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July 18, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Papua New Guinea - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Papua New Guinea, which has been tentatively scheduled for discussion on Wednesday, August 8, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. B. Smith (ext. (5)7301).

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INTERNATIONAL MONETARY FUND

PAPUA NEW GUINEA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Papua New Guinea

Approved by Tun Thin and Eduard Brau

July 17, 1984

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I. Introduction

A staff team visited Port Moresby during May 7-18 to hold the 1984 Article IV Consultation with Papua New Guinea. Discussions were held with Prime Minister Somare, Finance Minister Bouraga, Bank of Papua New Guinea Governor To Robert, and other officials of government departments and the Bank of Papua New Guinea. The staff team comprised Messrs. Smith, Schulz, Kohsaka and Thornton, and Mrs. Eulate (all ASD). Mr. Morrell was also present for the discussions.

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

II. Economic Background

Papua New Guinea is among the least developed of countries. It is geographically a rugged and dispersed country, which imposes difficult obstacles to transportation and communication. Essential physical infrastructure is undeveloped in most areas and will be enormously expensive to establish. Most of the three million inhabitants, who speak as many as 700 languages, retain close ties to traditional society, relying on subsistence agriculture and with only limited participation in the cash economy. For many, contact with the modern world is recent, and access to health, education and other social facilities remains poor. Because of isolation and lack of education, there is a persistent shortage of skilled workers and an overabundance of unskilled labor.

Much smaller in size, the modern economy has retained many features of its pre-independence origins. Reliance on Australian financial assistance continues to be high, despite efforts on both sides to reduce it. Foreign capital and personnel retain major roles in the commercial, plantation, and mining sectors which account for much of export earnings and government revenue, but contribute in only a limited way to domestic employment. The manufacturing sector is small and imports satisfy most demand for finished goods (including petroleum). Public administration also relies considerably on expatriate managers and skilled workers. Because of strong expatriate links, wage scales are high throughout the economy, and the public wages bill is large in relation to the indigenous production base.

The mining sector has a unique and important role: the large copper/gold mine of Bougainville Copper Ltd. (BCL) generates about one half of exports and a considerable share of government revenues, and reliance on the minerals sector will increase further when an equally large copper/gold mine at Ok Tedi begins production in mid-1984; both BCL and Ok Tedi are foreign direct investment enterprises. There has been a surge in investment since 1981 for the development of Ok Tedi and expansion at BCL, reaching more than 15 percent of GDP in 1983. The economy is open, with exports contributing over a third of GDP, and is vulnerable to wide swings in the terms of trade due mainly to developments in copper, gold, copra, coffee, and cocoa prices. As in many other countries, the world recession of the early 1980s had a severe impact on domestic activity and the balance of payments, and during this period sizable external debt was incurred.

III. Recent Economic Developments

1. The 1980-82 recession

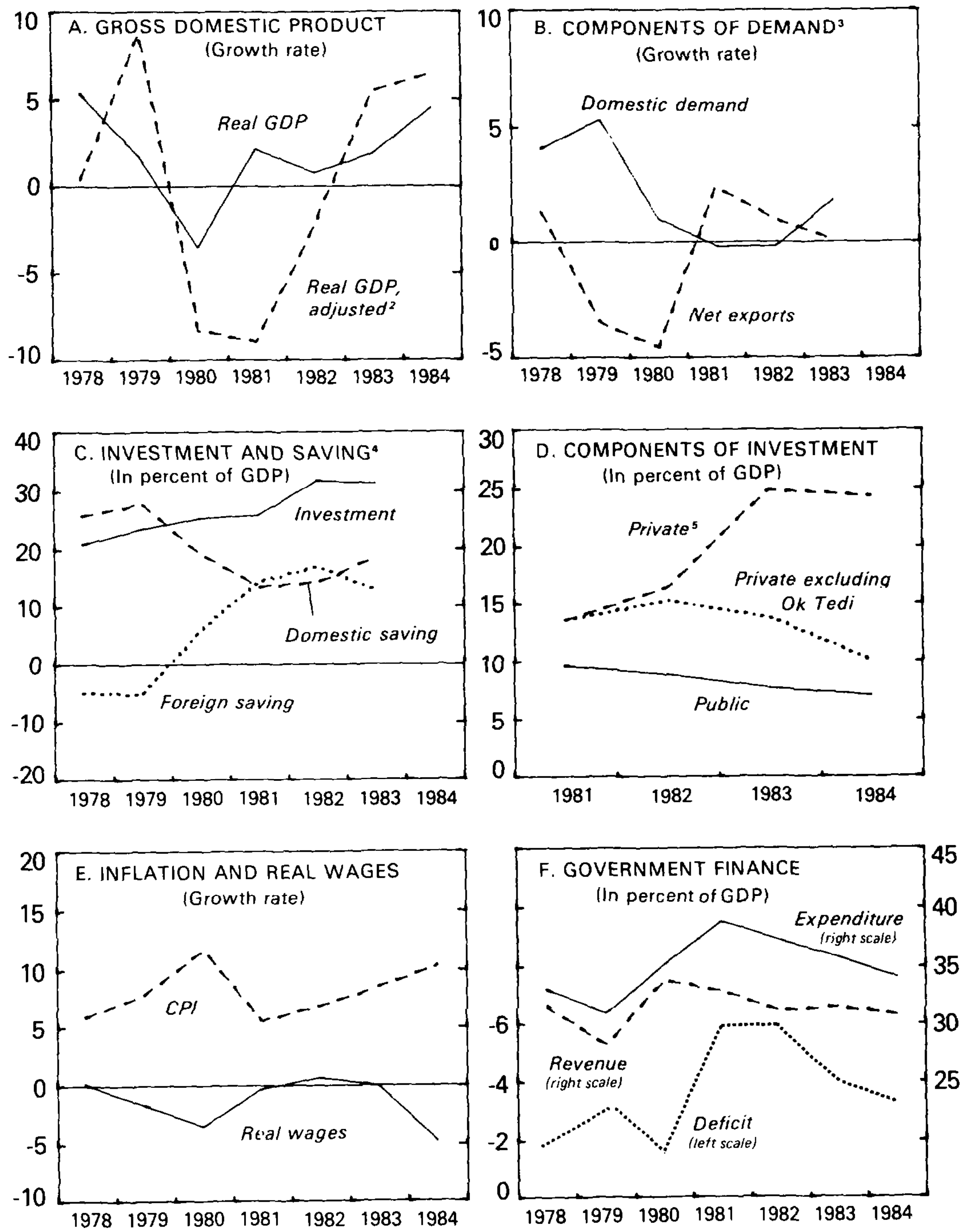
The commodity boom of 1979 ended quickly and by mid-1980 Papua New Guinea's economy, which had appeared so favorably placed less than a year earlier, entered the severe recession which was to last for the next three years. These years were marked by a massive weakening of the terms of trade, which, combined with stagnation in production, led to a substantial contraction in real incomes. The external current account, which had been in surplus, swung sharply into deficit in 1980 and the deficit widened in 1981. Domestic policies were slow to respond to the worsening environment. Both public and private demand remained strong in 1980 because of momentum gained during the commodity boom. Monetary policies were tightened in 1981, but the fiscal deficit widened as revenue performance weakened. With the emergence of fiscal and external payments imbalances, the Government borrowed heavily from foreign commercial sources beginning in 1980, and the overall balance of payments deficits were limited to manageable proportions.

The situation stabilized in 1982 as the deterioration in the world economy slowed down and adjustment policies began to take hold. Real GDP rose by 1 per cent, but incomes continued to fall (Chart 1). Economic activity received a boost from a stepup in investment in the Ok Tedi mine equivalent to 14 percent of GDP, although investment outside the mining sector continued to decline. Fiscal policy was strengthened considerably at mid-year as expenditures were cut to offset a prospective further revenue shortfall; as a result, the budget deficit was unchanged at 6 percent of GDP. Monetary growth was limited to 5 percent, somewhat below the official target of 7-10 percent, reflecting the impact of the recession on credit demand and continued tight credit policies. With moderation in import price increases, consumer price inflation slowed to an average of 5.5 percent from 8 percent in the previous year. The balance of payments position stabilized despite a further 3 percent decline in exports, and the current account deficit was unchanged at 21 percent of GDP. However, excluding imports financed by foreign investment for Ok Tedi development, imports were sharply reduced and the underlying current account deficit (excluding Ok Tedi imports) was reduced by about a third to 13 percent of GDP. With continued large foreign market borrowing, the overall deficit was contained to SDR 28 million, somewhat less than in 1981.

