technical Assistance from Headquarters:

FAD: A mission in December 2000 provided advice on the reconciliation of large and volatile differences in fiscal reporting based on information provided by the Department of Finance and Treasury and information reported by the Bank of Papua New Guinea. As a result, ongoing TA is now being provided to improve fiscal transparency and help resolve the discrepancy between fiscal and monetary accounts. A mission in February 2002 assessed progress to improve fiscal transparency. A joint FAD/PFTAC mission in March 2000 assisted the authorities in preparing a Report on the Observance of Standards and Codes Fiscal Transparency Module, that was published in October 2000.

LEG: A mission in November 1996 provided advice on the legal framework for the National Value-Added Tax.

MAE: A mission in November 2001 reviewed foreign exchange management in Papua New Guinea. A mission in June 2001 assessed the monetary policy implementation framework. A mission in November 1999 reviewed technical assistance requirements. Missions in November 1997, June 1998, and January 1999 provided advice on banking supervision. Ongoing technical assistance is being provided for the current financial sector restructuring and improving the accounting framework and monetary operations of the central bank. A resident advisor has been engaged during 2002-03 to provide ongoing assistance on monetary policy.

STA: Four missions over the period of August 1995 to April 1996 provided advice on the compilation of national accounts.

XI. Resident Representative:

A post was opened in Port Moresby in May 2000 and is currently filled by Mr. G. Yadav.

PAPUA NEW GUINEA: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE[1]

(As of March 18, 2003)

Assistance to PNG since 1996 has included 14 advisory missions, with a primary focus on public finance and in economic and financial statistics. During 1996–2002, PNG has sent 19 officials to the Centre's regional seminars, workshops, and training courses.

Public financial management

PFTAC assisted the authorities in the preparation of a Report on the Observance of Standards and Codes fiscal transparency module, which was published in October 2000. It subsequently participated in the FAD technical assistance mission (December 2000) on the reconciliation of fiscal and monetary reports on government activity and the correct treatment of treasury bill arrangements in the fiscal accounts. There has been no further PFTAC visit to PNG in the PEM area.

Tax administration and policy

A joint mission in 1997 (in coordination with FAD) took stock of the National Implementation Plan to facilitate VAT implementation and identify a long-term technical assistance expert to assist in the process. There has been no further PFTAC visit in the tax area.

Financial sector regulation and supervision

Two officials took part in the workshop for supervisors organized by PFTAC in November 2002 and in a subsequent meeting of Heads of Supervision in the Pacific. Long-term technical assistance has been provided directly by MAE to strengthen the regulatory framework and effective supervision.

Economic and financial statistics

In 2000, PFTAC conducted a review of statistical operations, with a follow-up mission in February 2001. In April 2002, a BOP mission was conducted to assist the Bank of Papua New Guinea. As part of the mission, progress at the NSO was assessed as inadequate. A full-time AUSAID statistical advisor has been appointed, and PNG has subsequently sought to activate its membership to the Fund's General Data Dissemination System (GDDS). Three officials attended the Suva GDDS Seminar in November 2002. Subject to progress on the GDDS meta-data, further technical assistance may be provided.

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[1]The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by IMF, ADB, AusAID, and NZAID, with the IMF as Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

PAPUA NEW GUINEA: RELATIONS WITH THE WORLD BANK GROUP
(As of March 18, 2003)

To date, the World Bank has provided 35 IBRD loans and 13 IDA development credits amounting to $786.6 million and $114.9 million. There are four active loans, totaling $49.7 million in commitments: the Forestry and Conservation Project ($17 million with a matching grant from the Global Environment Facility), Gas Development TA ($7 million), Mining TA ($10 million), and the Gazelle Restoration Project ($25 million). A Road Rehabilitation Project ($40 million) was approved in June 2002, although effectiveness is still pending. A $30 million Highlands Highway rehabilitation project is currently under preparation.

The World Bank is currently preparing a new three-year Country Assistance Strategy, in collaboration with the Asian Development Bank (ADB) and AusAID. The objectives of the CAS will be to help promote sustainability of development, stability, and improved governance in Papua New Guinea. The joint country strategy will be developed within the context of the government's own policy framework (e.g. the organic law, medium-term development strategy, medium-term fiscal framework, and poverty-reduction strategy). Specific assistance programs are expected to focus on strengthening budget planning, execution and monitoring, improvement and service delivery, and promoting rural economic/private sector development.

IFC, through the South Pacific Project Facility, has secured financing for 22 projects to support the development of small- and medium-sized enterprises. IFC is currently reviewing potential investments in the gas and telecommunications, manufacturing, and financial sectors. IFC has invested $3 million in the Port Moresby-based Kula Fund, which has made four investments in Papua New Guinea totaling $4.9 million since its establishment in 1997.

