FOR AGENDA

SM/86/231
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

September 19, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Papua New Guinea - Staff Report for the 1986 Article IV Consultation

The following correction has been made in SM/86/231 (9/4/86):

Page 21, beginning of page: insert "competitiveness. Such"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

competitiveness. Such steps are essential if progress in reshaping the economy toward one involving broad-based development based on widening employment and income-earning opportunities is to be initiated.

At the time of last year's consultation, there appeared to be a danger that the fruits of three years of painful fiscal restraint would be lost through an excessively expansionary fiscal policy in 1985. That this did not occur was due in part to unintended shortfalls in capital spending (which, while fortuitous in these circumstances, represents a serious development constraint). Nevertheless, the authorities deserve praise for the firm steps they took during the course of the year to contain public spending, which played an important part in maintaining the deficit at a low level and limiting recourse to external commercial borrowing. Budgetary policy for 1986 has returned to an appropriately cautious posture. Indeed, it now appears likely that revenues will exceed the budget estimate, and the authorities' intention to use these additional resources to reduce the deficit and external borrowing requirement below the budgeted amount, rather than relax expenditure restraint, is entirely appropriate. There is a strong case for increasing spending on economic services and infrastructure, to support private sector initiative and growth, as identified by the Government's sectoral spending priorities. However, with government spending levels and aggregate dissaving already high, resources to finance this must come in the first instance from reductions in other areas--especially general administration. In this, the authorities' intentions to reduce the size of the public service is well conceived, although firmer action than slated so far may be needed to yield significant results. At the same time, the role of public sector resource mobilization should not be ignored. The recent increase in the general import levy has the advantage of strengthening the indirect tax net, although the decision to exempt basic food items will tend to discriminate against domestic agriculture and limit progress in broadening the tax base, and should be reconsidered.

An important development since the last consultation is the restoration of discipline over the level of foreign commercial borrowing, including a renewed commitment by the authorities to eliminate such borrowings as soon as possible. Reduced borrowing in 1985, lower planned borrowings in 1986 and subsequent years, the restructuring of Ok Tedi debt, and lower world interest rates have combined to considerably reduce the likely path of debt service payments over the medium term. With a more favorable outlook for foreign exchange earnings, it now appears that the prospective debt servicing burden, which appeared so onerous last year, will be limited to manageable proportions. Nevertheless, the authorities will be wise to maintain vigilance in debt management and should move quickly to implement their announced intentions to establish comprehensive debt guidelines.

Monetary conditions remained easy during most of 1985, and while this supported domestic demand in the face of a cyclical downturn, it added to the weakening of the balance of payments, particularly through the financing of capital outflows. Convincing action to contain credit growth was delayed until late in the year when a significant tightening of bank liquidity was induced, leading to sharply higher interest rates. Underlying credit expansion returned to a more sustainable pace in the first half of 1986. Although the expansion in private nonseasonal credit now expected by the authorities of K 65-70 million in 1986 would be well in excess of the official ceiling, it would not appear excessive in light of current balance of payments prospects, being consistent with liquidity growth of less than 10 percent. The staff would, however, highlight the danger that, with the reintroduction of interest rate controls, credit growth could surge to considerably exceed this official estimate, especially in view of the wide interest differentials in favor of Australian dollar investments. Indeed, recent monetary developments provide warning that a need to tighten bank liquidity may be near at hand. However, such a move would conflict with the maintenance of interest rates at their new, lower, controlled levels. This would tend to exacerbate the inherent problems of efficient loan allocation under interest rate controls, despite the reintroduction of official credit guidelines. The staff urges the authorities to keep the level of interest rates under review to ensure that rates are kept broadly in line with those that market conditions can support. An attempt to maintain rates at artificially low levels would tend to discourage domestic savings mobilization, encourage intensive use of scarce capital resources at the expense of job creation, and may generate pressures for increased, rather than reduced, credit regulation.

Wages in Papua New Guinea are high in relation to labor productivity, which tends to reduce business profitability, discourage investment, and hamper job creation. It also creates an environment conducive to protectionism which has spread over recent years through the extension of import bans and quotas. High wages, which have been perpetuated by centralized wage indexation arrangements, involve, as a counterpart, an unrealistic international value of the kina. While these problems are by now well understood, a consensus among the various sections of the community on how to address this issue has yet to emerge. In this situation, the Minimum Wages Board has decided on the continuation, virtually unchanged, of the previous system of general wage indexation for the coming three years. In the present international environment of reduced inflation, the arrangement largely precludes any sizable reduction in real wage levels over the period up to 1989. Moreover, it will tend to reduce the scope for flexibility in the conduct of exchange rate policy if inflation is to be held in line with the low rates generally ruling abroad as the authorities, reasonably, intend.

The adoption of this new wages arrangement is a severe setback to the authorities' strategy of achieving a gradual but significant improvement in international competitiveness. The staff urges them to face this squarely and reinforce their efforts to promote acceptance, both by the Government and the public at large, of the necessity that this issue be confronted as a matter of national priority as soon as