CHART 1

PAPUA NEW GUINEA

SELECTED ECONOMIC INDICATORS, 1978-84[1]

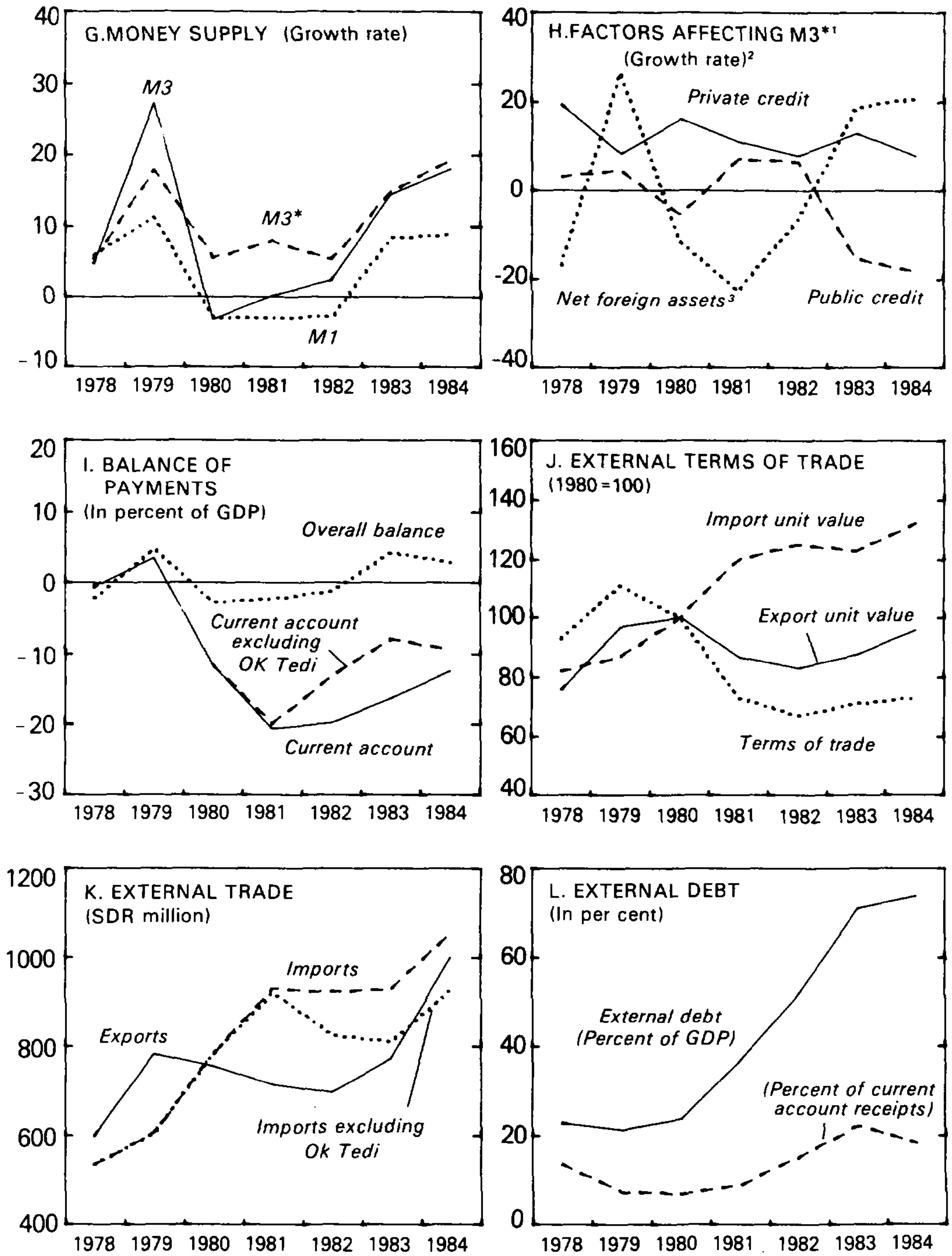


Sources: Data provided by Papua New Guinea authorities.
[1]Projections or latest observation in 1984.
[2]Adjusted for terms of trade by deflating exports of goods and services by import prices.
[3]Weighted percent contribution to GDP growth.
[4]Savings exclude statistical discrepancy.
[5]Private capital expenditure equals the difference between gross fixed capital formation and public sector capital expenditure.

CHART 1(continued)

PAPUA NEW GUINEA

SELECTED ECONOMIC INDICATORS, 1978-84[1]



[1] M3 less the deposits of BCL and the stabilisation funds for coffee, copra and cocoa.
[2] Aggregates expressed in percent of M3* one year earlier.
[3] Adjusted for valuation changes.

2. Developments in 1983 and early 1984

The economy turned upward during 1983 as external conditions became more favorable and adjustment policies were fully effective. Real GDP rose by 2 percent as consumer demand increased somewhat and the extensive inventory adjustment of 1982 was completed. Export prices rose during the course of the year and the terms of trade improved by an average of 7 percent, although the recovery represented only one fifth of the loss recorded in the preceding three years. Formal employment, which had contracted sharply during the previous two years, began to expand during the June quarter, and continued to grow modestly over the remainder of the year. The balance of payments position also began to strengthen in the June quarter with an upturn in export prices and moved into a strong surplus in the September quarter, as a result of a further surge in exports and the receipt of official borrowing abroad arranged before the turnaround was confirmed. For the year as a whole, exports rose by 11 percent (in terms of SDRs), reflecting an increase of 6 percent in export prices, and a rise of about 4 percent in volume mainly on account of increased production by BCL as new ore milling capacity came onstream. In contrast, imports rose only marginally, and excluding direct investment imports for Ok Tedi development, fell again, by 2 percent. The aggregate current account deficit declined to 16 percent of GDP, and the underlying deficit (excluding Ok Tedi) fell further to 8 percent of GDP. With long-term capital inflows of about the same high level as in 1982, the overall balance of payments surplus was SDR 93 million. The external position has continued to be in surplus during the early months of 1984; gross international reserves increased by SDR 27 million in the four months of 1984 to SDR 458 million, equivalent to five months of imports.

Budgetary policy for 1983 maintained the restrictive stance adopted in 1982. Expenditures were budgeted to rise by 9 percent from the 1982 level, implying a 5 percent real reduction from the prevailing expenditure rate in early 1982 when the authorities strengthened fiscal restraint to promote adjustment. Expenditure restraint involved tight control over departmental spending, including the retrenchment of about 10 percent of civil service positions. The retrenchment was carried through, and expenditure control in other areas maintained. Indeed, actual expenditures were 2 percent less than budgeted, reflecting mainly unplanned shortfalls in capital spending and reduced interest payments. In contrast, revenues, which had been budgeted to increase by no more than 7 percent, rose by 12 percent, despite some tax relief granted during the year in a business revival package. Direct tax collections were higher than expected, because of increased employment at Ok Tedi and the collection of company tax arrears, and there were gains from exchange rate adjustments. As a result, the deficit was substantially less than budgeted, falling to 4.2 percent of GDP. Foreign financing more than covered the deficit, and outstanding net borrowing from the banking system declined by K 29 million.

With the economy deep in recession, monetary policy was eased during 1983. Monetary growth (excluding stabilization deposits) continued at a moderate 5 percent during the first half of the year, but with the strengthening of the external account, rose abruptly in the September quarter. Private credit demand was generally subdued, and although some pickup was apparent at the end of the year, the increase in credit was well within the official credit ceiling. Monetary growth continued at a rapid rate during the final months, and for 1983 as a whole, was 14 percent, well in excess of the official target of 7-10 percent.

Although the recession came to an end in mid-1983, indications of a strong recovery in domestic demand and activity have been slow to emerge. Consumer price inflation rose somewhat to 8.5 percent over the course of 1983, compared with 7 percent in the preceding 12 months. However, the increase largely reflects higher import costs and supply disruptions for several consumption items. Monetary growth accelerated to 19 percent in the 12 months to March 1984, and inflation also has risen further. Nevertheless, demand conditions have not strengthened significantly. Import demand has only recently begun to increase, and then only modestly, and investment activity also continues at a low level.

The consultation discussions took place against the backdrop of an economy where the effects of a deep and painful recession remain readily apparent in the areas of employment, investment and general activity, and with the authorities anxious to encourage a broad-based economic revival, while keeping a cautious eye to the future.

IV. Report on the Discussions

1. Economic outlook

a. Prospects for 1984

The immediate outlook is for a continuation of the more favorable external conditions experienced in 1983 and a broadening of the recovery in domestic activity. Export prices for most major items have continued to be strong, although in most cases, the improvement is due to disruptions to supplies in other producing countries rather than an upturn in world demand. Export prices in 1984 are estimated to be about 9 percent (in SDRs) higher than in 1983, and the average terms of trade are projected to improve by a further 2 percent.

The authorities project that real GDP will grow by 4.5 percent in 1984. The accelerated growth is partly due to the commencement of production at the Ok Tedi mine expected in July 1984, which contributes somewhat less than 1 percentage point to the projected growth rate. However, faster growth is expected in other areas as well; export production of copra and palm oil, in particular, is likely to respond to higher prices, and activity in the economy at large should increase with improved income levels. While the authorities expect a broadening of the economic recovery in 1984, they stress that signs of a general upturn are weak at this stage. Demand has so far not shown a strong upward movement, although an upturn in consumer demand is expected during the year with higher export incomes and a recovery in employment. Investment in the mining sector is expected to be somewhat reduced as Ok Tedi moves into the production phase. General investment activity may increase, but business confidence remains low, despite a considerable improvement in profits. The authorities note that entrepreneurs are maintaining a cautious attitude toward investment. Many businesses contracted during the recession, and in some cases operations were consolidated on a narrower base. Despite tax and other measures taken during 1983 as part of a business revival package, a sustained improvement in business conditions will need to be established before sizable new investment is forthcoming.

Consumer price inflation rose to 10.3 percent in the 12 months to March 1984, and the authorities expect inflation to be about 9 percent for 1984 as a whole. Import costs are a major contributor to inflation, and somewhat higher inflation during the first part of the year is probably due to the continued flow-through of higher import prices, reflecting relatively strong inflation in Australia and an exchange rate depreciation in 1983. Moderation in import price increases is expected during the course of the year as inflation in Australia recedes and that in other major suppliers remains low. Also, the authorities do not foresee a recurrence of supply-induced price increases for some domestic items, which had a considerable impact on prices in 1983. Working in the opposite direction, demand conditions are expected to strengthen, despite a continuation of fiscal restraint, with the acceleration in monetary growth since the second half of 1983. This would be expected to have some impact, at the least by allowing the restoration of price margins which were squeezed during the recession. However, the authorities do not expect strong demand-induced price pressures to emerge this year. They noted that exchange rate movements have a strong influence on domestic prices and that, as in the past, exchange rate policy will be conducted with this linkage in view.