The Multilateral Investment Guarantee Agency (MIGA) has facilitated a total of $892 million in foreign direct investment in Papua New Guinea. MIGA currently has one guarantee in Papua New Guinea, in the mining sector, worth $51 million in gross exposure.

Papua New Guinea: IBRD Lending Operations
(In millions of U.S. dollar)

Fiscal Year	1998	1999	2000	2001	2002	2003
Commitments	5	0	132.3	0	57.4	0
Disbursements	21	11	40	5	61.3	4
Undisbursed balance	77	66	158.3	153.3	149.4	145.4

Papua New Guinea: Relations with the Asian Development Bank
(As of February 28, 2003)

Through end-February 2003, the Asian Development (AsDB) had approved 56 loans totaling $855 million for 47 projects. Of this total, 24 loans ($463 million) had been extended from ordinary capital resources and 32 loans ($393 million) from special funds resources. In addition, $42 million had been provided for 120 technical assistance projects. There are currently 11 active loans; a further Coastal Fisheries Management and Development loan was approved on October 24, 2002, but is not yet effective.

With the overarching objective of alleviating poverty, the AsDB strategy for Papua New Guinea focuses on improved governance, private sector development, and improved social conditions. Poor governance and ineffective public sector management being the main development problems, AsDB is focusing on strengthening public sector financial management and enhancing public sector management. For private sector development, in addition to improving the performance of the central agencies in support of the private sector, AsDB is helping to improve sector policy and institutional frameworks (especially in agriculture and fisheries), enhance factor productivity (skills development and microfinance services), and improve market access by selected infrastructure investments (transport) especially in rural areas. In the social sectors, AsDB will continue to assist in policy development in health and to support infrastructure investments and service delivery, especially in rural areas.

Subject to AsDB Board approval, it is presently envisaged that the second $35 million tranche of the Public Service Program will be released in the second or third quarter of 2003. In 2003, current plans now call for approval of three loan projects, totaling about $80 million, although the largest of these (related to infrastructure projects) may slip into 2004. Current plans envisage annual lending averaging about $33 million during 2003–05. The current 2003 program for grant-financed technical assistance comprises three projects totaling about $2 million.

Papua New Guinea: Loan Approvals and Disbursements, 1998-2003

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003 Proj.
Loan approvals	14.1	109.0	45.5	75.9	5.7	30-80
Loan disbursements	24.0	35.1	13.0	43.6	14.0	53.5

Source: Data provided by the AsDB.

Papua New Guinea: Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1994-00	East Asia & Pacific	Lower-middle-income
POPULATION					
Total population, mid-year (millions)	2.7	3.5	5.1	1,855.2	2,047.6
Growth rate (Percent annual average for period)	2.4	2.6	2.6	1.1	1.1
Urban population (Percent of population)	11.9	14.0	17.4	35.2	42.0
Total fertility rate (births per woman)	6.0	5.9	4.4	2.1	2.1
POVERTY					
(Percent of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (US$)	570	700	700	1,060	1,130
Consumer price index (1995=100)	28	55	175	135	146
Food price index (1995=100)	..	59	161	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	50.9	..	..
Lowest quintile (Percent of income or consumption)	..	..	4.5	..	..
Highest quintile (Percent of income or consumption)	..	..	56.5	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (Percent of GDP)	..	..	2.5	2.0	2.3
Education (Percent of GDP)	4.4	..	..	2.9	4.6
Social security and welfare (Percent of GDP)	..	..	..	..	..
Net primary school enrollment rate					
(Percent of age group)					
Total	..	..	85	91	91
Male	..	..	91	91	91
Female	..	..	78	91	91
Access to an improved water source					
(Percent of population)					
Total	..	..	42	75	80
Urban	..	..	88	93	95
Rural	..	..	32	66	69
Immunization rate					
(Percent under 12 months)					
Measles	..	33	58	85	89
DPT	..	40	56	85	89
Child malnutrition (Percent under 5 years)	..	30	..	10	11
Life expectancy at birth					
(years)					
Total	49	53	59	69	69
Male	49	52	58	67	67
Female	49	54	59	71	72
Mortality					
Infant (per 1,000 live births)	90	71	56	35	33
Under 5 (per 1,000 live births)	122	92	75	45	41
Adult (15–59)					
Male (per 1,000 population)	496	480	360	183	192
Female (per 1,000 population)	483	418	329	132	125
Maternal (per 100,000 live births)	..	..	390	..	..
Births attended by skilled health staff (%)	..	34	53	..	..

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.

