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Papua New Guinea: 2004 Article IV Consultation—Staff Report; Public Information Notice 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 the 2004 Article IV consultation with Papua New Guinea, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 11, 2004, 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 May 20, 2004. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 2, 2004 discussion of the staff report that concluded the Article IV consultation.

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

The document 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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PAPUA NEW GUINEA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Papua New Guinea

(In consultation with other departments)

Approved by Steven Dunaway and Juha S. Kähkönen

May 20, 2004

- The 2004 Article IV consultation discussions with Papua New Guinea (PNG) were held in Port Moresby during March 1–11. The staff team comprised Messrs. Browne (Head) and Sidgwick (both APD), Ms. Kojo (FAD), Mr. Tareen (PDR), and was assisted by Mr. Yadav (Senior Resident Representative). Mr. Callaghan (OED) also 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, senior officials, and representatives of the private sector, labor unions, civil society, and the donor community.

- In concluding the 2003 Article IV consultation on June 4, 2003, Executive Directors encouraged the authorities to strengthen budget finances and 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. In this context, they emphasized the critical need to ensure that the fiscal deficit target of 2 percent of GDP in 2003 was achieved. In the structural area, the Directors also stressed the urgent need to address the long-standing governance and law and order problems, and promote private sector activity, especially through a less restrictive regulatory regime and land reform.

- Papua New Guinea has accepted the obligations of Article VIII, Section 2(a), 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

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EXECUTIVE SUMMARY

Economic Background

- **Economic recovery and stabilization policies in Papua New Guinea started to take hold from mid-2003.** The budget deficit for the year was limited to 2 percent of GDP (5¾ percent in 2002). Real GDP growth is estimated at 2.7 percent in 2003, after three years of negative growth, owing mainly to stronger performance of the agricultural and mineral sectors. The 12-month consumer price inflation rate declined from 20 percent in the March quarter of 2003 to below 3 percent in the March quarter of 2004.

- **Favorable temporary factors also strengthened the balance of payments.** Strong world commodity prices, especially for gold, copper, and oil, underpinned a sharp rise in exports, thereby moving the external current account from a small deficit in 2002 to a surplus of 10 percent of GDP in 2003. The kina appreciated against the U.S. dollar by 20 percent during January 2003–April 2004. Gross international reserves rose to 6 months of nonmining imports during this period.

- **However, longstanding structural problems need to be addressed to strengthen the quality of public spending and promote private sector activity and these are proceeding only slowly.** In view of declining mineral output, medium-term prospects for faster sustainable growth and poverty alleviation will remain weak without significant progress on structural reforms.

Key Issues and Staff Recommendations

- **The government's 2004 budget target of an overall deficit of 1½ percent of GDP is appropriate.** However, insufficient actions have been taken to reduce the wage bill (currently at 9.2 percent of GDP) and reallocate spending to health, education, and infrastructure. Further fiscal consolidation will be required in 2005–09 (deficits averaging below 1 percent of GDP annually) to facilitate a steady decline in the public debt-to-GDP ratio.

- **The cautious stance of monetary policy needs to be continued, so as to keep inflation low and maintain a sound balance of payments.** The present level of the kina is broadly appropriate, notwithstanding its recent appreciation because of the strengthened fiscal position and improving external debt dynamics.

- **It is essential to accelerate the structural reform process, despite political uncertainties, including the adjournment of parliament as the government aims to avoid a no-confidence vote.** With regard to public sector reform, this should include early action to implement the recommendations of the World Bank-led Public Expenditure Review and Rationalization (PERR) that was finalized in mid-2003, as well as measures to strengthen the efficiency of provincial expenditure. The formidable structural impediments to private sector growth must be urgently addressed, in order to facilitate higher investment and employment and to improve social conditions, including by means of less corruption, better governance and law and order, and a more friendly regulatory regime.

I. RECENT ECONOMIC DEVELOPMENTS

1. **The present government faced daunting economic and financial challenges when it took office in August 2002.** The macroeconomic stabilization gains that were made under the last Stand-by Arrangement (SBA), March 2000–September 2001, eroded rapidly in the months before the national elections in June 2002, as election-related spending put a substantial strain on the budget. Adding to this were the deteriorating law and order situation, governance problems, dim prospects for medium-term mineral sector production, and deep-seated structural impediments to private sector growth.

2. **The new government made only limited immediate progress in restoring macroeconomic stability.** Reflecting expenditure over-runs, the fiscal deficit was 5.7 percent of GDP in 2002 (from 4 percent in 2001), despite a supplementary budget in August, and reached the equivalent of 2 percent of GDP during the first half of 2003 (the level targeted for the whole year). Inflation accelerated to 20 percent in the year to end-March 2003 because of the fiscal deterioration and the pass-through effect on prices of kina depreciation in the previous year. Domestic financing of the budget was substantial, partly as the expected donor flows did not fully materialize, and treasury bill rates rose to 20 percent (attracting large purchases by nonbanks).

3. **From mid-2003, Papua New Guinea's economic performance improved, helped importantly by the favorable temporary factors that boosted the mineral and agricultural sectors.** In 2003, real GDP is estimated to have grown by 2.7 percent, following three years of decline (Table 1 and Figure 1). Coffee and cocoa production benefited from better weather conditions and production of palm oil, rubber, tea, and copra oil also increased. The output of petroleum, gold, and copper rebounded, following the election-related disruptions in 2002. Reflecting the improved fiscal situation and exchange rate stability, the rate of inflation declined progressively to 3 percent in the year to the March quarter of 2004. Yet macroeconomic stability remains fragile and improved policy implementation is essential to secure higher sustained growth and to alleviate poverty.

4. **Assisted by cyclically higher revenue from the mining and petroleum sector and tighter expenditure controls, the budget was in overall balance during the second half of 2003.** The annual deficit was held at an estimated 2 percent of GDP, although there could still be some minor revisions as not all accounts have yet been finalized (Table 2). This outcome facilitated a decline in treasury bill rates from over 20 percent in August to about 16 percent in December 2003. Rates fell further to 10 percent for 28-day bills and 12 percent for 182-day bills in late April 2004. However, the required reallocation of spending toward health, education, and infrastructure has been largely held in abeyance, until the wage bill is reduced.

5. **Monetary policy was geared from late 2002 to keeping a firm grip on inflation and protecting the external position.** It was tightened during the period November 2002–June 2003, when the central bank increased its benchmark Kina Facility Rate (KFR) from

12½ percent to 16 percent. As the exchange rate appreciated, the central bank rebuilt international reserves, while undertaking large sales of central bank bills to keep the pace of reserve money in check. Subsequently, in response to the tighter fiscal policy and the declining rate of inflation, the authorities progressively reduced the KFR during August 2003–May 2004 to 10 percent. Nevertheless, the easing of monetary policy failed to lead to an expansion of commercial bank credit to the private sector, which declined by almost 3 percent in 2003 and remained weak in early 2004 (Table 3).

6. **The balance of payments situation has improved.** Higher world commodity prices underpinned a sharp rise in export receipts and the external current account registered a surplus of 10 percent of GDP, compared with a small deficit in 2002 (Table 4). Assisted by the prudent monetary stance, official gross international reserves rose to about 6 months of nonmineral imports at end-December 2003, and remained broadly unchanged in the first quarter of 2004. The kina appreciated in real effective terms by an estimated 8 percent during January 2003–April 2004, in contrast to the depreciation experienced in the preceding several years (Figure 2). The nominal exchange rate rose by 20 percent against the U.S. dollar, while falling somewhat against the buoyant Australian dollar.

7. **Progress in implementing structural reforms, however, has been disappointing.** With regard to public sector reform, little progress has been made in implementing the recommendations of the World Bank-led Public Expenditure Review and Rationalization (Box 1 and the accompanying *Selected Issues* paper). Efforts have also been minimal to strengthen the efficiency of provincial expenditure and tighten monitoring and reporting systems of their accounts. There is a continuing need to strengthen the monitoring standard and financial condition of the main public enterprises, with a view to their corporatization and possible sale. The structural impediments to private sector growth remain formidable with governance issues and poor infrastructure affecting agriculture, mineral, forestry, fisheries, and urban activity (Box 2).

II. Policy Discussions

8. **The Papua New Guinea authorities have been generally responsive to Fund policy advice in recent years, except for a period surrounding the 2002 general election.** After a series of adverse shocks in the late 1990s, including severe drought, the Asian crisis, and falls in prices for mineral exports, an SBA was negotiated to stabilize the macroeconomic situation and initiate a structural reform program. As noted above, the SBA was successfully concluded. The fiscal problems that then reemerged prior to the mid-2002 general election were not brought under control until mid-2003. Since then, however, authorities have taken action to restore fiscal discipline by tighter public expenditure control, in line with staff recommendations made in frequent visits. The authorities are also committed to accelerating structural reforms in accordance with Fund policy advice, but progress has been slow because of the difficult political situation.

9. **This year's discussions therefore focused on the policies that are required to achieve higher sustainable growth and alleviate poverty over the medium term.** In this regard, the improvement in the fiscal position and the higher export prices that have boosted the economy since mid-2003, while welcome, have barely contributed to resolving the challenging underlying structural issues. Without fundamental progress in public sector reform and the creation of a more favorable climate for private investment, economic prospects will remain poor. The authorities acknowledged that a successful medium-term strategy will certainly require further fiscal consolidation, as well as political stability, less corruption, improved governance and law and order, a more friendly private sector regulatory climate, and land reform. If policies are appropriate, given the country's resources, there is potential for faster growth in agriculture, light manufacturing, tourism, and other services.

A. Medium-Term Framework

10. **The authorities and staff agreed on the medium-term economic framework consistent with the government's development strategy prepared initially in 2002, which has been reviewed on several previous occasions.** Key macroeconomic objectives are to achieve real GDP growth of 2½ percent annually over the period 2004–09, with growth in nonmineral activity increasing gradually to about 3½ percent by the end of the forecast period. Inflation is targeted to decline further to 2 percent by 2009, assuming that fiscal and monetary discipline is maintained. The external current account is projected to move toward approximate balance during 2006–09, with higher nonmineral exports only partly offsetting the decline in mining and petroleum exports as existing resources are depleted. (No progress has been made over the past year in securing further sales contracts for the Queensland gas project.)

11. **The authorities stated that the main fiscal challenge is to ensure that the budget deficit averages under 1 percent of GDP in 2005 and beyond to permit a gradual decline in the public debt-to-GDP ratio** (Table 5). They noted that achieving this goal will be difficult, given the projected lower level of mineral revenue and the demand for improved social spending, notwithstanding higher grant disbursements from Australia. The staff underscored the need to revisit the possibility of an increase in the VAT/GST rate in 2005, as well as the importance of building upon recent steps to strengthen expenditure controls. While the authorities understood the potential need for additional fiscal measures, including further strengthening of expenditure controls, they could not make a commitment at present in view of the prevailing difficult political environment. Provided that the fiscal targets are met, central government debt could decline from 63 percent of GDP at end-2003 to 46 percent at end-2009, with the bulk of the reduction occurring in external debt (Box 3 and the accompanying selected issues paper).

12. **In this scenario, small external financing gaps are predicted, taking account of debt repayment obligations and the need to preserve adequate external reserves** (at least 4 months of nonmineral import cover). The staff observed that in these circumstances, to seek incremental concessional external financing, it is essential to maintain good relations with the

donor community. This requires the effective implementation of the enhanced cooperation program with Australia (Box 4), securing additional financing assurances from the European Union, and resolving disagreements on the World Bank Forestry Project and the Asian Development Bank projects (both of which are presently suspended because of governance concerns). The authorities responded that they had already made a significant progress in overcoming the difficulties in the implementation of the enhanced cooperation program, and steps were being considered to improve relations with the two development banks.