With the strengthening of export prices, increased export supplies and the lag in the recovery in domestic demand, the balance of payments position is expected to continue to be strong in 1984. Export earnings are projected to rise by as much as 29 percent in 1984 (Table 1); export prices are estimated to rise by 9 percent, and volumes by 18 percent because of the commencement of production at Ok Tedi and higher volumes of copra, oil palm, timber, and fish. In contrast, imports are projected to rise by only 13 percent, although this represents a significant recovery from the virtual stagnation during 1981-83. Despite an 11 percent rise in Australian grant assistance, the deficit on invisible transactions is expected to widen considerably, largely because of sharply higher investment income payments. The current account deficit would be

Table 1. Papua New Guinea: Balance of Payments, 1980-88

(In millions of SDRs)

	Actual				Est.	Projected			
	1980	1981	1982	1983	1984	1985	1986	1987	1988
Trade balance	-28	-217	-226	-156	-55	-90	-165	255	410
Exports, f.o.b.	756	714	698	775	1,000	1,090	1,110	1,510	1,790
Imports, f.o.b.	-784	-931	-924	-931	-1,055	-1,180	-1,275	-1,255	-1,380
Invisibles (net)	-199	-226	-210	-211	-260	-280	-295	-350	-450
Current account balance	-227	-443	-436	-367	-315	-370	-460	-95	-40
(Excluding Ok Tedi)	(-227)	(-427)	(-290)	(-180)	(-235)	(-340)	(-365)	(-375)	(-360)
Nonmonetary capital	90	358	437	436	385	355	440	40	-40
Net official capital	61 1/	98	92	140	65	45	60	-10	-55
Net private capital	35	249	346	290	320	310	380	50	15
Nonofficial monetary sector 2/	-6	21	-1	6	--	--	--	--	--
Errors and omissions	94	36	-29	24	--	--	--	--	--
Overall balance	-43	-49	-28	93	70	-15	-20	-55	-80
Memorandum items:									
Export prices (1980=100)	100	87	83	88	96	101	107	114	126
Copper price (US cents/lb)	99	79	67	72	70	80	80	80	90
Import prices (1980=100)	100	120	125	123	132	138	149	161	174
Terms of trade (1980=100)	100	73	67	71	73	73	72	71	72
Current account/ GDP (in percent)	11.7	20.7	19.7	16.4	12.5	13.2	16.1	3.0	1.1
(Excluding Ok Tedi) (in percent)	(11.7)	(19.9)	(13.1)	(8.0)	(9.4)	(12.1)	(12.8)	(11.8)	(10.0)
Government commercial borrowing	56	86	91	79	25	30	20	--	--
International reserves (end of period)	358	366	328	431	...	...	...	...	...
(Months of next year's imports)	(4.6)	(4.8)	(4.2)	(4.9)	...	...	...	...	...

Source: Data provided by the Papua New Guinea authorities.
1/ Includes Trust Fund loan of SDR 11 million.
2/ Commercial banks.

reduced further to 12 percent of GDP, although excluding Ok Tedi transactions (including exports), it would rise slightly to 9 percent. Nonmonetary capital flows are projected to be about SDR 50 million lower than in 1983; net private capital inflows would increase as loan repayments by BCL are sharply reduced and Ok Tedi related borrowing is maintained, but net official capital inflows will fall by SDR 75 million as government commercial borrowing is sharply reduced. The overall position is expected to continue to be in surplus, amounting to an estimated SDR 70 million for the year as a whole.

b. Medium-term perspective

If the economic prospects for 1984 are favorable, the medium-term outlook provides no basis for complacency. Medium-term projections for prices of major export items made by the World Bank and others indicate that the present favorable position is unlikely to be maintained; relative weakness could return within a couple of years and persist during much of the second half of the 1980s. In particular, the outlook for copper prices appears threatened by shifting usage patterns which weaken demand, large world production capacity, and protectionist pressure in the United States. Were weakness in copper prices to persist or become more pronounced, it would have adverse repercussions both on the balance of payments and government revenues. Moreover, it could force a reappraisal of the financial viability of the development of future stages of the Ok Tedi mine, which already faces cost overruns and site difficulties, and, hence, the future production base of the economy. The authorities therefore believe the present favorable environment is likely to be short-lived, and are making plans for the medium term on the assumption of a weakening of the terms of trade and generally less favorable circumstances.

(1) Balance of payments prospects

In some respects, the medium-term balance of payments outlook presented in Table 1 represents a constraint within which policies must be adapted. Exports are projected to rise by an average of 16 percent per annum between 1984 and 1988, with higher volume accounting for somewhat more than half of the growth. Exports of traditional agricultural items, especially coffee, smallholder cocoa, palm oil, and tea should expand moderately, while more rapid growth should be achieved in exports of fish, timber, and nontraditional items. Mineral exports are expected to grow strongly, mainly because of volume increases. The volume of exports by BCL will gradually decline as ore grades deteriorate, but those by Ok Tedi will rise sharply in 1985, recede somewhat in 1986 as the mining of the gold cap is completed, and increase strongly thereafter, assuming that mining of the copper lode under the second-stage development goes ahead as planned or without protracted delay.

Grant assistance from Australia (which, at SDR 237 million in 1983, is equivalent to 30 percent of export receipts), is projected to increase by 4 percent per annum. This results from the renegotiation on favorable terms of the Australia and PNG Aid Agreement in 1983. Under the revised Agreement, the rate of real reduction in assistance was revised from 5 percent per annum to 1 percent in 1983/84 (Australian fiscal year ending June), 2 percent in 1984/85 and 3 percent in 1985/86. The Australian Government is currently reviewing its aid policies, including the appropriateness of untied cash assistance, and depending on the outcome, this could have serious implications in subsequent years.

Private capital inflows are projected to continue at recent high rates until 1987 when Ok Tedi development will be complete. Taking account of undoubted, but still largely unexplored, resource abundance, private capital inflows for the development of new projects could well replace Ok Tedi flows; the authorities indicated that five large resource-based projects (including gold and hydrocarbons) are under study, but their feasibility is as yet unproven. Official capital inflows are forecast to remain at the reduced 1984 rate until 1987 when repayments of earlier heavy borrowings would fall due. Given this scenario, resources would be available to finance import growth of about 7 percent per annum between 1984 and 1988, and the overall balance of payments, while recording persistent overall deficits, would remain manageable.

The authorities believe this to be a realistic, central scenario around which policies can be framed. A more aggressive policy approach would be feasible if the trend in the terms of trade proves to be more favorable, and if the feasibility of new resource ventures is quickly determined. On the other hand, a more cautious strategy would be required if the trend in the terms of trade were more adverse, if Australian aid were reduced more quickly than expected, or if the Ok Tedi project were delayed substantially or not fully developed. Even if this scenario provides an accurate medium-term framework, past experience indicates that export prices and the terms of trade can fluctuate widely from year to year. Policies must also be framed to limit the adverse effects of such fluctuations. In particular, restraint and caution are required in periods such as the present one to avoid basing policies on a premature judgment that improved conditions will endure. Rather, favorable years provide the opportunity to conserve resources to support the economy when conditions again become adverse. Also, financial policies must be adapted flexibly to offset any persistent expansionary impetus to the domestic economy deriving from external strength.

(2) Development policies

The authorities emphasize that, as in the past, their development efforts will be framed in light of the medium-term external outlook and the need to avoid an excessive accumulation of debt. However, whereas in the first years of independence development policies were aimed particularly at distributional objectives, the focus has now shifted to economic growth. The Government has recently decided that development policies should, while taking account of equity considerations, aim primarily at promoting productive work opportunities. The strengthened emphasis on employment (including work opportunities in informal employment) is in recognition of the failure of the economy to provide sufficient jobs in recent years and growing social problems associated with unemployment.

The authorities are now beginning to consider the policy adjustments which will be needed to accomplish the new aims. These will be combined in a National Development Plan covering 1986-90. The move to a multi-year planning framework is aimed at providing greater emphasis on sectoral consistency in development spending and improving the efficiency of public investment, problems which the World Bank also identified. At this stage, the authorities do not envisage that the reform of the planning system will involve a substantial shift in the sectoral distribution of public development spending, which gives priority to agriculture, transportation, and education. However, policies on foreign direct investment are likely to be liberalized as part of new government initiatives to develop manufacturing industry.

2. Budgetary policies

With the turnaround on external account in mid-1983, the budgetary adjustment program initiated in 1982, which has been the principal instrument for external adjustment, is now virtually complete. Nevertheless, the authorities have maintained a cautious budgetary policy for 1984. Revenues and grants are projected to be 10 percent higher than in 1983 (Table 2). Some three quarters of the revenue increase is due to higher receipts from BCL, mainly reflecting the recovery in prices and operating volume in 1983. More than half of the remainder is due to discretionary measures introduced in the 1984 budget, including increased stamp duty on financial transactions; reduced tax deductions; increased import duties on gasoline; the removal of duty exemptions on imports by some statutory authorities; and a new tax on telephone lines. Total expenditure was projected to rise by 9 percent, unchanged in real terms. Expenditure on goods and services is budgeted to rise by 8 percent, with capital works spending increasing by 16 percent. Relatively rapid growth is budgeted for interest payments on public debt (10 percent) and, reflecting amounts postponed in 1983, net lending and investment (29 percent). The overall budget deficit is budgeted to be K 83 million, virtually the same as in 1983, but lower at 3.7 percent of GDP. The budget envisages that the deficit would be more than covered by project related borrowing from international agencies, and $65 million of new commercial borrowing (down from $100 million in 1983); net borrowing from the banking system was estimated to be reduced again, by K 19 million.