Source: 2002 World Development Indicators CD-ROM, World Bank

Papua New Guinea: Statistical Issues

In general, the quality, coverage, and timeliness of economic statistical releases significantly impede the conduct of macroeconomic policy in Papua New Guinea. The National Statistical Office (NSO) is underfunded and suffers from a lack of staff, especially those with computer training. It has been unable to obtain and collate data from businesses and other government departments, even though it does have the legislative authority to do so. As a result, the only economic release produced on a somewhat timely basis is the Consumer Price Index. The Bank of Papua New Guinea (BPNG) and the Department of Treasury produce most current data. The NSO, with assistance from AusAID, completed collections for the 2000 Population Census and released preliminary results in July 2001. Using some of the expertise and equipment it acquired for this census, the NSO intended to conduct a Household Income and Expenditure Survey (HIES) in 2002, but work on the survey was postponed due to funding constraints. Papua New Guinea is a participant in the GDDS project for Pacific island countries and attended a GDDS workshop held in Suva in November 2002. Papua New Guinea has nominated a GDDS coordinator and is working on the development of its GDDS metadata.

Monetary accounts: Monetary data are not available on a regular and timely basis and the timeliness and frequency of reporting to the Fund's Statistics Department (STA) needs to be improved. The monetary and financial data for December 2002 was published in the April 2003 issue of *International Financial Statistics (IFS).* A monetary and financial statistics mission is planned for the second quarter of FY 2004 to: (i) review the procedures for collecting, compiling, and reporting monetary data; (ii) develop an integrated database to be used by STA, APD, and the authorities; (iii) examine the national definitions of monetary aggregates; and (iv) assist the authorities in the implementation of the *Monetary and Financial Statistics Manual.*

National accounts: In July 2001, the NSO released a preliminary set of national accounts estimates for 1999. As these figures are still subject to revisions due to problems in compiling the GDP deflators, they have not been used to update staff's estimates. In mid-2000, the NSO released a set of national accounts estimates: *National Income, Expenditure and Product, 1993-98*. These estimates are compiled using the *1968 System of National Accounts*. However the NSO is currently working towards implementing the recommendations of the *1993 System National Accounts*. Estimates of value added are compiled using the production and expenditure approaches, with private final consumption expenditure derived as a residual in the latter approach.

A Pacific Financial Technical Assistance Centre (PFTAC) mission in February 2001 identified several sources that could be used to generate measures of business activity:

- Corporate income tax data from the Internal Revenue Commission (IRC); corporate profits, revenues and other financial data for 4,000 companies.
- Value-added tax data from the IRC: sales and inputs data for a broad range of businesses.
- Membership data from the superannuation funds: employment numbers for both the private and public sectors.

These partial measures of activity would be useful for the formulation of macroeconomic policy. The government needs to ensure that the NSO is granted access to these data and that additional resources are provided to compile these series on a timely basis.

Prices: The only price index currently compiled is a quarterly CPI; the main deficiencies include outdated weights that are based on consumption studies conducted in the mid-1970s and weaknesses in data collection practices. The NSO intends to use the results of the planned HIES to rebase the CPI. However, there is a need for technical assistance to computerize the collation and production of the CPI.

Government finance: While central government tax revenue statistics are generally accurate and timely, nontax revenue and public expenditure data are deficient. In particular, development budget expenditures and the utilization of grants and project loans are only recorded with large lags, and few records on the use of accrual trust accounts are available. Recently, however, the government has taken steps to improve these statistics. The timeliness of data after the end of the fiscal year and of current data throughout the year has improved. With the recent decision to pay market interest rates to all holders of government securities including the central bank, interest payment records should become more accurate. However, there are still timing issues regarding the recording of interest on discount securities. No data are available on deferred pension liabilities to civil servants, and on provincial and local government budgets, off-budget outlays and corresponding liabilities, and potentially large implicit transfers between the government and public enterprises.

The weaknesses in fiscal statistics lead to large discrepancies between observed domestic financing from monetary and debt data and the domestic financing requirement derived from fiscal data. The report of the December 2000 FAD technical assistance mission[1] identified the major deficiencies leading to this discrepancy. The authorities have agreed to implement the recommendations of the report and will request technical assistance from the Fund and Australia to assist them in doing so.

External sector: Quarterly data on the balance of payments are reported to the Fund for publication with a substantial lag. (The latest data published in the *IFS* are for the fourth quarter of 2001.) Balance of payments data are based on the exchange record system, which is not tightly monitored despite BPNG reporting requirements. The financial account data are of poor quality because of major deficiencies in data collection, especially in the areas of private external debt. In many cases, donors and lenders disburse funds directly to contractors for the purchase of goods and services, effectively bypassing the exchange record system. Therefore, a substantial proportion of current account and capital flows are not recorded. The authorities are attempting to address the problem with the coverage of the merchandise trade statistics by moving to customs-based data. The ASYCUDA customs system being used by the IRC now electronically records about 80 percent of trade transactions, but currently neither BPNG nor the NSO have the resources to access this database.

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[1]Steven Symansky and others, "Papua New Guinea: Improving Fiscal Reporting," Fiscal Affairs Department, December 2000.