13. **Papua New Guinea already faces considerable external vulnerabilities** (Table 6). The reform momentum has already slowed down this year because of political uncertainties, including the adjournment of parliament in January because of the government's unwillingness to face a possible no-confidence motion. Such a motion is permitted when parliament is in session, after a minimum period of 18 months following a general election. With party loyalties of some members often having proven to be rather unreliable, several coalition governments since independence have not been able to complete their full term in office, because of an adverse no-confidence vote.

14. **There are other risks that could add to fiscal and external vulnerabilities.** These include the possible impact of adverse movements in world commodity prices; threats to fiscal sustainability in light of projected declines in mineral output; difficulties in rolling over the high stock of domestic short-term treasury bills (20 percent of GDP); the need to make large official external debt repayments over the next three years (3–4 percent of GDP annually); and exchange rate depreciation that could aggravate debt sustainability. The authorities broadly shared these concerns. Nevertheless, given the present high level of reserves, the projected easing of the public debt burden and the country's excellent repayment track record, no difficulties are envisaged in Papua New Guinea's meeting its upcoming obligations to repay the Fund. The public external debt-service ratio is projected to decline from 8 percent of exports of goods and services in 2004 to 4½ percent in 2009, mainly reflecting repayments to multilateral institutions, including to the Fund of drawings under the 2000–01 Stand-by Arrangement.

15. **Confidence in the reform process could also be undermined if the authorities decide to proceed with the large nonconcessional commercial bond issue (up to $150 million or about 3 percent of GDP) that has been under consideration in recent months.** The staff argued that this would represent a serious deviation from existing policies which would be inconsistent with the government's strategy of steadily reducing the public debt-to-GDP ratio; there is no balance of payments need in the near term to justify such borrowing; the proceeds from the bond issue could be used not to restructure debt as originally indicated but to undermine fiscal discipline; the bond issue would certainly be very costly, given Papua New Guinea's poor credit rating in the international financial markets; the exchange rate risk could be substantial; and finally an unsuccessful bid for a bond issue could undermine foreign investor confidence. However, the Prime Minister in a parliamentary statement on May 12 indicated that the bond issue remains an option.

B. Fiscal Policy

16. **The 2004 budget target of an overall deficit of 1½ percent of GDP is consistent with the government's macroeconomic objectives of reducing inflation and domestic interest rates.** Revenue and grants are projected to increase slightly to 30.2 percent of GDP, mainly because of higher external grants. The staff team reiterated its concern about the shelving of the Cabinet-approved proposed rate increase in the VAT/GST from 10 percent to 12½ percent (estimated revenue loss of 0.7 percent of GDP); the gradual elimination of the lucrative mining levy (estimated loss of 0.3 percent of GDP); and granting of tax concessions to the agricultural sector (possible loss of 0.5 percent of GDP), which seem unlikely to boost economic activity. The authorities remarked that these measures were broadly offset by a temporary import levy of 2 percent, and a reduction in the number of dependents eligible for rebates from four to three. The staff team stated that, if it appeared during the year any revenue shortfall would emerge, additional actions should be taken to meet the budget target. It also urged the authorities to replace the import levy at the end of 2004 with alternative types of taxation that could be sustained over the medium term.

17. **Current spending is estimated to be about unchanged at 21.7 percent of GDP.** The staff team emphasized the importance of reducing the public sector wage bill (budgeted at 9.2 percent of GDP in 2004) and expressed disappointment over the lack of effort to date in this critical area, while recognizing that some progress has been made in computerizing the payroll, identifying ghost workers, and eliminating overpayments of allowances. However, the budget provides for a 3 percent wage increase and additional performance bonuses; the introduction of automatic annual growth of about 2 percent in the number of employees in the health, education, and law and order sector, notwithstanding the current hiring freeze; and the continued independence of the teachers services commission in recruiting new staff. The staff team stated that any increase in employment in the priority sectors should be fully offset by cutbacks in nonpriority areas.

18. **Another concern is the continued existence of domestic arrears.** Such arrears were substantially reduced during the 2000–01 SBA period, but new arrears were accumulated through the end of 2002. The authorities could not provide an annual data series, but estimated the total amount outstanding at nearly 2 percent of GDP at end-2003, notably in the form of government contributions to the state officials pension fund and verified legal claims against the state. The staff team urged the authorities to accelerate the repayment of these arrears, with a view to eliminating them by the end of 2005. The authorities also confirmed that there were some further claims on the government which were now with the Solicitor General for authentication purposes. For the sake of transparency and better budget execution, the staff team recommended a detailed audited accounting of the outstanding stock of arrears, by creditors and the timing of their occurrence. The authorities expressed their commitment to continue avoiding any new arrears. In this regard, efforts were being made to strengthen the Office of the Solicitor General.

19. **The staff team also expressed disappointment that the longstanding discrepancy between the monthly above-the-line data on the budget and below-the-line financing information had still not been resolved.** The authorities explained that work was in progress to further refine the system of reconciling the check-based expenditure data of the Ministry of Finance with the central bank's settlements data. They also stated that monitoring procedures were being established that will keep comprehensive monthly records of inflows and outflows from nonbank trust accounts. Further, the authorities will reduce greatly the number of trust accounts in the next one or two years and transactions would then take place through the government's main account at the central bank.

C. Monetary and Exchange Rate Policies and Financial Sector Issues

20. **The staff team supported the cautious monetary policy stance, outlined in the Governor's six-monthly statement of January 30, primarily aimed at restraining inflation and to provide the necessary foundation for sustained economic growth.** With a further projected decline in inflation and stability in the exchange rate, the central bank intends to continue to promote a gradual but steady decline in interest rates. With private sector credit remaining sluggish, commercial banks are correspondingly reducing their indicator lending rates, which is welcome. The authorities are committed to keeping real interest rates positive in the months ahead, in view of fiscal and external sector vulnerabilities and an uncertain political environment.

21. **The authorities and the staff team agreed that the floating exchange rate regime should be retained, given the country's vulnerability to external shocks.** The appreciation of the kina did not undermine competitiveness in 2003 because of high export prices. The foreign trade account is projected to remain in substantial surplus in 2004, with higher mineral and nonmineral exports. Import costs have been reduced in recent months as many importers have switched from traditional Australian suppliers to cheaper Asian sources, following the pronounced appreciation of the Australian dollar. Given the large import content of the consumer price index (over 50 percent), this is helping to hold down the rate of inflation.

22. **Financial sector issues were discussed against the background of a generally sound banking system,** although a full set of indicators is not available. The profitability of the domestically-owned bank (with nearly 60 percent of total deposits of the system) has improved considerably since its privatization in 2001. The two foreign-owned banks (about 40 percent of total deposits) have been profitable for many years, but as branches of their Australian headquarters operations, are not required to publish complete separate accounts. The staff team noted that asset quality of all banks remain satisfactory, reflecting continued improvement in credit procedures and the overall cautious approach to new lending, although investments in government securities continue to account for a large share of their assets. The banks all report further reductions in nonperforming loans (below 10 percent of deposits) and satisfactory capital adequacy ratios (above the 11 percent legal minimum requirement). However, the authorities agreed that there was room for further improvement in financial

reporting by banks to the central bank, and more effective enforcement of supervisory decisions. In this regard, they indicated that the recommendations of the Fund's technical advisors on bank supervision and regulation that were submitted to the Governor in December 2003 would be progressively implemented in full.

D. Structural Reform

23. **The government announced in February 2004 its Strategic Plan for Supporting Public Sector Reform, 2003–07, as an integral part of its medium-term development strategy.** The details are to be spelled out in a policy document that is expected to be approved by cabinet shortly, focused on downsizing the public service by 10 percent and fully implementing the PERR recommendations. The authorities have not yet established a clear phasing but have specified that priority would be attached to achieving fiscal sustainability, emphasizing better control of the payroll, and improving budget discipline. The staff team stressed that, while recognizing some of these important reforms can only be accomplished in the medium term, it is crucial there is no slippage in implementing this timetable, including the initiation of key actions during 2004.

24. **With regard to provincial spending, the authorities outlined their proposals to improve delivery.** The National Economic Fiscal Commission, a high level advisory body, is developing a system of functional grants to address the lack of funding for critical services. The Organic Law on provincial and local governments is then expected to be revised to reflect its recommendations while keeping these grants within limits that are financeable by the central government budget; to direct funds specifically to core priority expenditures on health, education, and road maintenance; and to extend grants to less-developed districts to make funding more equitable. Other proposed actions include implementation of reforms identified in the PERR to reduce and control local spending; ensure that all sources of provincial revenue are used in priority areas; and improve financial management and procurement practices.

25. **The financial condition of the main public enterprises remains poor, with most of them continuing to make losses.** The staff team pressed for an acceleration of the reform agenda. The authorities indicated that the early privatization of Telikom was in prospect, as foreign investors had shown interest. For other core businesses, including PNG Power, PNG Post, the Harbors Board, and Air Niugini, the focus was still on adopting more commercial criteria in their operations and improving standards of performance and corporate governance, with a view to possible privatization over the medium term. The staff team stated that the Independent Public Business Commission, which has ownership of all these assets, should exercise extreme caution in providing new capital injections. All receipts from privatization should be promptly transferred by the Commission to the central government budget and used to repay debt.

26. **The formidable structural impediments to private sector growth must be urgently addressed in order to generate investment.** In urban areas, the lack of job

opportunities is widely seen as contributing to high crime rates and poor social conditions. Agricultural output is adversely affected by the weak rural infrastructure, both for the feeder roads and the main highways. The forestry and fisheries sectors face serious governance problems. Although there has been an upturn in exploration permits, the mineral sector continues to be adversely affected by law and order problems. In addition, complex communal-based land owner rights in much of the country create the potential for compensation claims that discourage investors. The difficult regulatory requirements for domestic and foreign investors need to be simplified. The staff team urged the authorities to engage in a closer dialogue with the private sector to establish how these issues can best be resolved.

27. **The authorities outlined steps that were underway to overcome the poor state of governance.** They reiterated the intention to further enhance their "zero tolerance" policy for corruption, and to strengthen key government institutions, notably the Office of the Auditor General. They emphasized that in order to improve the transparency of public sector operations, the government will publish the Auditor General's report annually in a timely manner, in contrast to the lengthy delays of previous years in making them available to the public. The staff was emphatic that greater transparency in all areas of government would improve governance, including notably in the procurement area.

28. **The financial position of the pension funds has improved over the past two years, and they are now a potentially large source of funds for domestic private sector investment** (see the accompanying *Selected Issues* paper). A new Superannuation Act was passed in May 2002, based on the recommendations of a high-level task force appointed by the Prime Minister in August 2001. This legislation addressed many of the legislative and governance-related deficiencies that had contributed to the large losses in the late 1990s, as well as opening the sector to competition. In particular, government influence was greatly reduced; the functions of trusteeship, fund administration and investment management were separated and entrusted to professionals subject to fit and proper criteria; transparency and accountability were strengthened; and the central bank was given strong regulatory and supervision powers. The authorities stated that these changes had been fully implemented, as a result of which investment performance had greatly improved and administrative costs had been reduced.

29. **The authorities confirmed that the multi-year trade tariff reform program is on track and the trade regime remains open and supportive of export developments.** All tariffs were reduced by 5 percentage points with effect from January 2003, and the last and final stage of reductions is scheduled for January 2006. After the completion of this stage, all tariffs will fall into one of four tiers that will range between 0–40 percent. The simple average nominal tariff on imports is 6 percent (and only 4 percent for nonagricultural goods), giving Papua New Guinea a rating of one (least restrictive) on the Fund's index of trade restrictiveness. There are no significant nontariff barriers, but the authorities continue to impose export taxes of 5 percent on logs, mineral ores and concentrates, crocodile skins, and of 15 percent on sandalwood. They

also introduced for 2004 a temporary import levy of 2 percent. Papua New Guinea does not face any major problems in accessing its export markets.