Based on first quarter results and current expectations for the remainder of the year, the authorities expect that actual budgetary developments will be somewhat more restraining in 1984 than originally planned. Revenues are expected to be somewhat higher than budgeted,

Table 2. Papua New Guinea: Summary of Central Government Fiscal Operations, 1981-84 1/

	1981	1982	1983 Budget Est.	1983 Actual Outturn	1984 Budget Est.
			(In millions of kina)		
Total revenue and grants	558.0	559.7	598.1	628.9	694.0
Tax revenue	321.4	313.6	315.7	337.0	397.3
Nontax revenue	52.6	59.4	69.1	78.7	69.1
Foreign grants	184.0	186.7	213.3	213.2	227.6
Total expenditure 2/	658.8	667.1	730.5	713.1	776.9
Of which:					
Expenditure on goods and services 3/	(597.1)	(592.1)	(629.4)	(625.1)	(674.7)
Overall balance (deficit -)	-100.8	-107.4	-132.4	-84.2	-82.9
External financing (net)	83.7	75.7	109.1	110.9	95.1
International agencies	21.3	19.8	55.0	48.1	60.8
Other	62.4	55.9	54.1	62.8	34.3
Domestic financing (net)	17.1	31.7	23.3	-26.7	-12.2
Banking system	28.1	30.6	20.9	-28.8	-19.0
Other (including balancing item)	-11.0	1.1	2.4	2.1	6.8
			(Annual percentage change)		
Memorandum items:					
Total receipts	-2.8	0.3	6.9	12.4	10.4
Tax revenue	-1.9	-2.4	0.7	7.5	17.9
Nontax revenue	-26.0	12.9	16.3	32.5	-12.2
Foreign grants	4.8	1.5	14.2	14.2	6.8
Total expenditure	10.2	1.3	9.5	6.9	8.9
Of which:					
Expenditure on goods and services 3/	(6.9)	(-0.8)	(6.3)	(5.6)	(7.9)
			(As percent of GDP)		
Total receipts	32.8	31.1	29.9	31.5	30.6
Domestic revenue	22.0	20.7	19.3	20.8	20.6
Tax revenue	(18.9)	(17.4)	(15.8)	(16.9)	(17.5)
Foreign grants	10.8	10.4	10.7	10.7	10.0
Total expenditure	38.8	37.1	36.6	35.7	34.3
Of which:					
Expenditure on goods and services 3/	(35.1)	(32.9)	(31.5)	(31.3)	(29.7)
Overall balance	-5.9	-6.0	-6.6	-4.2	-3.7

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

1/ The budget summary shown here is a consolidation of fiscal operations effected through the National Budget, the National Debt Sinking Fund, and the Mineral Resources Stabilization Fund.

2/ Excludes promissory notes issued by the Government to reimburse the Bank of Papua New Guinea for foreign exchange losses resulting from exchange rate adjustments.

3/ Total expenditures less commercial investments and interest payments on public debt.

while on the expenditure side, higher spending on account of disaster relief would be more than offset by shortfalls in other areas, including capital works. As a result, the budget deficit could turn out to be some K 10 million less than budgeted. In these circumstances, and with the continuing external surplus, the authorities have decided to limit foreign commercial borrowings to well below the budgeted amount. At this stage, the authorities envisage that the $20 million first tranche of planned borrowing will go ahead, but that the remaining $45 million will be cancelled. If this is confirmed, net government borrowing from the domestic banking system would increase by no more than a modest K 6 million.

Notwithstanding the successful fiscal adjustment in 1982 and 1983 and the prospects for further improvement in 1984, the authorities perceive that a renewed weakening on external account will require a tightening of fiscal policies in the medium term, and are concerned that their options to achieve this have narrowed. As noted above, medium-term prospects for revenues are clouded by uncertainties surrounding copper prices and the size and form of Australian aid. There is also only limited scope for compensating tax increases in other areas to offset mineral and aid revenue shortfalls. The authorities stressed that business taxes are already high and that large additional revenues could not be obtained from this source without adversely affecting the business climate. They noted the need to improve tax administration, which is constrained mainly by a lack of available skilled manpower. They are also examining the possibility of broadening the existing indirect tax base to include basic consumer goods.

The guiding principle of the authorities' budgetary strategy is that government spending must be contained within an amount dictated by the medium-term availability of budgetary and external resources. Based on current resource and balance of payments forecasts, the authorities are hopeful that real expenditure increases of 2 percent per annum (broadly in line with population growth) can again be financed beginning in 1985. In order to encourage growth and job creation, efforts will be needed to increase the share of expenditures on development programs. In this, the Government does not seek to expand its role in commercial ventures, and has taken steps in the 1984 budget (and in line with technical advice provided by the Fund) aimed at ensuring that existing public enterprises are operated along profitable commercial lines. The authorities emphasize that the scope for efficiently redirecting expenditures to promote development is limited. Partly this is due to persistent bottlenecks in project implementation. Also, the share absorbed by general departmental expenditures is high because of high wages and is likely to remain so since the scope for further civil service retrenchment is small. Thus, opportunities to orient government spending to better serve development objectives are likely to evolve only slowly as progress is made in developing national skills that allow a reduced reliance on expatriates in public administration; with continued wages restraint; and as success is achieved in efforts to improve the efficiency of public administration.

3. Monetary policy

The banking system was faced with a tight liquidity position early in 1983 as the balance of payments deficit continued to drain resources from the banking system. In February, the authorities reduced the minimum liquid asset ratio by 2 percentage points to 14 percent to prevent tight liquidity from unduly restraining credit growth. With high real interest rates, some renewed liquidity tightness, and continued slow credit growth, policies were further eased at mid-year. In May 1983, the Bank of Papua New Guinea (BPNG) introduced a discount facility against which commercial banks could borrow up to established limits for periods of 7-90 days. Also, in June 1983 most interest rates were reduced by 1 percentage point; however, the rate for bank borrowing under the lender-of-last-resort facility was unchanged to reinforce its penal nature.

Monetary conditions eased abruptly at mid-year. The balance of payments moved into strong surplus, and the liquidity position of the banks improved substantially. Also, private credit growth began to pick up with the first signs of economic revival. The growth in broad money excluding stabilization deposits (M3*), which had been 6 percent in the 12 months to June 1983, surged to 15 percent by September (Table 3). Although during much of the second half of the year the growth in M3* was well above the official target of 7-10 percent for the year, the authorities did not introduce restraining measures. Rather, in November 1983 the BPNG reduced its own interest rates by a further one percentage point, and admonished the banks to make more energetic efforts to lend to the private sector.

This liberal stance has been carried further in 1984. No target for monetary growth was established, because wide short-term variability in monetary growth induced by swings in the balance of payments would make achievement of a target difficult; however, the authorities estimated that M3* would increase by some 10-15 percent over the course of the year. Broadly consistent with the upper end of this range, the ceiling on nonseasonal lending by the commercial banks was raised to K 70 million, well above both the ceiling (K 55 million) and actual (K 48 million) increases in 1983. At the same time, the lending guidelines established in 1980 were suspended; these had been aimed at encouraging bank lending for exports, import substitution and indigenously owned enterprises, and discouraging lending to finance consumption imports, to enterprises which could borrow overseas, and for speculative and foreign investments. Banks were also, for the first time, encouraged to act more competitively by adjusting interest rates at their own initiative in response to market forces and BPNG policy actions.

The authorities believe that the extremely liberal stance of monetary policies remains broadly appropriate in present conditions. They noted that economic activity continues to be weak and that, in view of the length and depth of the recent recession, business activity and

Table 3. Papua New Guinea: Monetary Survey, 1980-84

(Amounts outstanding at end-period; in millions of kina) 1/

	1980	1981	1982	1983 Mar.	1983 June	1983 Sept.	1983 Dec.	1984 Mar.
Foreign assets (net)	281.8	221.8	205.0	213.5	223.2	316.1	320.6	336.4
Domestic credit	287.0	365.0	425.8	459.3	459.5	407.4	417.3	417.1
Government (net) 2/	8.2	43.4	71.2	78.7	79.6	-0.4	4.8	2.6
Private sector	278.8	321.6	354.6	380.6	379.9	407.8	412.5	414.5
Other items (net)	-15.7	-32.2	-63.0	-111.9	-93.1	-89.4	-88.3	-92.0
Total money (M3)	553.1	554.6	567.8	560.9	589.6	634.1	649.6	661.5
Deposits of stabilization funds and Bougainville Copper Ltd.	170.4	141.8	133.3	140.8	143.3	145.6	150.8	159.9
Broad money (M3*) 3/	382.7	412.8	434.5	420.1	446.3	488.5	498.8	501.6
	(5)	(8)	(5)	(2)	(5)	(15)	(15)	(19)
Of which: Quasi-money	183.5	219.6	246.9	246.8	263.2	287.6	295.6	313.1

Sources: Data provided by the Papua New Guinea authorities; and Bank of Papua New Guinea, Quarterly Economic Bulletin.

1/ Figures in parentheses are 12-month percentage change.

2/ Banking system financing of the Government differs from that in the Summary of Central Government Fiscal Operations for three reasons: (i) for reporting purposes, the calendar year ends several days earlier in the case of the Central Bank; (ii) the transfer of profits from the Central Bank to the Government is captured one calendar year earlier in the fiscal accounts; and (iii) the fiscal accounts exclude liabilities in the form of non-negotiable promissory notes issued to finance the Government's payments to the Central Bank for the Bank's book losses due to revaluations of the kina.