Papua New Guinea: Core Statistical Indicators
(As of April 16, 2003)

	Exchange Rate	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/Debt Service
Date of latest observation	4/11/03	4/11/03	Feb. 03	Feb. 03	Feb. 03	12/31/02	2002 Q4	Dec. 02	2002 Q4	Dec. 02	2001	2002 Q4
Date received	4/13/03	4/13/03	4/2/03	4/2/03	4/2/03	1/3/03	2/15/03	2/15/03	2/15/03	2/15/03	07/17/02	2/15/03
Frequency of data 1/	D	W	M	M	M	W	Q	M	Q	M	A	Q
Frequency of reporting1/	W	W	M	M	M	W	Q	M	Q	M	A	Q
Source of data 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 3/	C	C	C	C	C	C	C	V	V	O	V	V
Confidentiality 4/	C	D	D	D	D	C	D	C	C	C	C	C
Frequency of publication 1/	W	W	Q	Q	Q	Q	Q	M	Q	M	A	Q

1/ D-daily; W-weekly; M-monthly; Q-quarterly; A-annually.
2/ A-direct reporting by Bank of Papua New Guinea and/or Department for Treasury and Planning.
3/ C-fax; M-mail; O-Internet; V-obtained during mission and/or Annual Meetings.
4/ C-for unrestricted use; D-embargoed for a specified period and thereafter for unrestricted use.

Port Moresby, Papua New Guinea
April 7, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington DC, 20431
United States of America

Dear Mr. Köhler,

As you are aware, the Government of Papua New Guinea has been working diligently in recent months to reestablish fiscal and exchange rate stability. At present, however, the external position remains difficult. Reserves have fallen to low levels, the current account has slipped into deficit, and uncertainty remains about prospective capital account flows. In these circumstances, our balance of payments situation has improved less rapidly than had been expected under the 2000-2001 Stand-By Arrangement. Therefore, we request on behalf of the Government an extension of the repurchase expectations falling due in the twelve-month period commencing on July 25 of this year. In line with the Fund's policy on early repurchase expectations, we understand that these repurchases would become due on the date of the obligation one year later.

Yours sincerely

/s/
Hon. Bart Philemon, MP
Minister for Finance and Treasury

/s/
Mr. L. Wilson Kamit, CBE
Governor, Bank of Papua New Guinea

Statement by the IMF Staff Representative
June 4, 2003

1. The following information has become available since the Staff Report was circulated to the Executive Board on April 28. The unexpectedly sharp increase in inflation and the large fiscal deficit during the first quarter of 2003 underscore the need for the policy adjustments outlined in the staff appraisal.

2. Inflation accelerated in the March 2003 quarter with consumer prices rising by 20.7 percent (year-on-year), compared with 14.8 percent in the December 2002 quarter; the rates of increase were broadly similar across all categories.

3. The fiscal deficit during the first quarter of 2003 was about 2 percent of GDP (the same figure as the budget target for the year as a whole) based on below-the-line financing data, although there are continued large discrepancies between the above and below-the-line deficit estimates. Revenue fell short of the authorities' target, and expenditure was insufficiently tightened. The deficit was fully financed from domestic sources; there were no privatization receipts and official aid flows were less than expected. Reflecting this, at the most recent auction, the yield on treasury bills reached almost 20 percent, 4–6 percentage points higher than at end-2002 (depending on the maturity).

4. Despite the difficult fiscal position and high inflation, the nominal effective exchange rate and the level of international reserves have remained broadly unchanged from their end-2002 levels. This is mainly due to the temporary surge in export receipts as the mining companies have run down their inventories, following the reopening of river-based transportation channels, as well as to the higher interest rates.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/78
FOR IMMEDIATE RELEASE
June 25, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Papua New Guinea

On June 4, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the 2003 Article IV consultation with Papua New Guinea.[1]

Background

Real GDP growth in Papua New Guinea slowed in the second half of the 1990s, reflecting growing governance and law and order problems, lack of new mineral exploration activities, deteriorating physical infrastructure in the rural areas that inhibited agricultural production, and the decline in export prices during the Asian crisis. As investor confidence evaporated, private capital outflows intensified, the kina depreciated, and international reserves fell sharply.

During 2000–01, efforts to stabilize the economy in the context of a Fund-supported program helped to overcome the serious macroeconomic imbalances, with a reduction in the inflation rate and an increase in the level of net international reserves. However, the pace of structural reform was slower than envisioned and, when combined with the gradual winding down of existing mining projects, the economy continued to contract. During 2002, real GDP is estimated to have declined by a further 3 percent. Production of crude oil and gold fell sharply mainly because of the continued depletion of reserves at existing projects, the effects of drought on river-based ore shipments, and election-related violence.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

In the lead-up to the June 2002 election, the deficit reached nearly 4 percent of GDP by midyear because of unbudgeted expenditure and cost overruns, notably on a bridge program approved outside of the regular 2002 budget, overspending on the national elections and the wage and salary bill, excessive disbursements under the rural development program, and the elimination of school fees. In late August, the new government passed a supplementary budget that sought to contain the 2002 deficit to 3.4 percent of GDP by curtailing current and development outlays. While this target was overly optimistic, the size of the deficit was contained to 5.5 percent of GDP in 2002, although the authorities' deficit estimate is only 4.1 percent of GDP derived from the recorded above-the-line outturn.