E. Other Issues

30. **Papua New Guinea has no specific anti-money laundering or anti-terrorism financing legislation at present.** However, the authorities stated that a preliminary draft law is now being circulated to appropriate agencies and authorized financial institutions for comments. The establishment of a Financial Intelligence Unit is also under discussion with appropriate law enforcement agencies. The authorities noted that Papua New Guinea ratified the International Convention for Suppression of the Financing of Terrorism in March 2003.

31. **Deficiencies exist in Papua New Guinea's macroeconomic database.** In particular, the quality, coverage, and timeliness of national, fiscal, and external accounting affect the quality of macroeconomic policy analysis. The National Statistics Office (NSO) is underfunded and suffers from a lack of trained staff. Papua New Guinea is a participant in the GDDS project for Pacific Island countries and is working to develop its GDDS metadata.

III. Staff Appraisal

32. **Papua New Guinea has made progress to restore macroeconomic stability since the last consultation was concluded in mid-2003.** The authorities took action to tighten fiscal policy, by means of better expenditure controls. Assisted by higher revenue from the mineral and petroleum sectors, the budget deficit was held to the government's initial target of about 2 percent of GDP for the year. This facilitated a marked drop in the rate of inflation and treasury bill rates declined.

33. **Favorable temporary factors have helped to boost agricultural and mineral output and strengthen the balance of payments.** Real GDP growth is estimated at over 2½ percent in 2003, after three years of negative growth. Strong world commodity prices underpinned a sharp rise in exports, and the external current account moved into substantial surplus. Official external reserves rose to the equivalent of nearly 6 months of non-mining imports and the kina appreciated.

34. **Notwithstanding these encouraging trends, the economic situation remains fragile.** Political uncertainties have further disrupted the structural reform process, which was already moving only slowly, with parliament adjourned from January 2004, as the government seeks to avoid a no-confidence motion. Long standing structural problems need to be addressed urgently to strengthen public sector efficiency and promote private sector activity. Without action, medium-term prospects for faster sustainable growth and poverty alleviation will remain weak.

35. **The government's 2004 budget deficit of 1½ percent of GDP is consistent with further improving the macroeconomic situation, but there are still questions about fiscal sustainability.** There are revenue losses from the shelving of the Cabinet-approved

increase in the VAT/GST rate and the introduction of tax concessions for the mining and agricultural sectors. On the expenditure side, while some progress has been made in removing payroll irregularities, insufficient actions have been taken to reduce the bloated wage bill. Another concern is that, as expenditure other than wages is compressed, domestic arrears could rise.

36. **Prudent monetary policy has helped in the disinflation effort and must be sustained to prevent the resurgence of inflationary pressures.** The present strategy represents a careful course of supporting the economic recovery while at the same time restraining inflation. However, the central bank needs to avoid unduly rapid easing of the policy stance and lowering of interest rates that could undermine the external position. The flexible exchange rate regime, which plays a key role in facilitating an orderly adjustment to external shocks, should be continued. The present level of the kina is broadly appropriate.

37. **With regard to public sector reform, the main task is to limit wage costs and switch resources to health, education, and infrastructure, within the restrained expenditure environment,** in line with the recommendations of the World Bank-led Public Expenditure Review and Rationalization. Further fiscal consolidation will be required over the medium term, with budget deficits of below 1 percent of GDP, to steadily reduce the public debt-to-GDP ratio. The recent steps to strengthen the expenditure and monitoring control system must be supported by tight enforcement of procedures. There is also a continuing need to strengthen provincial budgets and the financial conditions of the main public enterprises, with a view to privatization where possible. Government proposals in these areas are in the right direction, but they need to be implemented forcefully.

38. **The formidable structural impediments to private sector growth need to be urgently addressed.** Attention needs to be devoted to improving the weak rural infrastructure, especially roads; addressing governance issues in the forestry and fishery sectors; promoting law and order and land reform to encourage mining development; and simplifying the complex regulatory requirements for domestic and foreign private investors. Greater transparency in all areas of government operations would improve governance and accountability, and facilitate private sector activity.

39. **Most importantly, the success of the medium-term reform program depends crucially on the unwavering actions of the authorities to establish a sustained track record of policy implementation.** Over the past two decades, it has proved difficult to maintain a steady policy path for any length of time. As a result, there have been periodic bursts of high inflation and exchange rate pressures that have impeded growth. Present macroeconomic policies, together with the proposed structural reforms if fully implemented, would be consistent with building on the recent achievements.

40. **The authorities should avoid borrowing externally on commercial terms, including through an international bond issue.** There is no balance of payments need for external borrowing; the bond issue would be inconsistent with the aim of steadily reducing

the public debt-to-GDP ratio; the proceeds from the bond issue, if spent, would undermine fiscal discipline; and it is likely to prove very expensive.

41. **Papua New Guinea's economic statistics remain weak and the authorities should revive efforts to address longstanding deficiencies.** Improved statistics are essential to the effective execution of the government's reform program.

42. **The staff proposes that the next Article IV consultation be held on the standard 12-month cycle.**

Box 1. Papua New Guinea: Public Expenditure Review and Rationalization

The Public Expenditure Review and Rationalization (PERR) is geared towards generating specific reforms in six areas of public finance management, to be implemented in 2004 and beyond:

- **Road Map to Fiscal Sustainability:** Papua New Guinea's fiscal situation deteriorated markedly over the last decade, fueled by a large expansion of public sector employment. This led to reoccurring expenditure overruns, which crowded out spending on goods and services and health, education, and infrastructure projects. The authorities have established a medium-term macroeconomic framework that is broadly appropriate, but the key will be the implementation of the fiscal and structural polices that underpin it.

- **Civil Service Size and Payroll:** The rapid expansion of payrolls has occurred despite efforts to maintain a hiring freeze. There are at least 2,000 unattached officials that do no work, a large number of 'ghost workers,' many underemployed casual workers, payments of unallocated allowances and benefits, and high rates of absenteeism. Substantial amounts can be saved by cleansing payrolls, with no adverse impact on service delivery.

- **Restoring the Integrity of the Budget Institutions and Systems:** Papua New Guinea's budget systems are in principle quite strong. However, because of poor governance, many budget systems and processes are repeatedly flaunted (e.g., appropriations are routinely breached, and procurement procedures bypassed). In order to overcome these problems, Financial Controllers should be given more power, trust accounts should be closed, and individuals who breach budget protocols should be penalized.

- **Expenditure Adjustment and Prioritization:** While the medium-term development strategy prepared by the authorities helps to define a set of by-agency priorities for public expenditure, it must be strengthened by conducting a detailed agency review to identify which functions should continue to be performed by government, and which can be outsourced to the private sector. An institutionalized system for reporting expenditures on economic and functional classification also would facilitate decision-making.

- **Improving Health Spending:** Despite expanded donor funding, rural health services have deteriorated. Spending should be better prioritized, with more funds allocated towards the provision of drugs and medicines, and less on personnel. Additionally, there is significant scope for improving donor coordination.

- **Improving Education Spending:** To mitigate the budgetary impact of continuing high population growth on enrollments, post-primary school subsidies should be phased out. Additionally, expenditure on school supplies should be increased with some reduction in the number of teachers, whose employment has increased too rapidly in recent years.

Box 2. Papua New Guinea: Impediments to Growth and Poverty Alleviation

Papua New Guinea's per capita real GDP is 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, infant mortality 10 times higher than in developed countries, and rising prevalence of HIV/AIDS. Efforts to eradicate poverty have been hampered by the impediments to growth in all sectors and by the poor delivery of social services, especially in the rural area.

- **Mineral and petroleum sector:** Papua New Guinea has large deposits of gold, copper, and oil. Since independence, the mineral sector has generated fiscal revenues of about 5 percent of GDP. 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 large copper mine in Bougainville in the early 1990s, new exploration activity largely dried up. Deteriorating law and order and governance problems, crumbling infrastructure, overdue land reform, and low profitability have hampered the prospects for any large scale investment activity. Consequently, few projects are expected to be initiated in the years ahead, and fiscal revenues are expected to decline.

- **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 agricultural 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. 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.

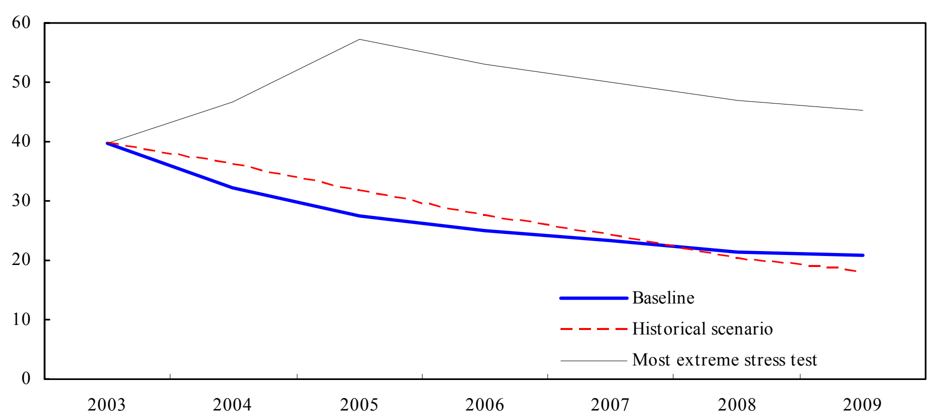
Box 3. Papua New Guinea: Public External Debt Sustainability[1]

- **Over the last decade, PNG has evolved from a situation of relatively low levels of public external debt to one where debt dynamics are of some concern.** Financial indiscipline, coupled with intermittent exogenous shocks to the economy, have been the main forces behind build up of debt. Public external debt rose from 26 percent of GDP in 1994 to a peak of 56 percent of GDP in 2002. Subsequently, it has declined to an estimated 44 percent in 2003, reflecting mainly higher nominal GDP growth and exchange rate appreciation.

- **The medium-term scenario prepared by the staff suggests that with continued efforts to strengthen financial policies and deepen structural reforms, PNG's external position would remain satisfactory despite the projected decline in mineral sector output and exports due to the depletion of reserves.** The baseline scenario incorporates the authorities' commitment to achieve a fiscal balance of 1½ percent of GDP in 2004, and envisages that the deficit would be contained under 1 percent of GDP during the projection period through a further restructuring of the budget, in particular wage bill restraint. While mineral real GDP is projected to decline modestly after 2005, nonmineral production is expected to grow at 3 percent annually, backed by strong structural reform policies. Overall GDP growth is projected to average 2½ percent a year through 2008 and 3 percent per annum thereafter.

- **The DSA results suggest that under these policies, the net present value (NPV) of PNG's public external debt-to-GDP ratio declines from 40 percent at present to about 21 percent by 2009.** These debt projections are particularly sensitive to negative shocks, applied over two years, to GDP deflator, export value growth, and exchange rate. The impact of shock to each of these variables would leave the NPV of external public debt at about the current high level. Applying a one-half standard deviation shock to a combination of real GDP growth and net nondebt creating flows would also have a more serious effect, causing the NPV of public external debt-to-GDP ratio to rise on average by 10 percentage points through 2009.

Net Present Value of Public External Debt-to-GDP Ratio



[1] The methodology draws on the recent Board paper *Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications*. A more detailed analysis is presented in the accompanying *Selected Issues* paper.

Box 4. Papua New Guinea: Australia-Papua New Guinea Enhanced Cooperation Program

At the fifteenth Annual Ministerial Forum in Adelaide on December 11, 2003, the Australian and Papua New Guinea governments agreed to a number of collaborative initiatives to address the core economic and development challenges identified in the Papua New Guinea government's Medium-Term Development Strategy. These initiatives, brought together for up to five years under the Enhanced Cooperation Program, involve the deployment of up to 294 Australian experts who will work side-by-side with PNG officials (some in-line positions) to strengthen law and order, governance, and economic and public sector administration. This hands-on technical assistance is supported by annual grants on the order of $330 million per year, including $120 million for policing activities alone. The first Australian experts arrived in February 2004.