3/ Broad money supply (M3) less deposits of the stabilization funds held with the commercial banks and the Bank of Papua New Guinea, and deposits of Bougainville Copper Ltd. held with the commercial banks.

credit demand will not respond quickly or vigorously to the improved environment in the near term. It is their view that economic recovery remains largely in the future and must be nurtured in its infancy if it is to flourish. A tightening of policies at this stage would send a contrary signal, reinforcing business caution, and could abort the recovery so urgently desired. The staff argued that growth in M3* had been rapid since the third quarter of 1983 and that the rise in incomes and liquidity accompanying the improvement on external account would, inevitably, lead to economic recovery, albeit with a lag. Under present policies, monetary growth appears likely to continue to substantially exceed the authorities' estimate throughout 1984, and a more cautious policy would avoid the risk that unsustainable demand pressures would emerge.

Commodity stabilization funds for coffee, cocoa and copra, and newly this year, oil palm, operate through levies and bounties on export sales to absorb purchasing power when export prices are high and support growers' incomes when prices fall. Although the funds remain largely under growers' control, they generally tend to dampen the strong cyclical forces affecting economic activity. The copra stabilization fund was exhausted in 1982, and subsequent support payments to growers could only be funded because the Government made financial advances to the fund. With the improvement in prices in the second half of 1983 and an adjustment to the threshold price, levies on growers have since been sufficient to repay these advances and rebuild a healthy balance in the fund. However, the historical average price formulae for determining the threshold below which bounties are payable to growers of coffee and cocoa appear to have become unreliable; even at present high price levels, bounties continue to be payable for these commodities. In recognition of this, the coffee fund has in 1984 ceased making most bounty payments. However, bounty payments continue for cocoa and are tending to exacerbate cyclical forces.

With the strengthening of the balance of payments, the liquidity of the banks has improved to the point where liquid asset holdings in March 1984 amounted to 27.2 percent of deposits, almost double the minimum requirement. The authorities are currently reviewing their policy regarding the liquidity ratio with the aim of strengthening the array of monetary control instruments. The liberalization of interest rate controls and the setting up of two new commercial banks during the past year are part of a program to promote greater competition and efficiency in financial markets. At the same time, the authorities recognize that the existing financial system does not serve equally the needs of all sections of the community. They are therefore considering ways in which the direction of credit flows can be efficiently encouraged to be more fully in line with national priorities; in this connection, they indicated that the reintroduction of some form of credit guidelines would probably be an early policy response were credit policies to be tightened. Such a move would aim to prevent a surge in lending for luxury imports, while continuing to encourage lending to indigenous entrepreneurs. The Government is also planning to transform the Development Bank into the Agricultural Bank of PNG in order to better serve the credit needs of the agricultural sector.

4. Employment and wages

Persistent increases in unemployment in urban areas and lack of opportunity at the village level reflect the longstanding failure of the economy to generate jobs to match the talents and aspirations of a growing labor force. This has been compounded recently by the impact of the world recession: employment fell sharply during 1980-82. Although formal employment increased by nearly 3 percent in 1983, the medium-term outlook, in the absence of concerted policy efforts, is for a further widening of the employment gap and a rise in social pressures.

In large part, the employment problem can be traced to wage levels which are high in relation to productivity. This is especially true in urban employment where wage levels continue to be influenced by expatriate standards which domestic productivity cannot support. Urban migration is encouraged by urban bias in the wage structure, which increased sharply in the mid-1970s but has been generally unchanged in recent years, and by a lack of understanding in rural areas of the problems of urban life. However, urban jobs are hard to find and hold for unskilled rural workers. A close social fabric alleviates some of the hardship associated with urban unemployment, and there are considerable impediments to the return of unemployed urban workers to village society, both of which tend to encourage unemployed workers to stay in urban centers.

The authorities have recognized that a reduction in real wages is necessary if the employment problem is to be solved. However, traditional centralized wage fixing arrangements have resulted in the indexation of minimum wage rates which affect most workers and, hence, have not allowed for a reduction in real wages. In early 1983 the Minimum Wages Board, meeting to set procedures for the fixing of minimum wages for the next three years, determined that in place of semiannual indexation to consumer price increases, indexation of minimum wages should be limited to the first 5 percent of consumer price inflation during each year, with annual adjustments. This decision will not promote as rapid a reduction in real wages as that proposed by the Government, but the authorities recognize that the decision represents a realistic compromise which is generally favorable to the Government's economic objectives.

During the past year, the wages agreement has achieved fairly wide political acceptance and has been effectively implemented. Minimum wage increases for 1984 were limited in line with the agreement, which allowed a reduction in real wages of some 3.5 percent. Also, although the agreement did not cover public sector workers, the Government extended the formula to include the public sector in 1983, despite considerable resistance. The authorities are aiming at achieving a reduction in real wages of about 10 percent during the three years covered by the wages agreement. While this would not be sufficient to fully redress the existing wages imbalance, it would represent significant progress in this direction, especially when combined with other changes, such as the adoption of piece rate payments in the plantation sector. At present, labor resistance to the real wage reductions is not strong, but the authorities recognize that were inflation to rise significantly and be attributable to government policies, the political consensus underlying the agreement would be subject to great strain.

5. External policies

a. Exchange rate

Since monetary independence in 1975 macroeconomic policies have been formulated on the understanding that import prices are the major determinant of domestic prices, and that wages adjust quickly to reflect developments in inflation. Chart 2 suggests that these relationships have generally held over most of the period. Consumer prices closely followed import price developments in kina terms until 1980 when there was an upward movement in domestic prices, partly related to demand pressures initiated during the 1979 boom. Subsequent price movements also followed those in import prices except in the most recent period where the sharp rise in import prices in terms of domestic currency is being reflected in domestic prices with a lag. Similarly, urban wages have, with some lag, moved closely in line with consumer price developments.

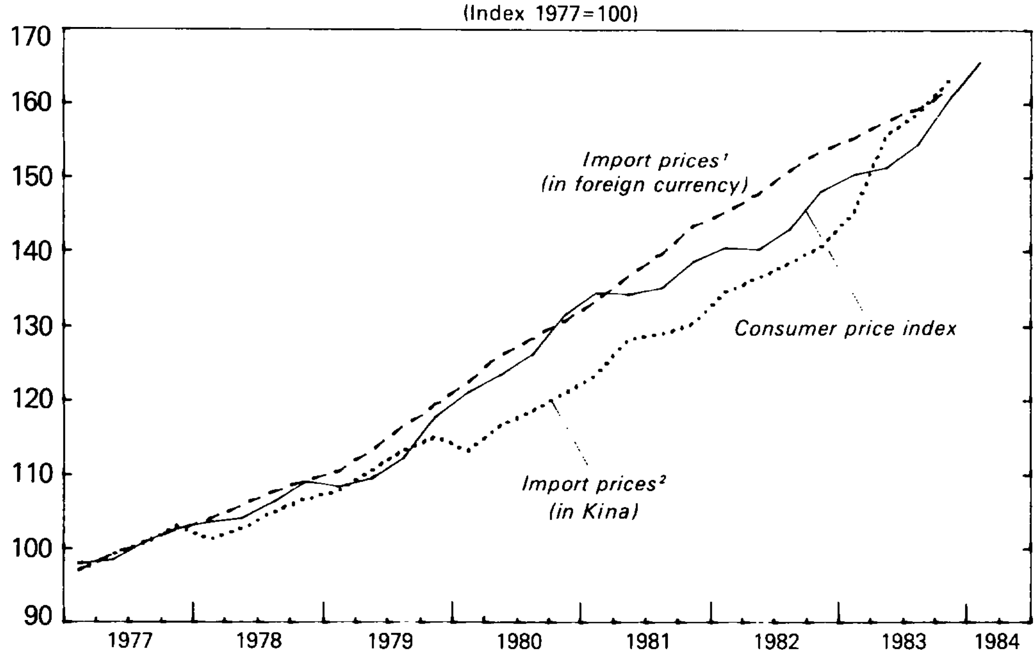
In these circumstances, the authorities have traditionally viewed exchange rate policy as a weak instrument for improving international competitiveness: an exchange rate depreciation resulted in inflation, and labor costs rose to offset most of the improvement in competitiveness stemming from the exchange rate change. In many cases, the change in the exchange rate needed to achieve a significant improvement in competitiveness would involve a high cost in terms of inflation. Indeed, during most of the period since 1975 the kina was revalued successively against the Australian dollar in order to contain inflation; with Australia supplying about half of imports, this resulted in a persistent appreciation in the import-weighted nominal exchange rate until early 1983 (Chart 3). Up until the end of 1978, the export-weighted exchange rate depreciated, reflecting the relative strength of the yen (as Japan is the largest export market), especially when compared with the Australian dollar. International competitiveness, as measured by the real export-weighted effective exchange rate, improved by about 16 percent as prices in Papua New Guinea increased by less than those in export markets, largely because of the appreciation vis-a-vis Australia. However, after the end of 1978 the export-weighted exchange rate appreciated sharply, largely because of the relative weakness of the Japanese yen, and export competitiveness deteriorated even more as prices rose faster in Papua New Guinea than in export markets, because

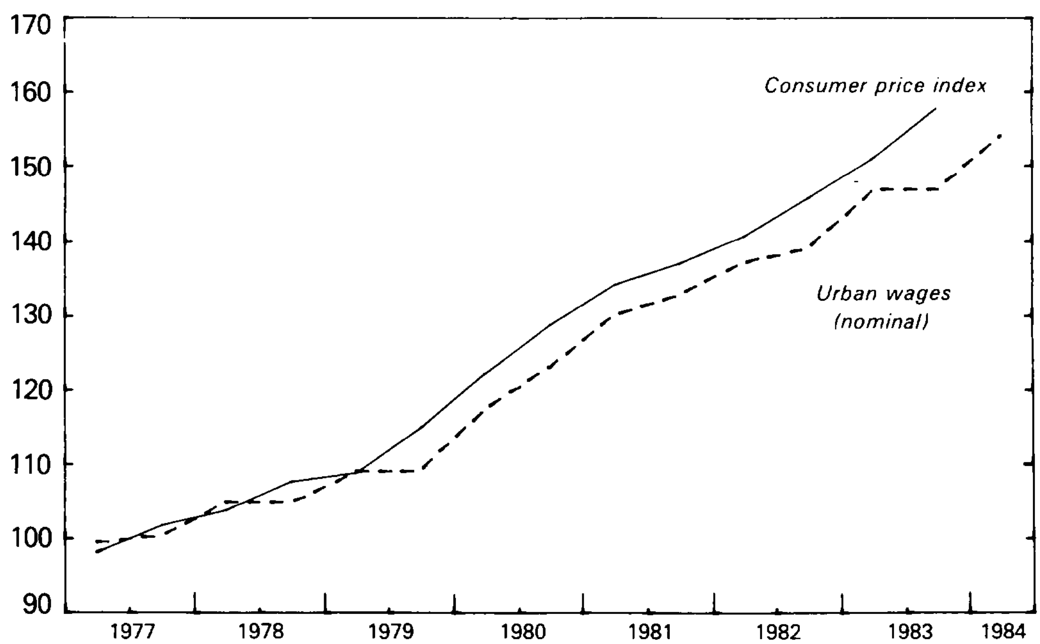
CHART 2

PAPUA NEW GUINEA

IMPORT PRICES, CONSUMER PRICES, AND WAGES, 1977-84

(Index 1977=100)





Sources: Data provided by the Papua New Guinea authorities; and IMF, *International Financial Statistics*.