For much of 2002, monetary policy was expansionary in order to finance the fiscal deficit. Given these excess liquidity conditions, the kina exchange rate against the U.S. dollar depreciated by 12 percent in the ten months to October, despite frequent intervention by the central bank. Further, consumer prices rose by almost 15 percent in the year to December 2002, reflecting fiscal slippage and the pass-through of the kina's sharp depreciation.

The current account deteriorated sharply in 2002, falling from a surplus of 6 percent of GDP in 2001 to an estimated deficit of 2½ percent of GDP. The large decline in the volume of mineral exports was only partly offset by higher commodity export prices and lower import demand. As in 2001, the capital account was also in deficit. Large net government debt repayments, lower inflows of direct investment, and increased commercial bank holdings of foreign assets, were only partially offset by higher private sector inflows to the mining sector. As a result, the overall balance of payments showed a deficit, compared with the surplus recorded for 2001. The public debt-to-GDP ratio increased to 74 percent at end-2002, reflecting the expanding budget deficit and the kina depreciation.

Fiscal and monetary policies were tightened towards the end of the year. The 2003 budget was passed in November, which targets a fiscal deficit of 2 percent of GDP, primarily through sizable cuts in goods and services expenditure. The Bank of Papua New Guinea also began to tighten monetary conditions in November. Correspondingly, treasury bill yields increased, pressure in the exchange market eased, and the level of international reserves stabilized. Nonetheless, preliminary data indicate the fiscal deficit measured on a financing basis was around 2 percent of GDP in the first quarter and inflation was over 20 percent in the year to March 2003.

Executive Board Assessment

Directors noted that adverse exogenous shocks, as well as domestic policy shortcomings, have slowed economic activity markedly and resulted in macroeconomic imbalances and structural weaknesses. Real GDP declined for the third consecutive year in 2002, which, in light of high population growth, has implied a considerable drop in per capita income and a worsening of social and poverty indicators. Directors noted that the fiscal discipline Papua New Guinea displayed under the Fund-supported program, which ended in 2001, was not sustained in the lead-up to the general election in mid-2002, with the fiscal deficit widening, inflation pressures increasing, official international reserves declining, and a depreciation in the exchange rate. While they acknowledged the action taken by the new government on coming into office, particularly the introduction of a supplementary budget, they expressed concern about the growing fiscal pressures and rise in inflation over the course of 2003. Directors underscored that, unless necessary reforms are successfully implemented, economic and poverty-reduction prospects for the medium-term would continue to be weak, given the projected decline in mineral output and structural problems that affect both rural and urban areas.

Against this background, Directors welcomed the intention of the new government to address these challenges in the framework of the country-owned Medium-term Development Strategy. They encouraged the authorities to strengthen budget finances and to tackle the deep-seated structural impediments to growth in order to achieve their medium-term objectives of macroeconomic stability and poverty alleviation, while ensuring a manageable external debt burden. Directors also stressed the importance of improving the environment for private sector activity and of further diversifying the economy.

Directors emphasized the critical need to ensure that the targeted fiscal consolidation in 2003 is achieved. They cautioned that, without forceful measures, the budget deficit would not be brought back in line with the authorities' target of 2 percent of GDP, especially given adverse trends in the first quarter. Directors suggested that early additional actions—including a supplementary budget—might be needed, in particular targeted toward lasting reductions in the civil service salary bill and in less efficient development expenditure.

Directors supported the authorities' intention to pursue its Medium-term Fiscal Strategy, which provides a forward-looking framework within which the country's development objectives can be achieved. In this context, they stressed that achieving an average fiscal deficit over the medium term of around 1 percent of GDP is essential to reduce the debt burden and its associated vulnerabilities. To meet this goal, most Directors said that measures to augment revenues were required, including the reversal of tax incentives to the mineral sector. Most importantly, Directors encouraged the authorities to improve expenditure control and redirect spending toward infrastructure, health, education, and poverty-alleviation. These actions should be guided by the findings of the Public Expenditure and Rationalization Review, to be completed soon with support from the World Bank, the Asian Development Bank, and AUSAID.

Directors commended the authorities for the tightening of monetary policy in recent months, which had been crucial to limit pressures on the exchange rate and external reserves, in view of fiscal and inflation developments. If inflation were placed on a firm downward path, and an appropriate degree of fiscal consolidation were achieved, interest rates could be gradually reduced, which would help to promote private sector activity.