Police, Law, and Justice

Australia will provide up to 230 police officers and basic policing equipment and training to build the capacity of the Royal PNG Constabulary, with initial deployment of officers in Bougainville, Port Moresby, Lae, Mount Hagen, and along the Highlands Highway. In addition, 18 senior legal specialists will be placed in the Solicitor General's office (including the Solicitor General), the Public Prosecutor's Office, the National and Supreme Courts, the National Court Registry, and the Department of Justice. Full implementation of the legal program of assistance will require a treaty between the two governments, as well as enabling legislation passed by the PNG Parliament.

Immigration, Border and Transport Security, and Aviation Management and Safety

Up to 10 Australian officials will help develop better border control and migration management, improved revenue collection, international trade security, border integrity, and enhanced security of aviation and maritime transport systems to meet international transport security obligations. With regard to the latter, an Australian will be placed as a high-ranking official in the Civil Aviation Authority to ensure a high standard of management and governance, particularly in relation to safety regulation and standards.

Economic Management and Public Sector Administration

Within the public sector, up to 36 economic and public administration specialists from Australia will be deployed in the Departments of Finance, Treasury, and Personnel Management. In addition to offering economic advice to senior PNG officials, they will help tighten payroll and expenditure controls, boost the efficiency of government spending to increase the funding of services and infrastructure, and improve budget formulation and execution to enhance overall fiscal discipline.

Table 1. Papua New Guinea: Selected Economic Indicators, 2000–04

Nominal GDP (2002): US$2.8 billion
Population (2002): 5.4 million
GDP per capita (2002): US$514
Quota: SDR 131.6 million

	2000	2001	2002	Prel. 2003	Proj. 2004
Real sector (percent change)					
Real GDP growth	-1.2	-2.3	-0.8	2.7	2.5
Mineral	-0.5	4.5	-18.7	3.0	2.0
Nonmineral	-0.5	-4.1	4.5	2.6	2.6
CPI (annual average)	15.6	9.3	11.8	14.7	7.4
CPI (12 months)	10.0	10.3	14.8	8.4	6.5
Central government budget (percent of GDP)					
Revenue and grants	31.2	31.0	29.4	30.0	30.2
Expenditure and net lending	32.3	34.7	33.8	31.2	31.7
Overall balance, cash basis (including grants) 1/	-1.4	-4.1	-5.7	-2.0	-1.5
Domestic financing, net 2/	1.2	0.9	6.2	3.8	2.2
Of which: Banking system	-1.4	-2.5	5.2	-0.8	0.5
External financing, net	0.2	3.1	-0.9	-2.2	-1.6
Privatization, net	0.3	0.0	1.8	0.3	0.5
Money and credit (end-period percentage change)					
Domestic credit	-4.5	-12.3	20.9	-6.9	4.9
Net credit to government	-12.5	-26.1	82.0	-7.9	5.7
Credit to the private sector	3.0	-1.2	-6.3	-2.8	4.5
Broad money	5.4	1.9	4.2	-3.3	5.5
Interest rate (182-day T-bills, end-period)	14.9	10.2	13.5	16.9	...
Balance of payments (millions of U.S. dollars)					
Exports, f.o.b.	2,215	1,878	1,646	2,213	2,329
Imports, c.i.f.	-1,490	-1,326	-1,292	-1,431	-1,610
Current account (including grants)	299	204	-20	346	176
(In percent of GDP)	8.7	6.9	-0.7	10.1	4.5
Overall balance	78	66	-96	183	32
Reserves and external debt (end-period, millions of U.S. dollars)					
Net international reserves	256	331	226	398	427
(In months of nonmining imports, c.i.f.)	2.7	4.3	3.0	4.5	4.2
Gross international reserves	304	440	343	523	515
(In months of nonmining imports, c.i.f.)	3.2	5.7	4.6	5.8	5.0
Public external debt service ratio(percent of exports) 3/	6.8	8.0	7.9	7.3	8.0
Public external debt-to-GDP ratio (in percent) 3/ 4/	42.8	54.7	56.4	44.1	36.0
Exchange rates					
US$/kina (period average)	0.3624	0.2976	0.2573	0.2816	...
US$/kina (end-period)	0.3255	0.2625	0.2488	0.3000	...
Nominal GDP (millions of kina)	9,515	9,948	10,992	12,204	12,596

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

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.
4/ The decline in the debt ratio in 2003 is mainly due to a significant increase in nominal GDP growth and exchange rate effects.

Table 2. Papua New Guinea: Summary of Central Government Operations 2000–04

(In percent of GDP)

	2000	2001	2002	Est. 2003	Proj. 2004
Revenue and grants	31.2	31.0	29.4	30.0	30.2
Revenue	25.8	24.8	23.1	23.8	23.6
Tax revenue	24.3	23.1	21.6	21.9	22.0
Mineral taxes	5.6	5.6	3.3	4.1	3.7
Nonmineral taxes	18.7	17.5	18.2	17.9	18.4
Nontax revenue	1.5	1.7	1.5	1.9	1.6
Grants	5.3	6.2	6.3	6.1	6.6
Total expenditure and net lending	32.3	34.7	33.8	31.2	31.7
Recurrent expenditure	24.1	24.3	23.2	21.9	21.7
National departments	12.8	12.5	12.3	9.7	10.4
Salaries and wages	5.0	5.4	5.2	5.1	5.1
Arrears payments	2.0	0.9	0.1	0.1	0.2
Goods and services	4.2	3.9	5.2	4.3	4.4
Other	1.6	2.3	1.8	0.2	0.7
Provinces	5.5	5.9	5.3	4.9	4.9
Salaries and wages	3.8	4.2	4.4	4.1	4.1
Goods and services	1.0	1.0	0.4	0.5	0.5
Conditional grants	0.7	0.7	0.5	0.2	0.2
Statutory authorities	1.3	1.7	1.5	1.7	1.5
Interest	4.4	4.2	4.0	5.6	4.9
Domestic	3.0	2.5	2.3	4.3	4.0
Foreign	1.4	1.7	1.7	1.3	1.0
Development expenditures and net lending	8.2	10.5	10.6	9.3	10.0
Development expenditure	8.2	10.5	10.6	9.4	10.0
Foreign financed	6.0	7.0	8.5	7.7	8.2
Project grants	5.2	5.5	6.2	6.1	6.6
Project concessional loans	0.9	1.4	1.1	1.1	1.4
Nonconcessional loans	0.0	0.0	1.3	0.5	0.2
Domestically funded	2.2	3.6	2.2	1.7	1.9
Net lending	0.0	0.0	0.0	-0.1	0.0
Overall balance (from above the line)	-1.1	-3.7	-4.3	-1.3	-1.5
Residual deficit	-0.3	-0.3	-1.4	-0.7	0.0
Overall balance (from below the line)	-1.4	-4.1	-5.7	-2.0	-1.5
Financing	1.4	4.1	5.7	2.0	1.5
External financing (net)	0.2	3.1	-0.9	-2.2	-1.6
Disbursements	2.9	6.3	2.3	1.6	1.6
Amortization	-2.8	-3.2	-3.3	-3.7	-3.2
Domestic financing (net)	1.2	0.9	6.6	4.1	3.1
Banking sector	-1.4	-2.5	5.2	-0.8	0.5
Nonbanks	1.7	2.1	1.0	4.6	1.7
Float	0.6	1.3	-1.4	0.0	0.4
Asset sales	0.3	0.0	1.8	0.3	0.5
Memorandum item:					
Nonmineral overall balance	-6.7	-9.3	-7.6	-5.4	-5.2

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

Table 3: Papua New Guinea: Summary Accounts of the Banking System, 2000–04

	2000	2001	2002	2003	Proj. 2004
Bank of Papua New Guinea	(In millions of kina)				
Net foreign resereves	812	1,249	908	1,288	1,343
Foreign reserves	934	1,656	1,379	1,705	1,614
Foreign liabilities	122	406	471	418	271
Net domestic assets	-280	-671	-264	-622	-667
Domestic credit	800	527	772	722	683
Net credit to government	741	472	717	667	628
Claims	772	746	727	709	709
Deposits	31	275	86	80	80
Credit to other sectors	59	56	56	55	55
Other items net	-1,080	-1,199	-1,036	-1,344	-1,350
Of which : Central bank securities	608	586	157	422	358
Reserve money	533	578	644	666	676
Currency in circulation	364	385	472	512	541
Deposits of commercial banks	169	188	162	153	135
Other deposits	4	4	9	0	0
Monetary survey	(In millions of kina)				
Net foreign assets	1,053	1,580	1,419	1,587	1,714
Net domestic assets	1,977	1,507	1,798	1,523	1,566
Domestic credit	2,699	2,367	2,862	2,666	2,796
Net credit to central government	943	697	1,269	1,169	1,235
Claims on other sectors	1,756	1,670	1,594	1,497	1,561
Of which : Private sector	1,562	1,543	1,445	1,405	1,468
Other items (net)	-722	-860	-1,064	-1,143	-1,230
Broad money	3,030	3,087	3,217	3,109	3,280
Narrow money	1,272	1,321	1,535	1,708	1,804
Currency outside banks	285	272	366	399	422
Demand deposits	987	1,049	1,169	1,309	1,382
Quasi money	1,759	1,766	1,682	1,401	1,475
	(Annual percentage change)				
Net foreign assets	50.6	50.0	-10.2	11.9	8.0
Net domestic assets	-9.1	-23.8	19.3	-15.3	2.8
Net domestic credit	-4.5	-12.3	20.9	-6.9	4.9
Of which: Private sector	3.0	-1.2	-6.3	-2.8	4.5
Broad money	5.4	1.9	4.2	-3.3	5.5
Memorandum items:					
Reserve money (percentage change)	-18.4	8.5	11.4	3.4	1.5
Gross reserves (in millions of U.S. dollars)	304	440	343	512	515
Broad money multiplier	5.7	5.3	5.0	4.7	4.9
Broad money velocity	3.1	3.2	3.4	3.9	3.8
Nominal nonmineral GDP/broad money	2.3	2.2	2.5	2.9	3.0

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

Table 4. Papua New Guinea: Balance of Payments, 2000–04

(In millions of U. S. dollars)

	2000	2001	2002	Est. 2003	2004
Current account balance	299	204	-20	346	176
Mineral	1008	802	468	788	840
Nonmineral	-708	-598	-489	-443	-664
Trade balance	724	552	353	782	718
Exports (f.o.b.)	2215	1878	1646	2213	2329
Mineral	1804	1598	1228	1718	1784
Nonmineral	410	280	417	495	544
Imports (c.i.f.)	-1490	-1326	-1292	-1431	-1610
Mineral	-363	-394	-397	-359	-382
Nonmineral	-1127	-932	-895	-1072	-1228
Services balance	-603	-498	-564	-675	-780
Mineral (net)	-434	-401	-363	-571	-562
Nonmineral (net)	-169	-97	-201	-104	-218
Unrequited transfers (net)	178	150	190	238	237
Official	188	192	168	195	195
Private	-10	-42	22	43	42
Capital account balance	-275	-239	-119	-124	-144
Medium- and long-term loan disbursements	-242	-205	-164	-141	-99
Official (net)	-64	-60	-26	-75	-69
Private capital flows (net)	-178	-144	-138	-66	-30
Foreign direct investment (net)	114	74	19	90	68
Change in net foreign assets of commercial banks					
Other (net)	-148	-111	59	-91	-110
Exceptional financing 1/	70	135	0	0	0
Errors and omissions	-16	-33	42	-39	0
Overall balance	78	66	-96	183	32
Change in net international reserves (-increase)					
Gross official reserves	-98	-136	97	-179	8
IMF (net)	18	70	0	-4	-39
Purchases	38	71	0	0	0
Repurchases	-19	-1	0	-4	-39
Other foreign liabilities	2	-1	0	0	0
Financing gap	0	0	0	0	0
Memorandum items:					
Current account (in percent of GDP)	8.7	6.9	-0.7	10.1	4.5
Mineral	29.2	27.1	16.6	22.9	21.5
Nonmineral	-20.5	-20.2	-17.3	-12.9	-17.0
Net international reserves					
In millions of U.S. dollars	256	331	226	398	427
Gross official reserves (end-year)					
In millions of U.S. dollars	304	440	343	523	515
In months of nonmineral imports	3.2	5.7	4.6	5.8	5.0
Public external debt service-export ratio (in percent)	6.8	8.0	7.9	7.3	8.0
Public external debt-GDP ratio (in percent) 2/	42.8	54.7	56.4	44.1	36.0

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

1/ Excludes US$35 million from AsDB in 2004, consistent with the conservative approach of the authorities.