[1]Calculated on the weighted average of Papua New Guinea's major importing partners consumer price indices

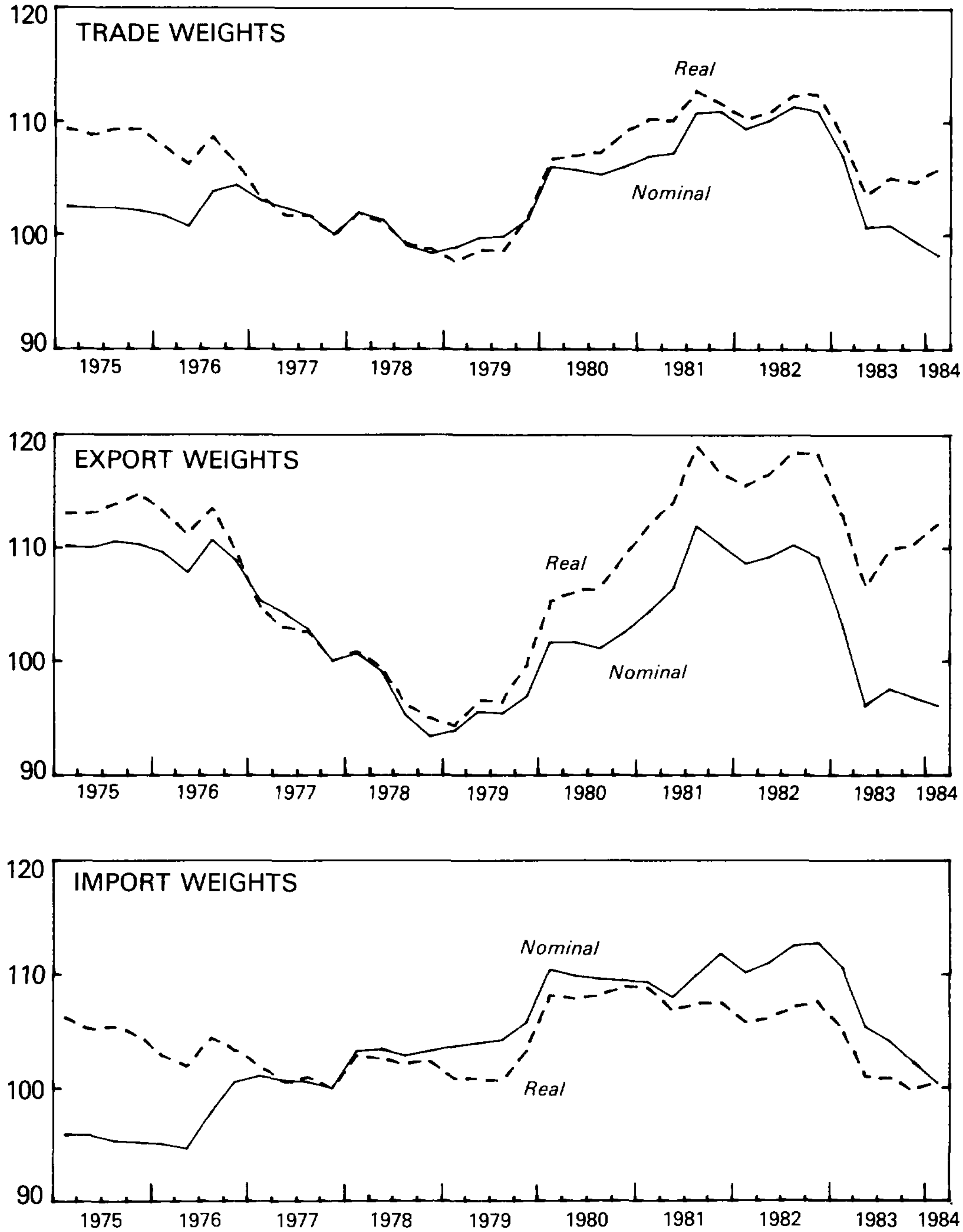
[2]Calculated on the weighted average of Papua New Guinea's major importing partners consumer price indices converted into kina.

CHART 3

PAPUA NEW GUINEA

INDICES OF NOMINAL AND REAL EFFECTIVE EXCHANGE RATES BASED ON VARIOUS WEIGHTS, 1975-MARCH QUARTER 1984

(Dec. Quarter 1977 = 100)



Sources: IMF, *International Financial Statistics;* and staff estimates.

of relative exchange rate movements and domestic demand pressures during part of the period. By the end of 1982, export competitiveness had weakened by about 24 per cent, and was some 4 percent below that in 1975.

The 1983 partial wage indexation agreement, which breaks the nexus between the exchange rate and prices and wages, has eased the earlier constraints on exchange rate policy. The authorities have taken full advantage of the additional flexibility afforded exchange rate policy since then to improve international competitiveness and strengthen the balance of payments, subject to the need to limit inflation to acceptable levels. When the Australian dollar was devalued by 10 percent in March 1983, the kina was depreciated in line with the Australian currency. Subsequently, the value of the kina has been maintained broadly unchanged in terms of the major international currencies, and has depreciated vis-a-vis the relatively strong Australian dollar. In nominal effective terms (both export- and import-weighted), the kina has depreciated by about 12 percent between the end of 1982 and the first quarter of 1984. However, in view of the relatively strong inflation in Papua New Guinea, the depreciation in the real export-weighted exchange rate has been lower at 6 per cent; export competitiveness, more broadly defined, improved by a larger amount as a result of the reduction in real wages.

b. External debt

External debt has increased sharply over the past few years. Beginning in 1980, the Government began to borrow on a substantial scale for the first time, and private borrowing accelerated. At the end of 1983, total medium- and long-term debt totaled SDR 1.6 billion, equivalent to about 70 percent of GDP, about equally divided between the public and private sectors; short-term debt is small (Table 4).

Debt service payments as a proportion of current receipts have risen sharply from 8.8 percent in 1981 to 22.3 percent in 1983. The ratio in 1983 is especially high because BCL took the opportunity afforded by increased earnings to reduce by $90 million the amount outstanding under its revolving and stand-by credit facilities. Excluding these transactions, the ratio would be reduced to 14.7 percent. On present projections, the ratio is expected to rise to a peak of about 24 percent in 1986 before receding. The sharp rise in the debt service ratio is primarily on account of private debt, and except in 1983, is mainly Ok Tedi related. The public debt service ratio has also risen, from 5.0 percent in 1981 to 7.6 percent in 1983, but on present expectations is projected to rise by only about 1 percentage point more over the next few years before receding.

Private debt is undertaken mainly by BCL and Ok Tedi without government guarantee. This borrowing is in support of the commercial development of rich mineral deposits which, in the view of the companies, promise profits and exports which would fully cover the cost of

Table 4. Papua New Guinea: External Debt and Debt Service, 1981-88 1/

(In millions of SDRs)

	Actual			Est.	Projected			
	1981	1982	1983	1984	1985	1986	1987	1988
External debt (outstanding)								
Public debt 2/	551	667	807	866	909	940	923	861
Of which: IMF	(65)	(65)	(65)	(49)	(39)	(12)	(8)	(5)
Private debt	240	492	781	996	1,140	1,308	1,289	1,235
Of which: BCL	(120)	(140)	(57)	(69)	(87)	(111)	(111)	(111)
Ok Tedi	(22)	(238)	(542)	(754)	(873)	(1,002)	(949)	(862)
Total	791	1,159	1,588	1,862	2,049	2,248	2,212	2,096
(as percent of GDP)	(37)	(52)	(71)	(74)	(73)	(79)	(70)	(58)
(of which: Ok Tedi)	(1)	(11)	(24)	(30)	(31)	(35)	(30)	(24)
Debt service								
Amortization	35	64	145	103	135	196	177	262
Public debt 2/	18	29	30	48	63	75	70	120
Of which: IMF	(5)	(--)	(--)	(15)	(11)	(25)	(4)	(4)
Private debt	17	35	115	55	72	121	107	142
Of which: BCL	(9)	(2)	(89)	(17)	(1)	(2)	(2)	(2)
Ok Tedi	(--)	(--)	(--)	(--)	43)	(81)	(83)	(118)
Interest	60	105	117	160	184	190	200	187
Public debt 2/	36	54	59	69	74	64	65	58
Of which: IMF	(--)	(3)	(3)	(3)	(3)	(--)	(--)	(--)
Private debt	24	51	58	91	110	126	135	129
Of which: BCL	(9)	(18)	(10)	(6)	(8)	(10)	(11)	(11)
Ok Tedi	(--)	(15)	(29)	(60)	(77)	(92)	(97)	(91)
Total	95	169	262	263	319	386	377	449
Public debt 2/	54	83	89	117	137	139	135	178
Private debt	41	86	173	146	182	247	242	271
Total (excluding Ok Tedi)	(95)	(154)	(233)	(203)	(199)	(213)	(197)	(240)
Debt service ratio (in percent) 3/								
Public	5.0	7.5	7.6	8.2	8.9	8.8	6.7	7.7
Private	3.8	7.7	14.7	10.2	11.8	15.5	12.1	11.7
Total	8.8	15.2	22.3	18.4	20.7	24.3	18.8	19.4
(excluding Ok Tedi)	(8.8)	(13.9)	(19.6)	(14.2)	(12.9)	(13.5)	(9.8)	(10.4)
Interest payments ratio 3/	5.5	9.5	9.9	11.2	11.9	12.0	10.0	8.1
Memorandum items:								
Current account receipts 4/	1,085	1,110	1,176	1,431	1,542	1,583	2,009	2,315
Ok Tedi exports	--	--	--	120	245	190	465	595