Directors agreed that the present floating exchange rate regime is appropriate to help maintain competitiveness, especially given Papua New Guinea's vulnerability to terms of trade shocks. However, further weakening of the kina would exacerbate external debt dynamics. Against this background, Directors emphasized the need to expedite the implementation of fiscal and structural reforms to safeguard Papua New Guinea's external position.

In the structural area, Directors were encouraged by the ongoing steps aimed at enhancing public sector efficiency and reducing regulatory impediments to private sector activity. They also stressed in particular that early and determined measures are needed to reduce corruption, improve governance, strengthen law and order, and enact land reform. Directors welcomed the establishment of the Independent Consumer and Competition Commission to depoliticize changes in utility and other controlled prices; commitments to progress in the multi-year trade reform program; planned measures to improve rural infrastructure; and the enactment of the Organic Law on the Integrity of Political Parties. They also endorsed the authorities' intention to improve the efficiency of assets under state management, with the view toward their accelerated privatization, provided that undue injections of public funds were avoided. While they noted that the financial system is generally sound, Directors said that steps to strengthen bank supervision are still necessary, in line with Fund technical assistance recommendations. The authorities were also encouraged to further strengthen their framework for combating money laundering and the financing of terrorism.

Directors stressed that, in line with the extensive technical assistance provided by the Fund, more and better quality economic statistics, including regular reconciliation of above- and below-the-line fiscal data, are important for properly monitoring developments.

Directors considered that decisive and comprehensive implementation of the authorities' reform program, which should include the governance area, could provide the basis to initiate negotiations on a Fund arrangement to assist the authorities in improving the economic outlook. The Board agreed to the authorities' request to extend their repurchase expectations to the Fund, in light of the deterioration in key external indicators and weakness in Papua New Guinea's balance of payments position.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Papua New Guinea is also available.

Papua New Guinea: Selected Economic Indicators, 1998–2002

	1998	1999	2000	2001	2002
Real sector (percent change)					
Real GDP growth	-3.8	7.6	-1.3	-3.4	-3.1
Mineral	16.8	10.0	-4.0	-0.6	-9.6
Nonmineral	-8.1	6.9	-0.5	-4.2	-1.3
CPI (annual average)	13.6	14.9	15.6	9.3	11.8
CPI (12 months)	21.8	13.2	10.0	10.3	14.8
Central government budget (percent of GDP)					
Revenue and grants	29.2	29.3	31.3	30.6	29.6
Expenditure and net lending	31.0	32.4	32.8	34.5	33.7
Overall balance, cash basis (including grants) 1/	-0.4	-4.3	-1.4	-4.1	-5.5
Domestic financing, net 2/	1.4	2.0	0.9	0.9	4.9
Of which: Banking system	1.7	1.2	-1.4	-2.5	5.3
External financing, net	-1.2	2.0	0.2	3.2	-1.3
Privatization, net	0.2	0.3	0.3	0.0	1.8
Money and credit (end-period percentage change)					
Domestic credit	17.1	4.0	-4.5	-12.3	20.9
Net credit to government	15.4	11.2	-12.5	-26.1	82.0
Credit to the private sector	29.0	10.5	3.0	-1.2	-6.3
Broad money	2.5	8.8	5.4	1.9	4.2
Interest rate (182-day T-bills, end-period)	23.9	20.4	14.9	10.2	13.5
Balance of payments (US$ millions)					
Exports, f.o.b.	1,848	2,019	2,214	1,878	1,624
Imports, c.i.f.	-1,425	-1,525	-1,503	-1,269	-1,225
Current account (including grants)	22	53	232	174	-74
(In percent of GDP)	0.6	1.5	6.7	6.0	-2.7
Overall balance	-190	-36	8	66	-96
Reserves and external debt (end-period, US$ million)					
Gross international reserves	187	206	304	440	343
(In months of nonmining imports, c.i.f.)	1.8	2.2	4.2	6.1	4.5
Public external debt-to-GDP ratio (in percent) 3/	35.6	42.2	41.8	51.4	54.4
Public external debt-service ratio (percent of GNFS exports)	7.3	7.5	6.7	7.1	7.4
Exchange rates					
US$/kina (period average)	0.4856	0.3922	0.3624	0.2965	0.2490
US$/kina (end-period)	0.4770	0.3710	0.3255	0.2658	0.2488
NEER (1990=100, end-period)	45.0	35.2	31.6	24.8	24.2
REER (1990=100, end-period)	82.1	74.0	77.7	69.7	70.6

Sources: Data provided by the Papua New Guinea authorities; and IMF staff estimates.

1/ Measured from below the line in the fiscal accounts.
2/ Includes changes in check float.
3/ Central government and Bank of Papua New Guinea.