2/ The decline in the debt ratio in 2003 is mainly due to a significant increase in nominal GDP growth and exchange rate effects.

Table 5. Papua New Guinea: Medium-Term Scenario, 2000–09

				Prel.	Projected 1/					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Growth and prices (change in percent)										
Real GDP 2/	-1.2	-2.3	-0.8	2.7	2.5	2.9	2.3	2.5	2.6	2.6
Mineral	-0.5	4.5	-18.7	3.0	2.0	3.0	-0.5	-0.7	-0.5	-0.5
Nonmineral	-0.5	-4.1	4.5	2.6	2.6	2.9	3.0	3.2	3.2	3.3
CPI (average)	15.6	9.3	11.8	14.7	7.4	6.0	4.5	3.0	2.2	2.0
CPI (end period)	10.0	10.3	14.8	8.4	6.5	5.5	3.5	2.5	2.0	2.0
Savings and investment (in percent of GDP)										
Foreign savings	8.7	6.9	-0.7	10.1	4.5	2.3	0.2	0.2	-0.1	-0.4
Public saving-investment balance 3/	-1.4	-4.1	-5.7	-2.0	-1.5	-0.8	-0.4	-0.1	0.0	0.0
Private saving-investment balance 4/	-7.3	-2.8	6.4	-8.1	-3.0	-1.5	0.2	-0.1	0.1	0.4
Central government operations (in percent of GDP)										
Total revenue and grants	31.2	31.0	29.4	30.0	30.2	30.1	29.5	29.0	28.3	27.9
Of which: Mineral tax revenue	5.6	5.6	3.3	4.1	3.7	3.2	2.8	2.4	2.0	1.9
Of which: Grants	5.3	6.2	6.3	6.1	6.6	6.5	6.0	5.6	5.1	4.8
Total expenditure	32.3	34.7	33.8	31.2	31.7	30.9	29.9	29.1	28.3	27.7
Primary balance 5/	3.1	0.1	-1.7	3.7	3.4	4.3	4.2	3.9	3.6	3.5
Overall balance 5/	-1.4	-4.1	-5.7	-2.0	-1.5	-0.8	-0.4	-0.1	0.0	0.2
Domestic financing (net) 6/	1.2	0.9	6.2	3.8	2.2	1.3	0.6	0.6	0.6	0.5
Foreign financing (net)	0.2	3.1	-0.9	-2.2	-1.6	-1.1	-0.7	-0.9	-1.1	-1.2
Privatization (net)	0.3	0.0	1.8	0.3	0.5	0.3	0.2	0.2	0.2	0.2
Gross central government debt (in percent of GDP) 7/	58.8	69.4	73.1	63.2	58.4	54.8	52.3	50.1	47.6	45.6
Domestic	19.6	21.1	23.5	24.6	26.2	26.2	25.2	24.6	24.2	23.8
External 8/	39.3	48.3	49.6	38.6	32.2	28.6	27.1	25.5	23.4	21.8
Money and credit (annual percent change, end period)										
Net foreign assets	50.6	50.0	-10.2	11.9	8.0	12.1	4.1	6.3	4.7	3.3
Net domestic assets	-9.1	-23.8	19.3	-15.3	2.9	2.8	10.7	6.7	7.0	8.0
Of which: Credit to private sector	3.0	-1.2	-6.3	-2.8	4.5	7.7	7.1	6.5	5.8	5.6
Broad money	5.4	1.9	4.2	-3.3	5.5	7.7	7.1	6.5	5.8	5.6
Balance of payments (in millions of U.S. dollars)										
Exports, f.o.b.	2,215	1,878	1,646	2,213	2,329	2,279	2,236	2,227	2,242	2,258
Of which: Mineral	1,804	1,598	1,228	1,718	1,784	1,716	1,647	1,614	1,601	1,588
Imports, c.i.f.	-1,490	-1,326	-1,292	-1,431	-1,610	-1,708	-1,784	-1,860	-1,904	-1,942
Current account	299	204	-20	346	176	98	9	10	-5	-22
As percentage of GDP	8.7	6.9	-0.7	10.1	4.5	2.3	0.2	0.2	-0.1	-0.4
Overall balance (including exceptional financing)	78	66	-96	183	32	39	-18	-4	-10	-54
External financing gap 9/	0	0	0	0	0	5	28	34	35	71
Gross official reserves (in millions of U.S. dollars)	304	440	343	523	515	500	485	515	540	557
(In months of nonmining imports, c.i.f.)	3.2	5.7	4.6	5.8	5.0	4.4	4.0	4.0	4.0	4.0
Net official reserves (in millions of U.S. dollars)	256	331	226	398	427	471	482	512	537	555
(In months of nonmining imports, c.i.f.)	2.7	4.3	3.0	4.5	4.2	4.2	4.0	3.9	4.0	4.0
Public external debt service-export ratio (in percent)	6.8	8.0	7.9	7.3	8.0	8.1	5.9	4.4	4.3	4.5
Public external debt to GDP ratio (in percent)	42.8	54.7	56.4	44.1	36.0	30.7	28.0	26.2	24.0	21.7
Memorandum items:										
Nominal GDP (in millions of kina)	9,515	9,948	10,992	12,204	12,596	13,284	14,159	14,901	15,596	16,315
Nominal GDP (in millions of U.S. dollars)	3,447	2,961	2,828	3,437	3,915	4,200	4,370	4,559	4,764	4,996

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

1/ Projections for 2004–08 are staff estimates broadly based on government intentions.
2/ GDP figures for 2000–03 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.
8/ Excluding central bank external debt, but includintg external financing gaps.
9/ Financing gaps shown are expected to be filled by assistance from the multilateral and bilateral donors.

Table 6. Papua New Guinea: Indicators of External Vulnerability, 2000–04

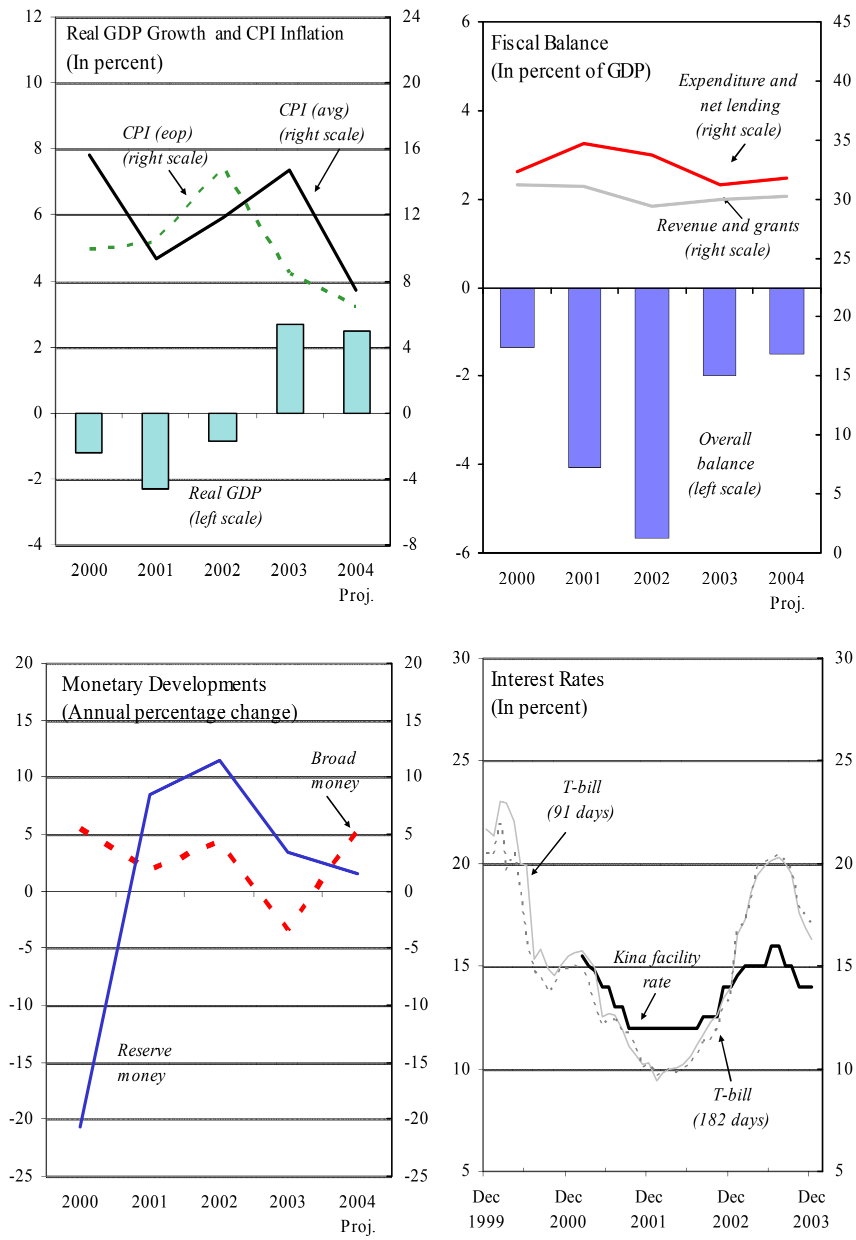
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	Est. 2003	Proj. 2004
Financial indicators					
Gross central government debt 1/	58.8	69.4	73.1	63.2	58.4
Broad money (percent change, 12-month basis)	5.4	1.9	4.2	-3.3	5.5
Private sector credit (percent change, 12 month basis)	3.0	-1.2	-6.3	-2.8	4.5
182 day T-bill yield 1/	14.9	10.2	13.5	16.9	...
182 day T-bill yield (real) 2/	4.4	-0.1	-1.1	7.9	...
External indicators					
Exports (percent change, 12-month basis in U.S. dollars)	9.6	-15.2	-12.4	34.5	5.2
Imports (percent change, 12-month basis in U.S. dollars)	1.3	-11.0	-2.5	10.7	12.6
Current account balance	8.7	6.9	-0.7	10.1	4.5
Capital and financial account balance	-8.9	-9.2	-4.3	-3.4	-3.6
Of which: Inward foreign direct investment	3.7	2.8	0.7	2.4	1.7
Gross official reserves (millions of U.S. dollars)	304	440	343	523	515
Central Bank short-term foreign liabilities (millions of U.S. dollars)	0.8	0.5	0.5	0.5	0.5
Commerical bank foreign assets (millions of U.S. dollars)	96.5	112.2	153.1	106.7	155.3
Commerical bank foreign liabilities (millions of U.S. dollars)	18.1	24.2	26.0	16.9	36.0
Gross official reserves (months of nonmineral imports, c.i.f.)	3.2	5.7	4.6	5.8	5.0
Broad money to gross reserves (ratio)	3.2	1.8	2.3	1.8	2.0
Total short-term external debt to reserves (percent) 3/	6.0	5.5	7.6	3.2	7.0
Public external debt to GDP ratio (in percent)	42.8	54.7	56.4	44.1	36.0
Public external debt service to exports (percent)	6.8	8.0	7.9	7.3	8.0
Total external debt service to ordinary governement revenues (percent)	46.2	31.2	23.5	30.4	30.7
Exchange rate (per U.S. dollar, period average)	2.76	3.36	3.89	3.55	3.22
Financial market indicators					
Foreign currency long-term government debt rating 1/					
Moody's 4/	B1(neg.)	B1(stab.)	B1(stab.)	B1(stab.)	...
Standard and Poors 5/	B+(neg.)	B(stab.)	B(neg.)	B(stab.)	...