Sources: Data provided by the Papua New Guinea authorites; and staff estimates.
1/ From 1983, improved coverage of private external debt statistics.
2/ Includes government and publicly guaranteed debt.
3/ Relative to current account receipts.
4/ Includes exports of goods and services, and private and official transfers.

borrowing; the risk, if any is involved, falls directly on the company shareholders, of which the Government is a minority one. Nevertheless, the authorities have adopted a comprehensive external borrowing and debt policy which takes account, in different ways, of borrowing by both the private and public sectors. This approach is especially appropriate, because lenders are concerned about their exposure to the country as a whole. In approving private borrowing applications, the authorities aim to ensure that the amounts are appropriate, favorable terms are obtained, and that borrowing is not used as a means of tax avoidance; more favorable consideration is generally given to borrowing for the development of export industries.

In deciding on the amount of public borrowing during any year the authorities take account of the level of public debt and its servicing profile, and developments in private debt. They also try to take account of financial market perceptions and sentiments toward developments in Papua New Guinea's economy and its debt situation. The authorities noted that Papua New Guinea's rating in international credit markets has strengthened since it began borrowing on a large scale. They indicated that lenders would not have been favorably disposed to continued borrowing by the public sector at the heavy 1983 rate, especially in view of large private borrowing for Ok Tedi. In this light, the Government's decision to reduce borrowing in 1984 has been well received in financial markets. The recent decision to further cut the amount of public sector commercial borrowing in 1984 was part of a longer-term strategy to eliminate such borrowing by 1987 at the latest. The vulnerability of the economy to wide fluctuations because of changing external conditions makes it appropriate to conserve borrowing potential at this stage. The authorities are also conscious of possible adverse implications if the present uncertainties concerning the future development of the Ok Tedi project are not settled quickly and favorably.

V. Staff Appraisal

The juxtaposition of a large and undeveloped traditional sector with a modern economy which maintains strong expatriate links creates special difficulties for macroeconomic management in Papua New Guinea. Among these are high wage levels which impose cost pressures and generate imbalances in the labor market; wage determination procedures which inhibit real wage changes and have limited the effectiveness of exchange rate policy; and continued heavy reliance on Australian financial assistance which, however, is gradually being reduced. Added to these, Papua New Guinea shares many of the problems of other developing countries. It is an open economy, and one very susceptible to swings in commodity prices; as such, it has suffered severely from the recent recession in the world economy. In order to moderate the impact of the recession, the authorities have in recent years borrowed heavily abroad, and the debt burden has increased considerably.

Against this background, the authorities have every reason to be satisfied with developments over the past year. The adjustment policies which the Government had implemented during the recession, reached their full effect. At the same time, prices for most export commodities, which had been depressed so deeply and for so long, turned upward. The result was a rapid turnaround in the balance of payments and an end to the long downward slide in economic activity. Moreover, the progress made over the past year runs deeper, and policy developments in such areas as economic planning, expenditure rationalization, wages and the exchange rate promise to allow some of the fundamental structural imbalances in the economy to be addressed more forcibly from here on.

Real economic growth seems likely to increase again in 1984, and the authorities' projection of 4.5 percent, or even somewhat higher, seems feasible. The opening of the Ok Tedi mine at mid-year signals the *first stage in a sizable buildup in the production base of the economy,* which, if current difficulties and uncertainties can be satisfactorily resolved, will provide the underpinning of future growth in the economy at large. Near-term prospects for production in other sectors are also favorable with improved prices and the prospect of a general economic upturn. Until now, nonmining investment has been weak, which is understandable in light of the depth of the recession and the business caution it engendered. Indications are now emerging of improving business confidence, and profit shares have recovered with the better terms of trade and wage restraint. The stage thus seems set for an upturn in private investment in the period immediately ahead, while private consumption, constrained for so long, seems likely to expand strongly.

Balance of payments prospects in the short term are favorable. Exports are likely to increase strongly in 1984, reflecting the full year effect of improved prices for agricultural items and the start up at Ok Tedi. Nontraditional exports, such as timber and fish, are also likely to grow, although concerted efforts will be needed over an extended period to overcome the infrastructural, financial, and marketing difficulties which impede a broadening of the export base. While import demand has been weak, a significant strengthening can be expected in view of the incipient rise in domestic demand. Transmission lags are difficult to predict, but the emergence of strong import growth in the current year, continuing into the next, appears virtually inevitable. Even so, the current account deficit should decline somewhat in 1984, and an overall surplus of some SDR 70 million seems likely. Looking to 1985 and beyond, external prospects are more clouded. The recent improvement in the terms of trade is not expected to continue; the balance of payments seems likely to weaken in 1985 with continued import growth, and external pressure could be a feature of the following few years. While this scenario is, of course, subject to great uncertainty, it serves to highlight the likely short-term cyclical nature of the present buoyancy and provides a sobering backdrop for domestic financial policies.

Budgetary policy has been employed with great success over the past two years to promote external adjustment. Commendably tight expenditure control, including the unpalatable but necessary retrenchment in the civil service, contributed importantly to the turnaround in the balance of payments position achieved last year; Executive Directors had emphasized the importance of effective implementation of the 1983 budget in last year's discussion. The 1984 budget has been framed so as to continue the tight fiscal strategy, albeit with some moderation when compared with the previous two years. Medium-term prospects warrant this cautious approach. It seems likely that revenues could well be somewhat stronger and some expenditures less than budgeted in 1984. In these circumstances, the authorities must be prepared to deal firmly with inevitable demands for additional public spending. The recent excellent record of expenditure control should not be allowed to slip merely because the overall economic position this year is less difficult.

In a longer-term perspective, the budget will need to be further strengthened to meet possible external weakness and accommodate a stronger national development effort. While there is scope to strengthen tax administration and broaden the tax base, the greatest opportunities lie on the expenditure side. Improving the structure of expenditures, including reducing the high share needed simply to run the Central and Provincial Governments, will be possible only gradually, and will take concerted efforts to develop national skills, control wages, and improve efficiency. The development of a multi-year National Development Plan should introduce a stronger sectoral cohesiveness in project selection and thus contribute to improving the efficiency of the development effort.

Credit policy was relaxed considerably in 1983 in order to encourage economic recovery. As events turned out, it is probably fortunate that credit demand remained weak so that private credit expansion remained below the ceiling set for the year. Even so, monetary growth, which had been subdued, surged at mid-year as an inevitable consequence of the improvement in the balance of payments. There are, at present, no effective policy constraints on private credit, and if the authorities are successful in their efforts to encourage an expansion in credit that comes close to the ceiling, the resulting monetary growth would substantially exceed the estimate of 10-15 percent throughout 1984. The continuation of rapid monetary growth for such a period would clearly run the risk of promoting excessive demand. In these circumstances, it is important to ensure that the benefits promised by appropriately cautious fiscal policies are not prejudiced by insufficiently restrained credit policies.

Rising unemployment has become a major social problem, and the Government has now turned to give top priority to the task of creating productive employment opportunities. There are a number of factors contributing to unemployment, among which high wages in relation to productivity is the most fundamental. Efforts to reduce labor costs have been rendered ineffective in the past by wage fixing procedures that maintain real wage levels. The decision limiting wage indexation, and its extension to the public sector, are pathbreaking events promising, for the first time, a real opportunity to tackle the wages and employment problems. Equally important, the partial wage indexation arrangement has weakened the link between import prices, which have a predominant impact on the domestic price level, and domestic wages. This affords greater flexibility than in the past to exchange rate policy as an instrument for improving competitiveness. The authorities are to be commended for their management of exchange rate policy over the past year, which has been in line with the recommendation made by Executive Directors during last year's discussion, and should be encouraged to continue to take advantage of this greater flexibility as appropriate opportunities arise. This will require skill to ensure that price increases are held within tolerable bounds, as it is of utmost importance that the partial indexation arrangement continue to be acceptable to all sections of the community.

External debt increased sharply over recent years as private borrowing expanded to finance the development of Ok Tedi, and the Government borrowed heavily to support the economy during the recession. A heavy debt-servicing burden will be felt over the next few years, but based on present projections, and with generally cautious management, the situation should prove manageable. The authorities have adopted a comprehensive debt management policy, and are sensitive to financial market perceptions affecting Papua New Guinea. The authorities' decision to reduce the level of government commercial borrowing in 1984 is most welcome. The present external strength provides an opportunity to conserve market access, and even rebuild it by retiring some outstanding debt, for use at a time when external conditions are again unfavorable.