Statement by Michael J. Callaghan, Executive Director for Papua New Guinea
June 4, 2003

Key Points

- The Papua New Guinean economy has experienced another difficult year, with economic activity expected to decline for a third year. Nevertheless, the authorities continue to be committed to achieving macroeconomic stability and pursuing the structural reforms necessary to achieve sustainable growth.

- On coming to office in 2002, the new government acted quickly to tighten fiscal policy to restore macroeconomic stability following a substantial easing in the lead-up to the general elections, and the monetary authorities took forceful action to guard against higher inflation.

- The authorities have also developed a medium-term fiscal framework within which they will pursue their development objectives. There is a pressing need to re-orientate expenditure towards improving the country's infrastructure and improving social services, particularly health and education. Improving law and order and governance are also critical.

- Notwithstanding the positive steps that have been taken, the authorities are currently facing a very difficult fiscal situation due to a delay in external financing and lower-than-expected privatization receipts, along with the ongoing challenge of implementing greater expenditure discipline.

- As Papua New Guinea's balance of payments situation has improved less rapidly than had been expected under the 2001 Stand-By Arrangement, the authorities are requesting an extension of the repurchase expectations falling due on July 25, 2003.

- The authorities appreciate the support they have received from the Fund and remain closely engaged with the Fund.

The Papua New Guinean authorities have faced many significant challenges in recent years. 2002 was no exception, with crude oil and gold production falling sharply, and agricultural output affected by drought which also curtailed river-based shipments of copper and gold. There was also a general election which was marked by a degree of violence in one part of the country. This election was particularly important, for following electoral changes the new government, headed by Sir Michael Somare, has the prospect of remaining in office for a full five-year term. No administration has achieved this to-date since independence as, in the past, political maneuvering destabilised governments and complicated economic policy making.

Macroeconomic Policies

On taking office in August 2002, the new government faced a very difficult fiscal situation following a substantial easing in fiscal discipline in the lead-up to the elections – a situation familiar in many other countries.

The government recognized the need for early action to address the deteriorating fiscal position and restore macroeconomic stability. It acted quickly to tighten fiscal policy by introducing a supplementary budget soon after taking office. The 2003 Budget, delivered in November 2002, included further adjustments in order to reduce the deficit and to lay the foundation for medium-term fiscal consolidation. The authorities were fully aware of the consequences of a no policy change scenario – revenue and grants would continue to fall, expenditure would continue to rise, and it would become increasingly difficult to finance deficits and provide basic social services. While the need to ensure fiscal soundness can in no way be disputed, it is relevant that these tough budget measures are being implemented in an economy which has experienced negative growth over the past three years and faces enormous demands to increase expenditure on infrastructure and social services.

Importantly, the 2003 Budget was developed in the context of a Medium-Term Fiscal Strategy (MTFS). This provided a forward-looking framework within which the government's development objectives can be achieved. The 2003-2007 MTFS aims to improve the net indebtedness of the public sector, to increase public savings and to allocate resources more effectively. The aim is to bring current expenditures and revenues into balance and reduce the interest and wage bill share of expenditure, while protecting essential current spending on infrastructure maintenance, health and education, and law and order. These objectives were set against the background of strong budgetary pressures, including: declining receipts from mining and petroleum activities; strong population growth; high salaries and wages; high debt servicing costs; and large external outflows.

At the same time, on the monetary side, against the background of a sharp fall in the exchange rate towards the end of 2002, the central bank authorities took forceful action to guard against higher inflation by raising the Kina Facility Rate by 150 basis points in November 2002 to 14 per cent, and raising it by a further 50 basis points on two separate occasions (in early 2003). As noted, this action was taken against the background of weak economic activity and little expansion in private sector borrowing.

Notwithstanding these actions, the authorities are currently facing a tight fiscal situation. Implementation of expenditure control measures remains a key challenge. The interest rate on treasury bills is just under 20 per cent, which the authorities recognize as unacceptable. There are, in particular, two aspects of the 2003 Budget that have not performed as expected – there has been a delay in the disbursement of the final tranche of the Asian Development Bank and privatization receipts have not come in as expected. The authorities are mindful of the importance of restoring fiscal discipline and remain confident that the Independent Public Business Corporation (IPBC) is also preparing to sell some non-core assets which would make up some of the shortfall. The authorities are monitoring current developments closely and will look at what action is needed in order to ensure macroeconomic stability.

Medium-Term Development Strategy and Structural Reform

Papua New Guinea has considerable potential with its rich resource endowments and great natural beauty. There are major challenges to be addressed in realizing that potential as outlined in the staff paper on 'Impediments to Growth'. The authorities believe PNG's future can be a bright one, provided it addresses its problems and does not squander its opportunities. The authorities also place a high value on ownership, with Prime Minister Somare stressing the importance of a home-grown strategy to achieve sustainable growth. The authorities' Medium-Term Development Strategy (MTDS) provides such a home-grown framework within which to realize PNG's potential.