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

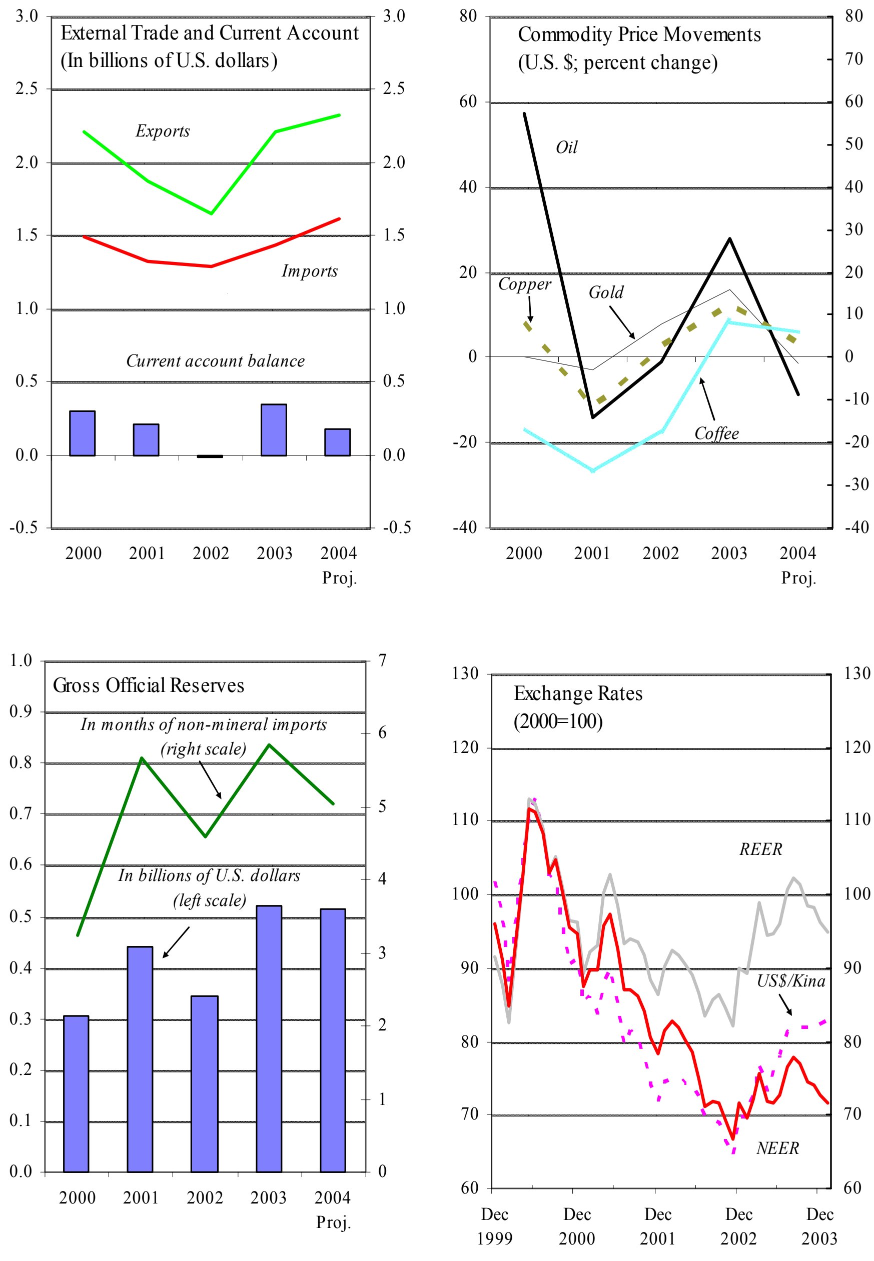
1/ End of period.
2/ Ex-post real rate.
3/ Covers only banking system short-term external debt.
4/ Initial rating of B1 (stable) in January 1999.
5/ Initial rating of B+(stable) in January 1999. Downgraded to B (stab.) in August 2001 and B (neg.) in 2002.

Figure 1. Papua New Guinea: Domestic Economic Indicators



Sources: Data provided by the Papua New Guinea authorities; IMF, Information Notice System; and Fund staff estimates.

Figure 2. Papua New Guinea: External Economic Indicators



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

PAPUA NEW GUINEA: FUND RELATIONS

(As of March 31, 2004)

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	210.64	160.06
Reserve position in Fund	0.40	0.30

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	9.30	100.00
Holdings	2.00	21.54

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
Stand-by Arrangement (SBA)	79.43	60.36

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

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

Expectations basis:

IV.

	OVERDUE	----------------**FORTHCOMING**	----------------------------			
	12/31/03	**2004**	**2005**	**2006**	**2007**	**2008**
Principal	0.0	38.05	41.38	0.00	0.00	0.00
Charges/interest	0.0	1.25	0.57	0.12	0.12	0.12
Total	0.0	39.30	41.95	0.12	0.12	0.12

Obligations basis:

V.

	OVERDUE	----------------**FORTHCOMING**	----------------------------			
	12/31/03	**2004**	**2005**	**2006**	**2007**	**2008**
Principal	0.0	23.89	39.02	16.52	0.00	0.00
Charges/interest	0.0	1.29	1.02	0.30	0.12	0.12
Total	0.0	25.17	40.04	16.82	0.12	0.12

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. BPNG will be subject to a full safeguards assessment when its next Fund arrangement is approved.

VIII. Exchange Rate Arrangement:

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.

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 9–18, 2003. The staff report (IMF Country Report No. 03/178) was considered by the Executive Board and the consultation concluded on June 4, 2003.

X. Technical Assistance from Headquarters:

FAD: 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. 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. A mission in February 2002 assessed progress to improve fiscal transparency.

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

MFD: A mission in November 2001 reviewed foreign exchange management. A mission in June 2001 assessed the monetary policy implementation framework. During 2001–03 assistance was provided through missions in bank supervision, financial sector restructuring and improving the accounting framework and monetary operations of the central bank. A resident advisor was assigned to the BPNG research department for 12 months through August 2003.

STA: Four missions in 1995–96 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 WORLD BANK GROUP
(As of April 6, 2004)

To date, the World Bank has provided 35 IBRD loans and 13 IDA development credits amounting to $786.6 million and $114.9 million in commitments respectively. There are five active loans, totaling $99 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), Gazelle Restoration Project ($25 million) and the Road Maintenance and Rehabilitation Project ($40 million).

In August 2003, the World Bank suspended disbursements on the Forestry and Conservation Project due to a number of areas of noncompliance with the loan agreement, with respect to which the government had been unable to make adequate progress in the preceding months. The government has expressed its commitment to the project and is continuing to work to address the outstanding issues with the support of the Bank, to allow the suspension to be lifted. In the interim, new project preparation has been deferred, but work is continuing on priority analytical/advisory services, in the fields of public expenditure management, health and education service delivery, HIV/AIDS strategy, and transport infrastructure.

Given the uncertain operating environment, the World Bank is currently preparing an Interim Strategy Note, in line with guidelines for assistance to Low-Income Countries Under Stress (LICUS). The broad objectives of the strategy are to help: (a) contain Papua New Guinea's economic decline and mitigate the impact of the contraction on the poor and vulnerable; and (b) build the foundations for revived economic growth, particularly in rural areas. The strategy focuses on three thematic areas: improving economic management and public sector performance, improving human development outcomes and protecting the poor and vulnerable, and strengthening the preconditions for pro-poor growth. The scale and scope of assistance is likely to be modest, with an emphasis on analytical work, policy advice, capacity-building, and communications/outreach.

IFC, through the Pacific Enterprise Development Facility, has secured financing for 22 projects to support 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 the mining sector worth $51 million in gross exposure.

Papua New Guinea: IBRD Leading Operations
(In millions of U.S. dollars)

Fiscal Year	1998	1999	2000	2001	2002	2003	2004[1]
Commitments	5.0	0.0	132.3	0.0	57.4	0.0	0.0
Disbursements	21.1	10.6	39.8	11.3	65.1	7.3	5.1
Undisbursed balance	53.7	43.0	134.5	114.1	106.4	85.8	98.6

Note: Fiscal year is July–June.
[1] As of March 31, 2004.

PAPUA NEW GUINEA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK
(As of March 31, 2004)

Through end-March 2004, the Asian Development Bank (AsDB) had approved 57 loans totaling $874 million for 47 projects. Of this total, 24 loans ($463 million) had been extended from ordinary capital resources and 33 loans ($412 million) from special funds resources. In addition, $42 million had been provided for 120 technical assistance projects. There are currently 11 active loans.

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.

One loan of $19 million for community water transport was approved on March 25, 2004. Subject to AsDB Board approval, it is envisaged that the second $35 million tranche of the Public Service Program may be released in the third quarter of 2004. No further lending is envisaged during 2004; but two loans are on standby. Current plans envisage annual lending averaging about $35 million during 2004–06. The current 2004 program for grant-financed technical assistance comprises four projects totaling about $2 million.

Table 1. Papua New Guinea: Loan Approvals and Disbursements, 1998–2004

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	Proj. 2004
Loan approvals	14.1	109.0	45.5	75.9	5.7	0	19.0
Loan disbursements	24.0	35.1	13.0	43.6	14.0	13.8	50.0

Source: Data provided by the AsDB.

Papua New Guinea: Relations with the Pacific Financial Technical Assistance Centre[1]

(As of April 4, 2004)

Assistance to Papua New Guinea (PNG) since 1996 has included 15 missions, with a primary focus in public finance and in economic and financial statistics. During 1996–2003, PNG has sent 23 officials to the Centre's regional seminars, workshops and training courses. As PNG's needs exceed our capacity, assistance is mostly provided directly by the Fund.

Public Financial Management

PFTAC assisted the authorities in the preparation of a ROSC, 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 in the public expenditure management area.

Tax Administration and Policy

PNG has received extensive assistance from bilaterals but there has been no PFTAC visit since 1997. However, officials attended our 2003 Regional Seminar in Tonga on "Basic issues when designing, administering, and implementing a VAT." The Tax advisor made a presentation on PFTAC's activities in Port Moresby at the Customs International Conference in March. To modernize its Customs Department PNG is implementing a customs automated system (ASYCUDA), despite the fact that financing is not secure; PNG officials expressed their interest in PFTAC technical assistance to draft a new Customs Act. As a first step, they may request a short term visit to assess needs. Provided such a request is made, PFTAC will consider it positively.

Financial Sector Regulation and Supervision

Despite relatively developed on-site examination capabilities within the central bank, the legislative framework is no longer adequate for effective supervision and regulation, and long-term technical assistance has been provided directly by MFD. The project coordinator visited Port Moresby in December 2003 to attend the South Pacific Governors' meeting where the new MOU of the Association of Financial Supervisors of Pacific Countries (AFSPC) was adopted.

Economic and Financial Statistics

In 2000, PFTAC conducted a fundamental review of statistical operations, with a follow-up mission in February 2001. A peripatetic adviser assisted the central bank on the balance of payments (switch to BPM5). PNG is a member of the IMF's General Data Dissemination System (GDDS); further TA will be subject to improvement with GDDS meta-data.