It is recommended that the next Article IV consultation with Papua New Guinea be held on the standard 12-month cycle.

Papua New Guinea - Fund Relations
(As of June 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a) Date of membership: October 9, 1975
(b) Status: Article VIII

(A) Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 65.9 million

	Amount	Percent of quota
(b) Total Fund holdings of currency:	92.1	139.8
(c) Fund credit:	31.5	47.8
Of which: CFF	31.5	47.8
(d) Reserve tranche position:	5.3	--

(e) Current Operational Budget: An early repurchase of SDR 13.5 million was made in the March-May period and a further early repurchase (SDR 7.4 million) is expected in the June-August period.

(f) Lending to the Fund: None

III. Current Stand-by or Extended Arrangement and Special Facilities

(a) Current stand-by or extended arrangement: None

(b) Previous stand-by and extended arrangements during the last 10 years: None

(c) Special facilities in the past two years: None

IV. SDR Department	Amount	Percent of allocation
(a) Net cumulative allocation:	9.3	100.0
(b) Holdings:	2.7	29.0
(c) Current Designation Plan:	3.2	34.4

V. Administered Accounts

		SDR mn.
(a)	Trust Fund Loans:	
	(i) Disbursed:	19.5
	(ii) Outstanding:	18.7
(b)	SFF Subsidy Account	None

VI. Overdue Obligations to the Fund — None

(B) Nonfinancial Relations

VII. Exchange rate arrangement

Since December 1976, the kina has been pegged to a basket of currencies of major trading partners. The exchange rate on May 30, 1984 was K 1 = US$1.1410. Since April 1980, the U.S. dollar has been used as the intervention currency. The representative rate of kina against the U.S. dollar is the mid-point between buying and selling rates for spot transactions in U.S. dollars as determined daily by the Bank of Papua New Guinea.

VIII. Last Article IV Consultation

The last Article IV consultation took place during April 5-15, 1983. It was proposed to hold the next Article IV consultation on the standard 12-month cycle.

IX. Technical Assistance:

(a) CBD: Three experts assigned to the Bank of Papua New Guinea to assist in the management of the Bank.

(b) Fiscal: Assistance in the field of information and reporting system of nonfinancial public enterprises and in the field of tax and customs administration.

X. Resident Representative/Advisor: None

Papua New Guinea--Relations with the World Bank Group 1/

(In millions of U.S. dollars)

A. IBRD/IDA Operations: 2/ (as of March 31, 1984)	Disbursed		Undisbursed	
	IBRD	IDA	IBRD	IDA
Agriculture and rural development	10.2	38.3	21.9	10.2
Education	--	10.0	6.0	6.0
Power	34.0	1.0	--	2.1
Telecommunications	17.0	--	--	--
Transportation	25.2	44.7	30.7	--
Total	86.4	94.0	38.6	18.3
Of which has been repaid	18.4	0.7		
Total now outstanding	68.0	93.3		

B. Annual net disbursements:	IBRD	IDA	Total
1978	1.4	8.5	9.9
1979	3.3	6.1	9.4
1980	3.6	5.2	8.8
1981	2.5	15.0	17.5
1982	2.7	7.2	9.9
1983	9.5	4.8	14.3

C. Technical assistance: The IBRD provides technical assistance to Papua New Guinea through its standard lending operations for projects as well as in the context of its economic and sector analyses.

D. Recent economic and sector missions: Economic Mission, February-March 1981. Energy Assessment Report, June 1982. Public Administration, September 1982. Mineral Sector Mission, October 1982.

1/ IFC has so far made no loans.
2/ Effective loans.

Papua New Guinea

Selected Economic and Financial Indicators

Area:	178,260 square miles (461,693 sq. km.)
Population (population growth):	1983: 3.1 million (1966: 2.0 percent per annum)
GDP (GDP per capita):	1983: SDR 2,241 million (SDR 723)
Exchange rate:	May 30, 1984 K 1 = SDR 1.0955

	1980	1981	1982	1983	1984
	(Annual percentage change)				
National income and prices					
GDP at constant prices	-3.5	2.2	0.8	1.9	4.5
GDP adjusted 1/	-8.3	-8.9	-2.1	5.5	...
GDP deflator	7.8	-2.0	4.9	9.0	9.0
Consumer prices	11.7	5.6	6.9	8.5	9.0
External sector (SDR basis)					
Exports, f.o.b.	-3.3	-5.6	-2.2	11.0	29.0
Imports, f.o.b.	26.7	18.8	-0.8	0.8	13.3
(Excluding Ok Tedi)	26.7	17.6	-10.4	-1.8	14.5
Terms of trade (deterioration, -)	-10.2	-27.3	-8.5	7.4	2.1
Nominal effective exchange rate (depreciation, -) 2/	4.6	4.7	--	-10.3	-8.1 3/
Real effective exchange rate (depreciation) 2/	7.4	2.4	0.7	-6.9	-2.7 3/
Government budget					
Revenue					
Excluding foreign grants	40.3	-6.2	-0.3	11.4	12.2
Including foreign grants	24.7	-2.8	0.3	12.4	10.4
Total expenditures	18.5	10.2	1.3	6.9	8.9
Money and credit					
Domestic credit	12.5	27.2	16.7	-2.0	-9.1 4/
Of which: Private sector	32.7	15.4	10.3	16.3	8.9 4/

Papua New Guinea
Selected Economic and Financial Indicators (continued)

	1980	1981	1982	1983	Proj. 1984
Broad money (M3*) 5/	5.5	7.9	5.3	14.8	19.4 4/
Velocity (GDP/M3*) 5/	4.4	4.1	4.1	4.0	...
Treasury bill rate	8.6	14.6	11.7	9.0	9.3 4/
		(In percent of GDP)			
Gross domestic investment	25.4	25.9	31.7	31.4	...
Private	13.6	16.5	24.9	24.3	...
Of which: BCL and Ok Tedi	1.6	3.6	14.2	15.4	...
Public	9.6	8.9	7.7	7.0	...
Gross domestic savings	19.2	13.5	14.2	18.5	...
Central Government budget deficit (-)					
Excluding foreign grants	-11.7	-16.7	-16.4	-14.9	-13.7
Including foreign grants	-1.4	-5.9	-6.0	-4.2	-3.7
Domestic bank financing	-1.2	1.7	1.7	-1.4	-0.8
Foreign financing	2.8	4.9	4.2	5.5	4.2
Tax revenue	19.3	18.9	17.4	16.9	17.5
Central Government expenditure	35.2	38.8	37.1	35.7	34.3
External current account surplus or deficit (-)					
Excluding official transfers	-12.7	-21.8	-20.8	-17.5	-13.6
Including official transfers	-11.6	-20.7	-19.7	-16.4	-12.5
Excluding Ok Tedi	-11.6	-19.9	-13.1	-8.0	-9.4
External debt					
Inclusive of use of Fund credit	24	37	52	71	74
(Excluding Ok Tedi)	(24)	(36)	(41)	(47)	(44)
External debt service ratio 6/	7.1	8.8	15.2	22.3	18.4
(Excluding Ok Tedi)	(7.1)	(8.8)	(13.9)	(19.6)	(14.2)
Interest payments ratio 6/	2.4	5.5	9.5	9.9	11.2

Papua New Guinea

Selected Economic and Financial Indicators (Concluded)

	1980	1981	1982	1983	Proj. 1984
	(In millions of SDRs)				
Exports	756	714	698	775	1,000
Imports	-784	-931	-924	-931	-1,055
(Excluding Ok Tedi)	-784	-922	-826	-811	-929
Oil imports	-135	-199	-179	-194	...
External current account	-227	-443	-436	-367	-315
Overall balance of payments	-43	-49	-28	93	70
Gross official reserves	358	366	328	431	458 7/
(In months of imports)	(4.6)	(4.8)	(4.2)	(4.9)	(5.2)
External payments arrears	--	--	--	--	--
External debt outstanding (SDR million)	467	791	1,159	1,583	1,862

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

1/ Adjusted for terms of trade by deflating exports of goods and nonfactor services by import prices.
2/ Fourth quarter to fourth quarter.
3/ To first quarter 1984.
4/ To March 1984.
5/ Excludes deposits of Bougainville Copper Limited and those of the commodity stabilization funds.
6/ Relative to current account receipts (includes official transfers).
7/ April 1984.

Papua New Guinea--Statistical Issues

1. Coverage, Currentness, and Reporting Frequency

		Latest Data in June 1984 IFS
Real Sector	- National Accounts	1982
	- Prices	Q4 1983
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Central Bank	January 1984
	- Deposit Money Banks	January 1984 (partial)
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	December 1983
	- Merchandise Trade: Prices	December 1983
	- Balance of Payments	Q4 1983
	- International Reserves	April 1984
	- Exchange Rates	April 1984

During the past year, the reporting of data for inclusion in IFS has been adequate, although the currentness of deposit money banks' data could be improved and there is a lack of data for other financial institutions, production, and government finance.

2. Outstanding Statistical Issues

Government Finance Statistics

No data are presently reported for publication in IFS, but the annual data in the 1983 issue of the GFS Yearbook are through 1981 for Central Government and through 1986 for local governments.

Money and Banking

Improvements are needed in the presentation of data in the Central Bank's balance sheet and there are some inconsistencies between these data and the counterpart entries in the commercial banks' balance sheets. Furthermore, some items in the latter are reported on a less current basis. The most recent complete data relate only to October 1983.

3. Technical Assistance

The authorities in Papua New Guinea have expressed interest in receiving technical assistance in several areas of statistics, notably money and banking, production, national accounts, and government finance. A technical assistance mission in money and banking data is tentatively scheduled for the November 1984-April 1985 mission period.