The key focus of the authorities' MTDS (2003-2007) is to target export-driven growth, rural development and poverty reduction. To achieve these objectives, the MTDS will aim to put in place the enabling environment that will empower the private sector, including PNG smallholders to drive the development process. The MTDS has also been designed in conjunction with Papua New Guinea's National Poverty Reduction Strategy and the two are closely integrated. It is intended that the MTDS will be tabled in Parliament in June 2003.

The MTDS will target the growth areas of agriculture, agro-forestry, fisheries and manufacturing where value added can be achieved on a competitive basis. The agriculture sector will be the principal priority sector under the strategy as it supports around 85 percent of the population. Under the MTDS, the focus will be on the expansion of Papua New Guinea's traditional major crops such as coffee, palm oil and food crops, including greater diversification into high-value niche crops such as vanilla and spices. Where viable, downstream processing of agricultural products will also be encouraged. In order to create the enabling environment for accelerated agricultural development, it is currently proposed that the expenditure priorities under the MTDS will comprise basic education, primary health care, transport infrastructure maintenance, law and order, and specific interventions to directly promote income-earning opportunities in rural areas such as agricultural extension and micro-credits.

A further growth area, which offers considerable potential, is tourism. However, the poor state of the country's core infrastructure and law and order problems have been major constraints to the development of this sector. Both constraints will be targeted under the MTDS. More generally, to generate investment and growth in both the formal and informal sectors, the government recognizes that it is essential to address law and order problems and improve governance. This is a critical, but difficult area.

There has been a comprehensive review of law and justice. As a result of the review, law and justice agencies are developing an implementation plan to improve their efficiency and effectiveness. The Prime Minister will shortly announce the start of implementation measures. A Law and Justice National Coordinating Mechanism (NCM) is being introduced to improve the response of the law and justice system to crime and overcoming the delays in processing civil cases. In addition, a Justice Advisory Group has been established to support the government in strategic assessments, policy development and monitoring of the law and justice sector's performance. Legislation for the establishment of the Independent Anti-Corruption Commission (IACC) is soon to be tabled in Parliament for its second and subsequent readings.

Papua New Guinea has faced substantial challenges in seeking to stabilize the economy in the face of domestic and external shocks. The platform for a resilient economy has been continually undermined by the absence of sound institutions and administrative systems. As such, the promotion of good governance is a key component of the reform program as it is necessary to support and sustain other structural reforms.

The Public Expenditure and Rationalization Review (PERR), which has been prepared with the assistance of the World Bank, Asian Development Bank and AusAID and is nearing completion, aims to design a range of reforms that will strengthen fiscal discipline and assist to guide the reallocation of resources to developmental needs. Important areas under review are: wages, personnel and industrial relations; retrenchment; and removing and rationalizing budget agencies. The successful implementation of the measures coming from the PERR will be critical to placing PNG's public sector expenditure on a sound basis. With decentralization, there is a focus on improving financial management at the provincial and district levels of government with a public finance management training program underway. The government also plans to undertake a review of 'red tape' and public service impediments to business. The authorities have taken close note of the staff's recommendation that an appropriate mix of expenditure and revenue measures are necessary in order to maintain a sound fiscal position, as well as meeting developmental priorities.

On coming to office, the government undertook a review of the privatization program. Following this review, the primary objective of the privatization policy has been defined as improving the management and performance of state assets and associated liabilities. The government's strategy involves firstly rehabilitating the core assets of Telikom, PNG Power, PNG Harbours Limited, Post PNG, PNG Dams, Water Board and Eda Ranu and Air Niugini. The second part of the strategy is to identify privatization plans for individual enterprises on a case-by-case basis, including privatization and public/private partnership arrangements. The third element is the efficient disposal on non-core assets. Some such assets – including public buildings and an oil palm project – are already slated for sale.

Request for Extension of Repurchase Expectations

The external position is difficult – reserves have fallen to low levels, the current account has slipped into deficit and there is uncertainty about prospective capital flows. Against this background, Papua New Guinea's balance of payments situation has improved less rapidly than had been expected under the Stand-By Arrangement approved in March 2000. Therefore, the authorities are requesting an extension of the repurchase expectations falling due on July 25, 2003.

Engagement with the Fund

Papua New Guinea faces major challenges and a very difficult economic environment. It greatly appreciates the support and assistance it has received from the Fund. It successfully completed a Stand-By Arrangement (March 2000 to September 2001) which helped to address serious economic imbalances. However, the growth performance was considerably weaker than that assumed under the program, with economic activity continuing to decline. Capacity limitation is a major constraint and Papua New Guinea appreciates the advice and technical assistance it has received from the IMF.

Papua New Guinea will maintain an active engagement with the International Financial Institutions.