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[1] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a regional technical assistance institution operated by the IMF with financial support of the Asian Development Bank, Australia, Japan and New Zealand. 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: SOCIAL INDICATORS

	Latest Single Year			Same Region/Income Group	
	1970–75	1980–85	1995–2002	East Asia and Pacific	Low-Income
Population					
Total population, mid-year (millions)	2.7	3.5	5.4	1,838.5	2,494.6
Growth rate (percent annual average for period)	2.4	2.6	2.5	1.0	1.9
Urban population (percent of population)	11.9	14.0	17.9	38.2	30.6
Total fertility rate (births per woman)	6.0	5.9	4.3	2.1	3.5
Poverty (percent of population)					
National headcount index	...	...	37.5	...	...
Urban headcount index	...	...	16.1	...	...
Rural headcount index	...	...	41.3	...	...
Income					
GNI per capita (U.S. dollars)	560	700	530	960	430
Consumer price index (1995=100)	28	55	214	...	...
Food price index (1995=100)	...	59	182	...	...
Income/consumption distribution					
Share of income or consumption					
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)	...	...	3.9	1.9	1.1
Education (percent of GDP)	4.4	...	2.3	3.2	3.1
Social security and welfare (percent of GDP)	...	...	...	...	...
Net primary school enrollment rate (percent of age group)					
Total	...	...	77	92	80
Male	...	...	82	92	85
Female	...	...	73	92	74
Access to an improved water source (percent of population)					
Total	...	...	42	76	76
Urban	...	...	88	93	90
Rural	...	...	32	67	70
Immunization rate (percent under 12 months)					
Measles	...	33	71	70	65
DPT	...	40	57	78	65
Child malnutrition (percent under 5 years)	...	30	...	15	42
Life expectancy at birth (years)					
Total	49	53	57	69	59
Male	49	52	56	68	58
Female	49	54	58	71	60
Mortality					
Infant (per 1,000 live births)	90	79	70	32	79
Under 5 (per 1,000 live births)	147	108	94	42	121
Adult (15–59)					
Male (per 1,000 population)	496	480	359	184	310
Female (per 1,000 population)	483	418	329	129	259
Maternal (modeled, per 100,000 live births)	...	...	300	...	...
Births attended by skilled health staff (percent)	...	...	53	68	...

Source: 2004 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 found it difficult 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 the 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 was represented at the GDDS workshop held in Suva in November 2002. Papua New Guinea has also nominated a GDDS coordinator and is working on the development of its GDDS metadata.

Monetary accounts: The timeliness and frequency of reporting 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) need to be improved. A monetary and financial statistics mission is planned for the second quarter of FY 2005 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 March 2004, the NSO released a preliminary set of national income, expenditure, and production accounts estimates for 1994–2002, rebased to 1998 prices. As these figures are still subject to revisions, 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*. All these estimates are compiled using the *1968 System of National Accounts*. However, the NSO is still working toward implementing the recommendations of the *1993 System National Accounts*.

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 some 4,000 companies.

- Value-added tax data from the IRC: sales and input 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. In general, although the timeliness of fiscal data has improved, they are subject to a number of significant deficiencies. Interest payment records are accurate, except that there are 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 still lead to discrepancies between observed domestic financing from monetary and debt data and the domestic financing requirement derived from fiscal data.

External sector: Quarterly data on the balance of payments are reported to the Fund for publication with a substantial lag. 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. As a first step, 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.

PAPUA NEW GUINEA: CORE STATISTICAL INDICATORS
(As of March 31, 2004)

	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	3/26/04	3/26/04	Jan. 04	Jan. 04	Jan. 04	3/24/04	2003 Q4	Dec. 03	2003 Q4	Dec. 03	2003	2003 Q4
Date received	3/04	3/04	2/04	2/04	2/04	3/04	2/04	3/04	3/04	2/04	3/04	3/04
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; O-Internet; V-obtained during mission and/or Annual Meetings.
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INTERNATIONAL MONETARY FUND
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EXTERNAL
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Public Information Notice (PIN) No. 04/125
FOR IMMEDIATE RELEASE
November 10, 2004

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

IMF Concludes 2004 Article IV Consultation with Papua New Guinea

On June 2, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Papua New Guinea.[1]

Background

Papua New Guinea's macroeconomic performance improved from mid-2003, helped importantly by the favorable temporary factors that boosted the mineral and agricultural sectors. In 2003, real GDP is estimated to have grown by 2.7 percent, following three years of decline. Coffee and cocoa production benefited from better weather conditions and production of palm oil, rubber, tea, and copra oil also increased. The mining sector was not disrupted by election-related violence, as in 2002, and output of petroleum, gold, and copper was higher. The rate of inflation declined to 8½ percent in the year to the December quarter, primarily because of the improved fiscal situation and exchange rate stability. Yet, the economic situation remains fragile, and improved policy implementation is essential to secure higher sustained growth and to alleviate poverty.

Assisted by higher revenue from the mining and petroleum sector and tighter expenditure controls, the budget was in overall balance during the second half of 2003, and the annual deficit was held at about 2 percent of GDP. This outcome facilitated a decline in treasury bill rates from over 20 percent in August to about 16 percent in December 2003. Rates fell further

[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.

to 10 percent for 28-day bills and 12 percent for 182-day bills in late April 2004. However, the required reallocation of spending toward health, education, and infrastructure has been largely held in abeyance, until the wage bill is reduced.

Monetary policy was geared from late 2002 to keeping a firm grip on inflation and protecting the external position. It was tightened during the period November 2002–June 2003, when the central bank increased its benchmark Kina Facility Rate (KFR) from 12½ percent to 16 percent. Subsequently, in response to the declining rate of inflation and the relatively stable exchange rate, the authorities progressively reduced the KFR to 10 percent in May 2004. Nevertheless, the easing of monetary policy failed to lead to an expansion of commercial bank credit to the private sector, which declined by almost 3 percent in 2003 and remained weak in early 2004.

The balance of payments situation has improved. Higher world commodity prices underpinned a sharp rise in export receipts and the external current account registered a surplus of 10 percent of GDP, compared with a small deficit in 2002. As a result, official gross international reserves rose to about 6 months of nonmineral imports at end-December 2003, and remained broadly unchanged in the first quarter of 2004. The kina appreciated in real effective terms by an estimated 8 percent during January 2003–April 2004, in contrast to the depreciation experienced in the preceding several years. The nominal exchange rate rose by about 20 percent against the U.S. dollar, while falling somewhat against the buoyant Australian dollar.

Unfortunately, progress in implementing structural reforms has been limited. With regard to public sector reform, progress has been slow in implementing the recommendations of the World Bank-led Public Expenditure Review and Rationalization. Efforts have also been minimal to strengthen the efficiency of provincial expenditure and tighten monitoring and reporting systems of their accounts. The financial condition of the main public enterprises remains poor. The structural impediments to private sector growth are formidable with governance issues and weak infrastructure affecting agricultural, mineral, forestry, fisheries, and urban activity.

Papua New Guinea’s medium-term economic outlook as outlined in the government’s development strategy is to achieve real GDP growth of 2½ percent annually over the period 2004–09, with growth in nonmineral activity increasing gradually to about 3½ percent by the end of the forecast period. Inflation, which has now been brought down to single digits, is expected to decline steadily to 2 percent by 2009, assuming that fiscal and monetary discipline is maintained. The external current account is projected to move toward approximate balance during 2006–09, with higher nonmineral exports only partly offsetting the decline in mining and petroleum exports as existing resources are depleted. The main fiscal challenge is to ensure that the budget deficit averages under 1 percent of GDP in 2005 and beyond to permit a gradual decline in the public debt-to-GDP ratio.

Executive Board Assessment

Executive Directors welcomed the improvement in Papua New Guinea’s macroeconomic performance, including a return to positive growth supported by higher agricultural and mineral output, a sharp decline in inflation, and a strengthening of the external current account and international reserves position. While these developments partly reflect the large increases in commodity export prices, Directors also highlighted the positive role being played by the authorities' efforts to restore macroeconomic stability. Going forward, they saw as priorities to further strengthen macroeconomic policies and press ahead with wide-ranging reforms to address remaining vulnerabilities and improve the outlook for higher and broad-based private sector growth and employment.

Directors commended the authorities for holding the fiscal deficit to 2 percent of GDP in 2003, in line with the budget target, which reflected tightened expenditure controls in the second half of the year as well as higher mineral tax receipts. To contain domestic debt and interest payments, they supported the 2004 budget objective of further reducing the deficit to 1.5 percent of GDP. Expenditure restraint should be at the core of the fiscal adjustment effort, and in particular the authorities should make every effort to contain the public sector wage bill. Directors also urged the authorities to accelerate the repayment of domestic arrears, and to eliminate them as soon as possible. A detailed, audited accounting of the outstanding stock of arrears should support this process.

Directors commended the authorities' prudent monetary policy stance, which has contributed to the fall in inflation and the strengthening of the external position. They considered the recent lowering of interest rates to be helpful to encourage private sector activity, but it will remain important to monitor conditions closely, and to maintain a cautious monetary policy stance in order to keep inflation restrained. Directors saw the recent appreciation of the kina as appropriately reflecting the strengthened fiscal position and improving external debt dynamics, and supported maintenance of the flexible exchange rate system, given the country's vulnerability to external shocks.

Directors noted that Papua New Guinea's financial system is generally sound. The profitability of the commercial banks is satisfactory, and the asset quality of all banks has improved, reflecting improvements in credit procedures and the overall cautious approach to new lending. However, further efforts are needed to enforce bank supervisory decisions more effectively, and in that vein, Directors were encouraged that the authorities had indicated that the recommendations of Fund technical assistance in this area would be progressively implemented. Directors welcomed the improvement in the financial performance of the public and private sector pension funds over the past two years. They also welcomed the progress being made on legislative steps to combat money laundering and the financing of terrorism, and encouraged the authorities to press ahead with their efforts in this area.

Directors underscored the importance of a sustained reform effort aimed at improving public sector efficiency and strengthening the foundations of private sector activity. This will be essential to improve social conditions, support economic diversification in the face of a prospective decline in mineral output, and address remaining fiscal and external vulnerabilities. To ensure a steady decline in the public debt-to-GDP ratio, further fiscal consolidation, with deficits below 1 percent of GDP, will be required over the medium term. Directors urged the authorities to accelerate public sector reform in line with the recommendations of the recent World Bank-led Public Expenditure Review and Rationalization study. Action is needed to further reduce the government wage bill, including through a stricter hiring freeze, removal of ghost workers, elimination of unauthorized allowances, and retrenchments. Progress in this area would permit the reallocation of resources to health, education and infrastructure, and reinforce the fight against poverty. Directors also noted the importance of efforts to strengthen and broaden the revenue basis over time. They welcomed the temporary nature of the import levy.

Directors urged the authorities to address the longstanding structural impediments to private sector growth, and higher investment and employment. In particular, decisive efforts will be required to overcome the poor state of governance, reduce corruption, improve the law and order situation and the transparency of government operations, address land tenure issues, and simplify regulatory requirements for domestic and foreign investors. The need to give new momentum to the privatization program was also highlighted. Directors were encouraged that the authorities' medium term development strategy is designed to tackle these challenges in a comprehensive manner. They stressed that success will depend crucially on a sustained record of policy implementation, and urged the authorities to build on their improved macroeconomic policies to mobilize support for the needed institutional and structural reforms.

Directors underscored the importance of a prudent debt management strategy, including reliance on concessional financing based on close cooperation with the donor community. They welcomed in this regard the authorities' recent announcement to defer proceeding with an international bond issue to allow further assessment. They discouraged new public external commercial borrowing, in light of the strategy of reducing the public debt-to-GDP ratio, the absence of a balance of payments need, and the questions it could raise about the commitment to macroeconomic stability.

While the quality of economic statistics has improved, Directors saw a need for further efforts, in particular to improve the quality and timeliness of national accounts, and budgetary and balance of payments data.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Papua New Guinea is also available

Papua New Guinea: Selected Economic Indicators, 2000–04

	2000	2001	2002	Est. 2003	Proj. 2004
Real sector (percentage change)					
Real GDP	-1.2	-2.3	-0.8	2.7	2.5
Mineral	-0.5	4.5	-18.7	3.0	2.0
Nonmineral	-0.5	-4.1	4.5	2.6	2.6
CPI (period average)	15.6	9.3	11.8	14.7	7.4
Central government budget (percent of GDP)					
Revenue and grants	31.2	31.0	29.4	30.0	30.2
Expenditure and net lending	32.3	34.7	33.8	31.2	31.7
Overall balance, cash basis (including grants) 1/	-1.4	-4.1	-5.7	-2.0	-1.5
Domestic financing (net) 2/	1.2	0.9	6.2	3.8	2.2
Of which: Banking system	-1.4	-2.5	5.2	-0.8	0.5
External financing (net)	0.2	3.1	-0.9	-2.2	-1.6
Privatization (net)	0.3	0.0	1.8	0.3	0.5
Money and credit (percentage change; end-of-period)					
Domestic credit	-4.5	-12.3	20.9	-6.9	4.9
Net credit to government	-12.5	-26.1	82.0	-7.9	5.7
Credit to the private sector	3.0	-1.2	-6.3	-2.8	4.5
Broad money	5.4	1.9	4.2	-3.3	5.5
Balance of payments (in millions of U.S. dollars; unless otherwise indicated)					
Exports, f.o.b.	2,215	1,878	1,646	2,213	2,329
Imports, c.i.f.	-1,490	-1,326	-1,292	-1,431	-1,610
Current account (including grants)	299	204	-20	346	176
(In percent of GDP)	8.7	6.9	-0.7	10.1	4.5
Overall balance	78	66	-96	183	32
Reserves and external debt (end-of-period)					
Gross international reserves (millions of U.S. dollars)	304	440	343	523	515
(In months of nonmining imports, c.i.f.)	3.2	5.7	4.6	5.8	5.0
Public external debt-to-GDP ratio (in percent) 3/	42.8	54.7	56.4	44.1	36.0
Public external debt-service ratio (percent of GNFS)	6.8	8.0	7.9	7.3	8.0
Exchange and interest rates					
US$/kina (period average)	0.3624	0.2976	0.2573	0.2816	…
US$/kina (end-of-period)	0.3255	0.2625	0.2488	0.3000	…
Interest rate (182-day Treasury bills, end-of-period)	14.9	10.2	13.5	16.9	…
Nominal GDP (millions of kina)	9,515	9,948	10,992	12,204	12,596

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

1/ Measured from below the line in the fiscal accounts.
2/ Includes changes in check float.
3/ The decline in the debt ratio in 2003 is mainly due to a significant increase in nominal GDP and exchange rate effects.

Statement by Michael J. Callaghan, Executive Director for Papua New Guinea
June 2, 2004

Key Points

- Sound macroeconomic management has contributed to the improvement in the Papua New Guinean economy over the past year or so, particularly tighter fiscal policy and the prudent operation of monetary policy.
- Decisive action taken in mid-2003 ensured that the deficit was held at the originally-budgeted target of 2 percent of GDP.
- The targeted deficit of 1.5 percent of GDP in 2004 will ensure continued progress in moving public finances onto a more sustainable basis.
- The introduction of an import levy in 2004 was a necessary temporary measure, given the importance of maintaining sound fiscal policy and the time needed for more fundamental expenditure and revenue initiatives to take effect.
- The possible international bond issue has been deferred.
- The government recognizes the importance of removing impediments to private sector activity, including addressing infrastructure bottlenecks, improving governance, ensuring the maintenance of law and order, and enhancing political stability. Progress is being made in all these areas.

Restoring macroeconomic stability

The improved performance of the Papua New Guinean economy over the past year or so reflects in part a recovery in commodity prices and more favorable agricultural conditions. Importantly, however, it is also the result of sound macroeconomic management, including a tightening in fiscal policy and the prudent operation of monetary policy.

This year's staff report emphasizes the importance of addressing the structural impediments to private sector growth. The Papua New Guinea government is fully aware of the reform challenges it faces and is making progress in tackling a sizeable structural reform agenda. However, no sustained advancement in lifting the economy's growth potential is possible in the absence of macroeconomic stability. This was the focus at last year's Article IV consultation, when Directors expressed concern over growing fiscal pressures and rising inflation. These concerns have been addressed and over the course of 2003 considerable progress has been made in restoring macroeconomic stability. The basic theme of the budget was "stabilization with growth". The authorities should be commended for the significant policy advancements that have been made since the last consultation.

An improved economic performance

After three years of negative growth, real GDP is estimated to have increased by 2.7 percent in 2003 and further growth is forecast for 2004.

Inflation has fallen from 20 percent in the March Quarter 2003 to be currently around 3 percent.

International reserves have risen to over six months of non-oil imports and are now at their highest levels since the country gained independence.

The overall balance of payments moved from an estimated deficit of 2.2 percent of GDP in 2002 to a surplus of 2.8 percent in 2003.

Private sector employment rose by nearly 9 percent in the 12 months to June 2003, compared with just above 1 percent growth in the previous 12-month period.

There are also a number of promising forward indicators. The number of new petroleum licenses issued has grown from 1 in 2002 to 12 in 2003. In line with this, the number of new exploration wells has risen from 4 active wells in 2002 to 8 active wells by end-2003, and outlays on mining exploration doubled in 2003 compared with 2002. It is to be hoped that this resurgence in exploration, which is in part a response to incentives provided to the mining and petroleum sectors in 2003, will lead to new discoveries and production over the medium term.

Enhanced fiscal discipline

Underpinning this better performance have been significant improvements in fiscal management.

A number of factors complicated fiscal policy in 2003, including the shortfall in privatization proceeds and, importantly, donor flows, particularly the non-receipt of a US$35 million drawdown from an Asian Development Bank loan. This shortfall in external financing resulted in the government having to resort to higher domestic borrowing and the increased volume in Treasury Bills issued, along with tight monetary policies, saw Bill yields increase sharply. The resulting higher than budgeted interest rate expense imposed upward pressure on the budget deficit. As was noted by the Board during the 2003 Article IV consultations, firm action was required to bring the deficit back in line with targeted levels.

The authorities implemented the necessary forceful action with a decisive mid-year expenditure adjustment equivalent to 0.8 percent of GDP. The result was that the Budget was in overall balance during the second half of 2003 and the deficit was held at the originally budgeted target of 2 percent of GDP.

This sound approach to fiscal management has been continued into 2004, where the budgeted deficit is 1.5 percent of GDP. Importantly, the 2004 Budget is based around a medium-term strategy with the following key components:

- Reducing public debt to around 60 percent of GDP by 2007.
- Further reducing budget deficits over the period 2005 to 2007 and a balanced budget thereafter.
- Introducing improved governance and stringent controls on expenditure.
- Reallocating where possible increased expenditure so as to improve the range and quality of government services.
- Pursuing aggressive medium-term plans to promote growth in export-oriented sectors.

In presenting the 2004 Budget, the Minister for Finance and Treasury noted that the targeted reduction in the deficit in 2004 maintained the strategy of moving public finances onto a more sustainable basis. He emphasized, however, that it takes time to develop the necessary measures for effective control and rationalization of public expenditure. This includes the acknowledged need to address public sector employment. Significantly, following the input from the Public Expenditure Review and Rationalization Study which was prepared with the assistance of the World Bank, important new governance and expenditure control measures are being introduced. Personnel controls are receiving increased attention and the recruitment freeze on public sector positions has been maintained along with new restrictions on the recruitment of casual employees.

With time needed to fully implement the required tightening and prioritization of expenditure, the maintenance of sound fiscal policies places additional pressure on the revenue side of the accounts. The government is of the view, however, that the incidence of taxation in PNG is high by regional and international standards. It also considers it necessary to maintain a tax structure that would support private sector activity. As such, rather than increasing tax rates, the focus has been directed at improving the taxation administration system, although again this is an area where time is needed to reap the benefits of reforms.

Against this background, and in order to ensure continued progress in putting public finances on a more sustainable footing, the government introduced a temporary import levy in 2004 of 2 percent. In announcing this levy, the Minister for Finance and Treasury stated that “I very frankly would prefer not to have applied this temporary levy, but it has been found to be unavoidable to ensure fiscal responsibility throughout 2004 while our broader reforms are put in place”.

Papua New Guinea faces large net outflows in 2004 to cover payments to the Asian Development Bank, World Bank , IMF and an earlier bilateral loan payment to Australia. Ongoing large net outflows to major official lenders are an important medium-term challenge. In addressing this challenge, the government is pursuing a strategy of transferring Papua New Guinea from a country dependent on aid to one that is more self-reliant.

In the 2004 Budget, the government announced that against the background of large net outflows to official creditors, the government would consider small external commercial financing. Earlier this year, the government considered an international bond issue, although in a statement to Parliament on May 12, 2004, the Prime Minister announced that the government had deferred proceeding with the bond issue to allow further assessment of the prospects for the issue given market developments. In making this announcement, the Prime Minister emphasized that the government was only testing the market and would not proceed with the bond issue "..... and put the country into greater debt, with all the associated foreign exchange risks, if the market is not yet ready for us, and if we are unable to secure competitive terms".

Prudent operation of monetary policy and strengthening the financial sector

The Bank of Papua New Guinea (BPNG) has implemented a prudent monetary policy stance which has contributed to the achievement of macroeconomic stability. Specifically, the BPNG has focused on the task of reducing inflation and maintaining the stability of the financial system. An excessively expansionary budget deficit in 2002 was countered by tight monetary policy. Greater fiscal discipline and the decline in inflation has allowed BPNG to lower the kina facility rate (the official rate used to indicate the central bank's monetary stance) by 100 basis points on two occasions so far this year.

In the 2004 Budget speech, the Minister for Finance and Treasury reaffirmed the government's commitment to the total independence of BPNG. The central bank has demonstrated its capacity to conduct an independent monetary policy and this has been a positive factor for investor confidence.

In terms of financial sector supervision, the financial position of the pension funds has been significantly improved under new regulatory arrangements. The Superannuation Act and Life Insurance Act has removed all political interference in the operation of pension funds and tightened regulatory oversight with BPNG tasked with administering the superannuation and life insurance acts.

Advancing structural reforms

As noted, the government fully recognizes the structural reform task it faces. It appreciates that the pace of economic activity will crucially depend on removing bureaucratic and infrastructure impediments to private sector investment, as well as addressing problems of law and order and enhancing overall governance arrangements. As the Minister for Finance and Treasury noted in his speech to the 2003 Bank/Fund Annual Meetings, the problems in terms of governance within Papua New Guinea do not stem from shortcomings with the system itself, but rather weakness in the accountability framework. These weaknesses are being addressed.

The government is rebuilding a public sector that is professional, has integrity and is committed. Steps have been taken to strengthen and de-politicize the appointment process in the public sector, re-orient personnel management systems, strengthen probity and oversight agencies, improve the delivery of major services, strengthen government procurement practices and procedures, improve debt management, liberalize investment and promote private sector participation and review and progress the privatization process to ensure that proper procedures are adopted and clear net benefits can be obtained.

Political stability is an essential ingredient in advancing reforms as well as boosting investor confidence. The introduction of the Integrity of Political Parties and Candidates Acts in 2002 was an important step in providing greater political stability in Papua New Guinea.

The staff state that the reform momentum has slowed this year because of political uncertainties, including the possibility that the government could face a no-confidence motion in parliament, given that the 18-month embargo on such motions following a general election has now passed. The government's position has, however, recently been strengthened with a number of members of the opposition party joining the government.

My authorities would like to thank the Fund for the assistance Papua New Guinea has received, not only through the formal Article IV process, but also through frequent staff visits and valuable technical assistance.